Involuntary Creditors and the Case for Accounting-based Distribution Regulation

David Kershaw This article argues that accounting-based distribution regulation provides variable and at times significant protection to both existing involuntary creditors—by increasing the probability that they will be paid—and the constituency of involuntary creditors—by decreasing the probability that companies' actions will produce involuntary creditors. These benefits become visible when close attention is paid to the interaction of applicable accounting standards on the recognition of provisions with the United Kingdom's existing distribution regime. Whilst the current debate and reform consensus correctly analyses the relationship between the current regime and adjusting creditors, the article argues that the organising category of the "capital maintenance doctrine" has obstructed inquiry into the ways in which the existing rules' dependence on accounting standards results in benefits for involuntary creditors.

Walford v Miles in Japan: Lock-in and Lock-out Agreements in Sumitomo v UFJ

Koji Takahashi On October 1, 2005, a merger in Japan culminated in the launch of the world's largest financial group by assets. In the background, a legal battle was unfolding over lock-in and lock-out agreements. This article sets out the legal issues involved, examines the decisions of the Japanese courts, and compares them with the English precedents. The issues discussed include whether lock-in and lock-out agreements are binding and enforceable, in what circumstances an interim injunction may be obtained to restrain their breach, what the measure of damages for their breach is, and the enforceability of a clause on break-up fees.

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Liability of Directors as Joint Tortfeasors

Stefan H.C. Lo This article examines the tort liability of directors in relation to torts committed in connection with or in the course of the company's activities. The difficulties in the law as to the tort liabilities of directors have often been perceived to arise from a conflict between company law principles and tort law principles. Various commentators and court decisions had previously limited the tort liability of directors upon the premise that this is necessary to give effect to the company law doctrines of limited liability and separate entity. A more recent approach in England, followed elsewhere, for example in Hong Kong, is to simply apply general principles of joint tortfeasance to directors. It is argued in this paper that this latter approach is the correct approach under the law and can be justified as a matter of both principle and policy.

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Articles

British Business Law

Liability of Directors as Joint Tortfeasors

Stefan H.C. Lo*

Directors' liabilities; Joint tortfeasors; Limited liability; Tortious liability

Introduction

Where tortious conduct is attributed to a company such that the company is liable, there is also the possibility of the company's directors being jointly liable in relation to the tort. In the last century, the courts in England and other common law jurisdictions applied three tests in determining directors' tortious liabilities—the "direct and procure" test, the "make the tort his own" test and the "assumption of responsibility" test. One view, in relation to these tests, has proceeded upon the basis that the general principles of joint tortfeasance under common law principles of tort are either not applicable to directors or are applied differently to directors owing to company law doctrines of limited liability and separate entity. The perceived impact of these company law doctrines is that directors are not necessarily liable although they might otherwise be under tort law principles. The view that special rules on directors' liabilities are required because of principles of company law, as opposed to a straightforward application of common law principles of joint tortfeasance, is supported by various decisions in the common law world. However, more recent decisions in England and elsewhere, as exemplified by the cases of *Standard Chartered Bank v Pakistan International Shipping Corp (No.2)*[1] and *MCA Records Inc v Charly Records Ltd*,[2] have challenged that paradigm of directors' tortious liability by re-focusing the liability of directors within the framework of general principles of joint tortfeasance.[3] It is argued in this article that this approach is the correct one, being supported both by the existing authorities in England and by an analysis of the principles and policy concerns involved.

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[1] *Standard Chartered Bank v Pakistan International Shipping Corp (No.2)* [2003] 1 A.C. 959 HL.

[2] *MCA Records Inc v Charly Records Ltd* [2003] 1 B.C.L.C. 93 CA (Civ Div).

[3] The application of joint tortfeasance principles to directors in *MCA Records v Charly Records* [2003] 1 B.C.L.C. 93 CA (Civ Div) was still qualified to an extent by the court, but as will be seen in the discussion below, the general thrust of the approach in that decision can justifiably be taken further to give full effect to the application of the tort principles to directors.

From the perspective of both principle and policy, various judges and academic commentators have often emphasised the need for company law concepts of limited liability and separate entity to have primacy over tort law principles in shielding directors from the degree of liability that might otherwise arise from a simple application of tort law. However, other judges and commentators have lamented the problems for tort victims that can result from according primacy to the company law doctrines. If the company is generally the only party liable to the tort victim, then there is the possibility of corporate controllers engaging in excessively risky activities through under-capitalised companies, leaving the tort victims uncompensated for their losses. Yet, a priori, there is nothing in the principles of limited liability and separate entity which necessarily require that the company law doctrines should lead to a limitation of the liability of directors. As a matter of policy, there is also no reason for allowing the company law doctrines to be applied in a way which protects directors from liability in tort.

Conversely, there is a need to prevent company law doctrines from being used in a way that overrides the policy objectives of tort law in preventing tortious conduct and in compensating tort victims. This imperative can be seen against the background of corporate social responsibility. The concept of "corporate social responsibility" (CSR) is wide and the term has been used in different contexts.[4] A broad theme of CSR though is that companies should be operated in a way that minimises harm caused to others in the community, and one strand of CSR is aimed at ensuring that companies comply with specific legal regulations.[5] In the debate over CSR, even advocates of shareholder primacy would accept that the principle of profit maximisation can only be achieved within the framework of external laws that apply to both individuals and companies.[6] If the objectives of such external laws, including tort law, are not to be defeated, then it is important for such laws to be effectively enforced against companies. Accordingly it would be inappropriate to allow particular company law doctrines to defeat the policy goals of tort law. Some might question whether this would unjustifiably detract from the policy goals of company law. However, it will be argued that, properly understood, the company law doctrines of limited liability and separate entity would not affect the ordinary application of tort law principles to directors, and that allowing directors to be liable as joint tortfeasors with the company under general principles of tort does not defeat the appropriate policy objectives of company law.

The above view, that tort law principles of joint tortfeasance ought to be directly applicable to directors, is now clearly supported by English case law. This approach has also been adopted in Hong Kong. A number of Australian decisions

[4] See, e.g. J.E. Parkinson, *Corporate Power and Responsibility* (Oxford: Clarendon Press, 1993); L.E. Mitchell (ed.), *Progressive Corporate Law* (Boulder: Westview Press, 1995); C.A. Harwell Wells, "The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-first Century" (2002) 51 *Kansas Law Review* 77.

[5] J. Tolmie, "Corporate Social Responsibility" (1992) 15 *University of New South Wales Law Review* 268, 269.

[6] See, e.g. J.G. MacIntosh, "Designing an Efficient Fiduciary Law" (1993) 42 *University of Toronto Law Journal* 425, 428.

have, however, expressly accepted that the general joint tortfeasance principles are inapplicable, and the approach adopted in various leading decisions in New Zealand and Canada also explicitly or implicitly give pre-eminence to company law doctrines. The law in these latter jurisdictions is not entirely settled, though, and in the writer's view the more recent decisions in England have set the common law back on the correct course by expressly affirming the role of the general principles in tort.

This article is structured as follows. The following section outlines two broad alternative approaches to the liability of directors—first the view that there are special tests derived from company law, and secondly, the alternative approach that gives full effect to tort law principles of joint tortfeasance in their application to directors. Which approach is more appropriate as a matter of principle and policy will then be analysed, and the state of the authorities will be assessed. It will be concluded that, both from an analysis of principle and policy and from an analysis of the existing English precedents, it is incorrect to conceive of the rules of directors' liabilities as being based on special principles of company law. Rather, the proper approach to directors' liabilities is to simply apply the ordinary principles of joint tortfeasance, the scope of which is not limited by the company law doctrines of limited liability and separate entity.

Two alternative approaches to directors' liabilities

Specific tests necessitated by company law doctrines?

It is clear that directors are not personally liable for the company's torts merely because they are directors of the company.[7] Generally three tests have been applied by the courts on different occasions in ascertaining directors' liability.[8] First, a director would be regarded as liable where he has authorised, directed or procured the tort.[9] Secondly, some courts have taken a stricter approach by requiring a greater degree of involvement by directors such that it can be said that the directors

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[7] *Rainham Chemical Works Ltd v Belvedere Fish Guano Co Ltd* [1921] 2 A.C. 465 HL at 476; *Wah Tat Bank Ltd v Chang Cheng Kum* [1975] A.C. 507 PC (Sing) at 514; *Microsoft Corp v Auschina Polaris Pty Ltd* (1996) 71 F.C.R. 231.

[8] For an overview, see, e.g. J.H. Farrar, "The Personal Liability of Directors for Corporate Torts" (1997) 9 *Bond Law Review* 102; H. Anderson, "The Theory of the Corporation and its Relevance to Directors' Tortious Liability to Creditors" (2004) 16 *Australian Journal of Corporate Law* 73 and see also R. Chesmond, "When Legal Fictions Collide: The Primacy (Or Otherwise) of the Separate Entity Principle of Corporate Law in Intellectual Property Cases" (2006) 11 *Deakin Law Review* 69.

[9] *Rainham Chemical Works v Belvedere Fish Guano* [1921] 2 A.C. 465 HL; *Performing Right Society Ltd v Ciryl Theatrical Syndicate Ltd* [1924] 1 K.B. 1 CA; *Kalamazoo (Aust) Pty Ltd v Compact Business Systems Pty Ltd* (1985) 5 I.P.R. 213 Sup Ct (Qld); *Microsoft Corp v Auschina Polaris Pty Ltd* (1996) 71 F.C.R. 231; *Microsoft Corp v Goodview Electronics* (2000) 49 I.P.R. 578; *Wah Tat Bank v Chang Cheng Kum* [1975] A.C. 507 PC (Sing).

have made the tortious act their own as distinct from that of the company.[10] Thirdly, courts have also set out a test that directors could be liable where they have assumed personal responsibility to the claimant through his conduct.[11]

One approach to directors' liabilities in relation to torts committed in the corporate context has proceeded upon the premise that such liability is determined by the aforementioned specific tests rather than the general principles of joint tortfeasance.[12] This view has been expressly adopted in Australia by a number of judges at the Federal Court level, who have stated that whether a director is liable for the company's torts is not answered by principles dealing with joint tortfeasors.[13] This approach also appears to be implicit in leading decisions in New Zealand[14] and Canada,[15] and is, furthermore, supported or accepted by a number of academic commentators.[16]

Principles of joint tortfeasance

An alternative approach to directors' liabilities is to simply apply the ordinary principles of joint tortfeasance to directors. It may be helpful to briefly outline

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[10] *Mentmore Manufacturing Co Ltd v National Merchandising Manufacturing Co Inc* (1978) 89 D.L.R. (3d) 195; *White Horse Distilleries Ltd v Gregson Associates Ltd* [1984] R.P.C. 61 Ch D.

[11] *Trevor Ivory Ltd v Anderson* [1992] 2 N.Z.L.R. 517; *Williams v Natural Life Health Foods Ltd* [1998] 1 W.L.R. 830 HL.

[12] See, e.g. Farrar, "Personal Liability of Directors for Torts of Company" (1997) 71 *Australian Law Journal* 20; J. Payne, "Personal Liability for Directors" [1998] J.B.L. 573; R. Grantham and C. Rickett, "Directors' Tortious Liability: Contract, Tort or Company Law?" (1999) 62 *Modern Law Review* 133; Anderson, "The Theory of the Corporation and its Relevance to Directors' Tortious Liability to Creditors" (2004) 16 *Australian Journal of Corporate Law* 73.

[13] *WEA International Inc v Hanimex Ltd* (1987) 17 F.C.R. 274 at 284; *King v Milpurrurru* (1996) 66 F.C.R. 474 at 494; *Microsoft Corp v Auschina Polaris* (1996) 71 F.C.R. 231 at 241.

[14] See *Trevor Ivory v Anderson* [1992] 2 N.Z.L.R. 517; *Livingston v Bonifant* [1994] B.C.L. 1024; *Laughland v Stevenson* Unreported March 17, 1995, per Hillyer J.; *Tait v Austin* Unreported March 16, 2000 HC CP 100/99; M.-A. Simpson, "Directors' Liability in Tort" [1995] *New Zealand Law Journal* 6; A. Borrowdale and M.-A. Simpson, "Directors' Liability in Tort: Recent Developments" (1995) 13 *Company and Securities Law Journal* 400.

[15] See *Mentmore Manufacturing v National Merchandising* (1978) 89 D.L.R. (3d) 195; *Scotia McLeod v Peoples Jewellers* (1995) 129 D.L.R. (4th) 711; and cf. *ADGA Systems International Ltd v Valcom Ltd* (1998) 168 D.L.R. (4th) 351. See generally C. Feasby, "Corporate Agents' Liability in Tort: A Comment on *ADGA Systems International Ltd v Valcom Ltd*" (1999) 32 *Canadian Business Law Journal* 291.

[16] See, e.g. Grantham and Rickett, "Directors' Tortious Liability" (1999) 62 *Modern Law Review* 133; S. Griffin, "Company Director's Personal Liability in Tort" (1999) 15 *Law Quarterly Review* 36; Feasby, "Corporate Agents' Liability in Tort" (1999) 32 *Canadian Business Law Journal* 291; R. Grantham, "Limited Liability of Company Directors" [2007] L.M.C.L.Q. 362.

these general tort law principles before examination of the implications of applying such principles to directors.

Concept of joint tortfeasors The concept of joint tortfeasor has been defined as involving:

> "... those cases in which the claimant has one cause of action against two or more persons who have, in one way or another, acted in concert".[17]

For purposes of greater clarity in examining the precise basis for liability, it is useful to adopt the concepts of primary and secondary liability of tortfeasors.[18] A primary tortfeasor can be regarded as a person who has himself carried out the acts or omissions constituting the tort. That is, all the elements of the tort can be established as against that person. Where there is someone else who is liable for the same tort pursuant to principles of joint tortfeasance, then the primary tortfeasor would be a joint tortfeasor along with the other joint tortfeasor. Secondary or accessory liability can be said to arise where, although not all the elements of the tort can be established against the person, the law requires that person to be liable owing to his involvement in a tort that is committed by another. The person to whom such secondary liability attaches is a joint tortfeasor with the primary tortfeasor.

Primary liability Two categories of primary liability within the context of joint tortfeasance are outlined here: first, the liability of an agent who is a joint tortfeasor with the principal and, secondly, where two or more persons jointly owe a duty of care.

The general principle of tort law is that an individual would be liable for his own acts or omissions amounting to a tort and, moreover, an individual acting as an agent (including employees)[19] would still be liable even though he was acting under the authority of another (the principal).[20] The relationship of principal–agent may

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[17] R.P. Balkin and J.L.R. Davis, *Law of Torts* (Sydney: Butterworths, 1991), pp.897–898. Situations involving joint tortfeasors are distinguished from those involving several tortfeasors acting independently to produce the same damage (several concurrent tortfeasors) or several tortfeasors causing different damage: see generally G.L. Williams, *Joint Torts and Contributory Negligence* (London: Stevens and Sons, 1951), Ch.1; J. Murphy, *Street on Torts*, 12th edn (Oxford: Oxford University Press, 2007), pp.623–632.

[18] cf. *Credit Lyonnais Bank Nederland NV v Export Credit Guarantee Department* [1998] 1 Lloyd's Rep. 19 CA (Civ Div) at 42–46.

[19] *Stephens v Elwall* (1815) 4 M. & S. 259; *Standard Chartered Bank v Pakistan International (No.2)* [2003] 1 A.C. 959 HL at [40].

[20] e.g. *Bennett v Bayes* (1860) 5 H. & N. 391; *Swift v Jewsbury and Goddard* (1874) L.R. 9 Q.B. 301 Ex Chamber; *Standard Chartered Bank v Pakistan International (No.2)* [2003] 1 A.C. 959 HL. See generally F.M.B. Reynolds, *Bowstead and Reynolds on Agency*, 18th edn (London: Sweet & Maxwell, 2006), pp.577–586.

have consequences as regards the principal's vicarious liability for the agent's acts,[21] but whether such liability exists or not does not detract from the liability of the individual who committed the tort.[22] Where the principal is liable, then the agent would be a joint tortfeasor with the principal; however, the agent's liability can be seen to be primary as the elements of the tort are established as against the agent.

Where a duty of care is imposed on a person,[23] and the person has failed to take reasonable care leading to damage suffered by the claimant, then the person could be liable in negligence. Other persons may also owe a duty of care to the claimant in the same circumstances, and a breach of duty by all the persons concerned may lead to such persons being joint tortfeasors.[24] The liability of each of the persons who breached the duty would be primary though, as again, each individual's acts or omissions looked at in isolation would be sufficient to establish liability as against that individual.

Secondary liability Where a person commits a tort, a second person who has not himself committed all the acts giving rise to the tort can be liable as joint tortfeasor with the first if he (the latter person) was sufficiently involved in the commission of the tort so as to warrant the imposition of liability as joint tortfeasor.[25] The degree of involvement required before there would be liability as joint tortfeasor

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[21] If the principal is vicariously liable as well, then the principal and the agent would be joint tortfeasors: see generally Williams, *Joint Torts and Contributory Negligence* (1951), pp.6–9; Murphy, *Street on Torts* (2007), p.653.

[22] See *Standard Chartered Bank v Pakistan International (No.2)* [2003] 1 A.C. 959 HL at [22], [40].

[23] Whether such a duty exists depends on the established categories in law or upon the general principles as to the existence of a duty of care. In England, the basic test is the "threefold test", which involves examination of whether there was reasonable foreseeability of harm, proximity between the claimant and the defendant, and questions of policy as to whether it is fair, just and reasonable to impose a duty on the defendant in the circumstances: see *Donoghue v Stevenson* [1932] A.C. 562 HL; *Home Office v Dorset Yacht Co Ltd* [1970] A.C. 1004 HL; *Anns v Merton LBC* [1978] A.C. 728 HL; *Caparo Industries Plc v Dickman* [1990] 1 All E.R. 568 HL; *Customs and Excise Commissioners v Barclays Bank Plc* [2007] 1 A.C. 181 HL; and see generally, e.g. Murphy, *Street on Torts* (2007), Ch.11; W.V.H. Rogers, *Winfield and Jolowicz on Tort*, 17th edn (London: Sweet & Maxwell, 2006), Ch.5. The threefold test is sometimes supplemented by looking at the question of whether, objectively speaking, the defendant voluntarily assumed responsibility to the claimant. Furthermore, the development of novel categories of negligence is checked by the recognition that such development should only proceed incrementally and by analogy with established categories. For a review of these principles, see *Customs and Excise v Barclays Bank* [2007] 1 A.C. 181 HL.

[24] The parties will be joint tortfeasors where the duty is imposed jointly on them. If the duty arises independently for each of the parties, then the parties may be liable not as joint tortfeasors but as several concurrent tortfeasors. For the significance of the distinction, see Williams, *Joint Torts and Contributory Negligence* (1951), p.5; Murphy, *Street on Torts* (2007), p.657.

[25] See generally, e.g. Williams, *Joint Torts and Contributory Negligence* (1951), pp.6–16; Murphy, *Street on Torts* (2007), pp.653–654.

on this basis was reviewed at some length by Hobhouse L.J. of the English Court of Appeal in *Credit Lyonnais Bank Nederland NV v Export Credit Guarantee Department*.[26] Hobhouse L.J. held that a person can be liable as a joint tortfeasor first, if he solicited, incited or conspired with another to commit a tort or, secondly, if the person has participated in a joint enterprise or common design to engage in the acts that constitute the tort.[27] In earlier cases this second category has also been described as a situation where the joint tortfeasors' respective shares in the commission of the tort are done in furtherance of a common design.[28] Such a common design can arise on the basis of tacit agreement, and moreover there need not be any need for knowledge by all the parties that their acts would be tortious; it is enough if the parties combine to secure the doing of acts which in the event prove to be tortious.[29] So long as there is concerted action in this sense, one person can be liable as joint tortfeasor even if it is only the other party who engaged in any particular act which constitutes an element of the tort.[30] Merely doing an act which facilitates the commission of the tort would not be sufficient to ground liability though, even if done with knowledge that the other party intends to commit the tort.[31] While such assistance might come within the concept of aiding and abetting under the criminal law so as to give rise to criminal liability as accessory, there is no separate category of tortious liability based on aiding and abetting.[32] Acts of

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[26] *Credit Lyonnais Bank Nederland* [1998] 1 Lloyd's Rep.19 CA (Civ Div). The two other members of the court also agreed with Hobhouse L.J.'s reasoning, and further, the decision of the Court of Appeal was affirmed on appeal by the House of Lords in *Credit Lyonnais Bank Nederland NV v Export Credit Guarantee Department* [2000] 1 A.C. 486 HL.

[27] *Credit Lyonnais Bank Nederland* [1998] 1 Lloyd's Rep. 19 CA (Civ Div) at 42–46; see also *CBS Songs Ltd v Amstrad Consumer Electronics Plc* [1988] A.C. 1013 HL at 1058, per Lord Templeman. The two categories are overlapping and not mutually exclusive.

[28] *Itria, The v Koursk, The* [1924] P. 140 PDAD at 156, per Scrutton L.J.; *CBS Songs v Amstrad* [1988] A.C. 1013 HL at 1054, per Lord Templeman.

[29] *Unilever Plc v Gillette (UK) Ltd* [1989] R.P.C. 583 CA (Civ Div) at 609, per Lord Mustill; *Credit Lyonnais Bank Nederland* [1998] 1 Lloyd's Rep.19 CA (Civ Div) at 45–46, per Hobhouse L.J.

[30] *Brooke v Bool* [1928] 2 K.B. 578 KBD; *Credit Lyonnais Bank Nederland* [1998] 1 Lloyd's Rep. 19 CA (Civ Div) at 42–46, per Hobhouse L.J. This was explained by Hobhouse L.J. as a form of agency. Thus if there is a joint enterprise between two persons, and each of them carry out separate acts constituting the tort, each will be a joint tortfeasor on the basis that each has authorised the other to carry out the acts.

[31] *Credit Lyonnais Bank Nederland* [2000] 1 A.C. 486 HL, affirming *Credit Lyonnais Bank Nederland* [1998] 1 Lloyd's Rep. 19 CA (Civ Div); *Douglas v Hello!* [2003] EWHC 55 (Ch). For example, a vendor who sells articles to a purchaser knowing that the purchaser would use the articles in a manner which infringes a third party's intellectual property rights would only be facilitating the infringement and would not be liable as a joint tortfeasor: *Dunlop Pneumatic Tyre Company Ltd v David Moseley and Sons Ltd* [1904] 1 Ch. 612 CA; *Credit Lyonnais Bank Nederland* [1998] 1 Lloyd's Rep. 19 CA (Civ Div) at 42–46.

[32] *Credit Lyonnais Bank Nederland* [2000] 1 A.C. 486 HL, affirming *Credit Lyonnais Bank Nederland NV v Export Credit Guarantee Department* [1998] 1 Lloyd's Rep. 19 CA (Civ Div).

aiding and abetting can only lead to liability as joint tortfeasor if the acts come within the two categories of liability set out above.[33]

Application of joint tortfeasance rules to directors The application of the above tort law principles to directors means that directors can be regarded as joint tortfeasors with the company where both the company and the directors are liable in relation to the same tort. Thus, where a director has himself engaged in the tortious conduct while carrying out his duties on behalf of the company, the director could be liable as principal tortfeasor. The company could be vicariously liable for the director's acts as agent; however the director himself would still be personally liable for his own tortious conduct.[34] Examples of such situations include where the director has personally engaged in the acts of deceit giving rise to liability in the tort of deceit,[35] or where the director has engaged in the acts constituting nuisance.[36] Also, where the director's role in the company includes personal responsibility to carry out or oversee certain activities that give rise to a personal duty of care to prevent injury or damage to third parties, then the director can be liable as a primary tortfeasor where he has been negligent. Situations coming within this category include the following: where the director was personally responsible for the safekeeping of customers' goods[37]; where the director himself placed a worker in a dangerous working environment leading to personal injury[38]; or where the director negligently drives a motor car while carrying out his responsibilities for the company.[39] In such cases involving negligence, it should be noted that while a director of the company can owe a duty of care to others jointly with the company, a director's (or indeed any agent's) responsibility for carrying out activities on behalf of the company might not always lead to a personal duty of care being imposed on him.[40] Situations involving risk of physical injury or damage would generally require a duty of care to be imposed, pursuant to the ordinary principles in negligence as to the establishment of a duty. However, in cases of negligent advice leading to pure economic loss, where the cause of action requires that the defendant assume responsibility for the provision of the advice, a director might not be liable on the grounds that, in the consensual dealing between the company and the claimant, it is understood that the company assumes responsibility for the advice and not the director.[41]

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[33] *Credit Lyonnais Bank Nederland* [1998] 1 Lloyd's Rep. 19 CA (Civ Div) at 36, 42–46.

[34] *Standard Chartered Bank v Pakistan International (No.2)* [2003] 1 A.C. 959 HL.

[35] *Standard Chartered Bank v Pakistan International (No.2)* [2003] 1 A.C. 959 HL; *Daido Asia Japan Co Ltd v Rothen* [2002] B.C.C. 589 Ch D.

[36] *Sullivan v Desrosiers* (1986) 76 N.B.R. (2d) 271.

[37] *Fairline Shipping Corp v Adamson* [1975] Q.B. 180 QBD.

[38] *Lewis v Boutilier* (1919) 52 D.L.R. 383; and see also *Berger v Willowdale AMC* (1983) 145 D.L.R. (3d) 247.

[39] See *Microsoft v Auschina Polaris* (1996) 71 F.C.R. 231 at 242.

[40] See Reynolds, *Bowstead and Reynolds on Agency* (2006), p.579.

[41] This would be so on the basis of application of general principles of liability for negligent misstatements and not on the basis of any special principles applicable only to directors:

Directors can be liable as secondary tortfeasors where they intend, procure or share a common design that the conduct amounting to the tort should take place.[42] Cases that can be regarded as coming within this category include the following: where the directors authorised or instigated others within the company to engage in acts that constitute conversion,[43] waste,[44] or passing off[45]; or where they have engaged in particular acts as a part of a joint enterprise or common design that leads to an infringement of intellectual property rights.[46] Whether secondary liability would be imposed on the directors would depend on the degree of their involvement in the tortious conduct, and this would depend on the ordinary principles in tort as to joint tortfeasors. Since a person who authorises or instigates another to commit an act amounting to a tort could incur secondary liability under the general principles in tort, then it would seem that in principle directors can be liable on this ground purely by voting in favour of the conduct at a board meeting.[47] Moreover, directors who participate in the activity leading to the commission of a tort could be liable on the basis of participating in a common design even though they have not themselves engaged in all the elements of the tort. It must be remembered though that not any degree of involvement will be sufficient to render the director (or any person) a party to the common design, as mere facilitation of the tort is not enough, and moreover an agent is not responsible for the conduct of another agent unless he does something by which he can be regarded as having made himself a principal in the activity.[48] Thus, for example, a director in the company who was not involved in formulating the policy that led to negligent infliction of damage (for instance due to the release of hazardous chemicals) by other employees or officers and whose duties within the company cannot be said to have included oversight of or responsibility for the negligent conduct would arguably not be liable as a joint tortfeasor even though the director may have assisted in the operation in some way (e.g. having been responsible for the finance side of the particular business venture). The reason would be that the director neither authorised the negligent conduct, nor was so closely involved with the specific negligent acts as to be regarded as principal in relation to those acts. Although the director is part of the same operation

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see the discussion below, and see also Reynolds, *Bowstead and Reynolds on Agency* (2006), pp.578–579.

[42] *MCA Records v Charly Records* [2003] 1 B.C.L.C. 93 CA (Civ Div); *Kabushiki Kaisha Yakult Honsha v Yakudo Group Holdings Ltd* [2004] 1 H.K.C. 630.

[43] *Wah Tat Bank v Chang Cheng Kum* [1975] A.C. 507 PC (Sing).

[44] *Mancetter Developments Ltd v Garmanson Ltd* [1986] Q.B. 1212 CA (Civ Div).

[45] *T Oertli AG v EJ Bowman (London) Ltd* [1956] R.P.C. 282 Ch D.

[46] See *Reitzmann v Grahame-Chapman and Derustit Ltd* (1950) 67 R.P.C. 178 Ch D; *Microsoft v Auschina Polaris* (1996) 71 F.C.R. 231; *Microsoft v Goodview Electronics* (2000) 49 I.P.R. 578; *MCA Records v Charly Records* [2003] 1 B.C.L.C. 93 CA (Civ Div); *Yakult Honsha v Yakudo Group* [2004] 1 H.K.C. 630.

[47] See further "Analysis of the precedents" below.

[48] *Cargill v Bower* (1878–79) L.R. 10 Ch. D. 502 at 513 Ch D. See also *Credit Lyonnais Bank Nederland* [2000] 1 A.C. 486 HL, affirming *Credit Lyonnais Bank Nederland* [1998] 1 Lloyd's Rep. 19 CA (Civ Div); *Douglas v Hello!* [2003] EWHC 55 (Ch).

or enterprise that leads to the negligence, it would seem that more is required to render the individual a party to the common design that leads to liability as joint tortfeasor. Whether this analysis is correct or not need not be finally resolved for the purposes of this article—the important point for present purposes is that the outcome should depend simply on the ordinary principles of joint tortfeasance and should not turn on whether the individual was a director or not in a company.

The above discussion has sought to outline principles of directors' liabilities arising from the application of tort law principles of joint tortfeasance. Whether this approach (as opposed to the traditional approach of focusing only on special rules of directors' liabilities necessitated by company law doctrines) can be justified as a matter of principle and policy and whether it is the correct approach under the existing authorities will be examined in the following parts of this article.

Analysis of principle and policy

The question of which of the two alternative approaches discussed above is to be preferred can be regarded as involving at some level a conflict between tort law principles and company law principles. The conflict is often seen as one that exists between tort law principles of liability and the company law doctrines of limited liability and separate entity.[49] The argument for the application of special principles that would, to some extent, limit the liability of directors is based on the notion of primacy of company law over tort law due to the (perceived) need to uphold the doctrines of limited liability and separate entity.

The discussion below begins by outlining the policy aims of tort law. The objectives of the company law doctrines of limited liability and separate entity will then be examined, before analysis of the (supposed) conflict between company law and tort law. It will be argued that, properly understood, there is no conflict between the company law doctrines and tort law, and thus from the perspective of principle and policy, there is no need for special principles to limit the tortious liability of directors. Rather, it would be appropriate to give full effect to the application of ordinary principles of joint tortfeasance to directors.

[49] See, e.g. Farrar, "Personal Liability of Directors for Torts of Company" (1997) 71 *Australian Law Journal* 20, 20; Grantham and Rickett, "Directors' Tortious Liability" (1999) 62 *Modern Law Review* 133, 135; S. Griffin, "Company Director's Personal Liability in Tort" (1999) 15 *Law Quarterly Review* 36, 36; R. Grantham, "Attributing Responsibility to Corporate Entities: A Doctrinal Approach" (2001) 19 *Company and Securities Law Journal* 168, 178–179; *Mentmore Manufacturing v National Merchandising* (1978) 89 D.L.R. (3d) 195 at 203; *White Horse Distilleries v Gregson Associates* [1984] R.P.C. 61 Ch D at 91–92; *Williams v Natural Life* [1998] 2 All E.R. 577 HL at 581–582; *Trevor Ivory v Anderson* [1992] 2 N.Z.L.R. 517 at 520, per Cooke P., at 527, per Hardie Boys J.; *King v Milpurrurru* (1996) 66 F.C.R. 474 at 494, 500.

Policy objectives of tort law

One principal objective of tort law is to compensate, by an award of damages, those who have been harmed by certain conduct regarded as wrongful.[50] For the most part, liability to make compensation in tort is based on fault, whether involving intention to commit the tortious act or some negligent act or omission.[51] Fault-based liability in tort is often justified on the ground that it is right to impose liability on the person who has caused or was responsible for the wrong. This is usually analysed as an example of corrective justice, which has been referred to in this context as "requir[ing] those who without justification harmed others by their conduct to put the matter right".[52] Apart from achieving the demands of corrective justice, there is also the element of deterrence or prevention in fault-based liability, with the goal of eliminating or reducing the undesirable behaviour.[53]

Policy objectives of corporate law doctrines of limited liability and separate entity

Under the doctrine of limited liability, the shareholders of a company limited by shares are not, in effect, liable for the debts of the company beyond the amounts contributed or liable to be contributed as share capital. The main policy reason for this doctrine is generally accepted to be the promotion of investment in business and the encouragement of entrepreneurship.[54] Limited liability is also justified from the economic perspective on the basis of its efficiency. For instance, it has been argued that limited liability lowers monitoring costs of investors in relation to both monitoring of the company and of other shareholders, promotes the transferability of shares which in turn gives managers incentives to act efficiently, allows for shares to be homogeneous commodities which makes it possible for

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[50] See T. Honoré, *Responsibility and Fault* (Oxford: Hart Publishing, 1999), pp.69–70, 74; and on the compensatory nature of damages, see *Pickett v British Rail Engineering Ltd* [1980] A.C. 136 HL.

[51] Rogers, *Winfield and Jolowicz on Tort* (2006), p.71.

[52] Honoré, *Responsibility and Fault* (1999), pp.73–78. On corrective justice in tort law, see generally G.P. Fletcher, "Fairness and Utility in Tort Theory" in S. Levmore (ed.), *Foundations of Tort Law* (New York: Oxford University Press, 1994), pp.48–58; R.A. Posner, "The Concept of Corrective Justice in Recent Theories of Tort Law" in *Foundations of Tort Law* (1994), pp.59–66; B.C. Zipursky, "Philosophy of Tort Law" in M.P. Golding and W.A. Edmundson (eds), *Blackwell Guide to the Philosophy of Law and Legal Theory* (Malden: Blackwell Publishing, 2005), pp.122–125; J.J. Coleman, "Tort Liability and the Limits of Corrective Justice" in J.J. Coleman and A. Buchanan (eds), *In Harm's Way: Essays in Honor of Joel Feinberg* (Cambridge: Cambridge University Press, 1994), p.140.

[53] Honoré, *Responsibility and Fault* (1999), p.68; Murphy, *Street on Torts* (2007), p.16.

[54] See, e.g. N. Hawke, *Corporate Liability* (London: Sweet & Maxwell, 2000), pp.114, 117; L. Bergkamp and W.Q. Pak, "Piercing the Corporate Veil: Shareholder Liability for Corporate Torts" (2001) 8 *Maastricht Journal of European and Comparative Law* 167, 181; Companies and Securities Advisory Committee (Australia), *Corporate Groups: Final Report* (May 2000), p.20.

a single market price to capture information about the value of the company, and allows for more efficient diversification for investors.[55] For Easterbrook and Fischel, such factors reduce the agency costs of separation between investment and management in public companies, thereby providing for an efficient form of business organisation.[56] Others have emphasised the importance of such factors to the promotion of efficient and organised securities markets.[57] It is also argued that the shifting of greater risk to creditors under a limited liability regime leads to lower transactional costs overall, thereby reducing the cost of capital to firms.[58]

Under the separate entity principle, the company is a separate legal entity from the shareholders and directors of the company.[59] This concept serves important purposes,[60] such as allowing for the possibility of continuity of ownership of assets held by the company notwithstanding changes in shareholders, but it also provides a conceptual foundation for the operation of the limited liability doctrine in that debts incurred by the company are incurred by an entity (i.e. the company) separate from the shareholders or directors. Accordingly the shareholders and directors would generally not be personally liable for the company's debts.

Tort creditors and the intersection of corporate law and tort law

There is no direct conflict between personal liability of directors in tort and the limited liability doctrine since the latter doctrine is concerned only with the limited liability of shareholders.[61] Nonetheless, to allow directors to incur personal liability does have significant ramifications for the limited liability of shareholders, since there are a great many closely held companies where the shareholders are

[55] F.H. Easterbrook and D.R. Fischel, "Limited Liability and the Corporation" (1985) 52 *University of Chicago Law Review* 90, 94–97.

[56] Easterbrook and Fischel, "Limited Liability and the Corporation" (1985) 52 *University of Chicago Law Review* 90, 92–97.

[57] P. Halpern, M. Trebilcock, and S. Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 *University of Toronto Law Journal* 117.

[58] Easterbrook and Fischel, "Limited Liability and the Corporation" (1985) 52 *University of Chicago Law Review* 90, 98–101; and see also R. Posner, "The Rights of Creditors of Affiliated Corporations" (1976) 43 *University of Chicago Law Review* 499. For a general summary, see, e.g. B. Pettet, "Limited Liability—A Principle for the 21st Century?" (1995) 48 *Current Legal Problems* 125, 144–147; Bergkamp and Pak, "Piercing the Corporate Veil" (2001) 8 *Maastricht Journal of European and Comparative Law* 167, 181–183.

[59] *Salomon v Salomon and Co* [1897] A.C. 22 HL.

[60] See generally, P.L. Davies, *Gower's Principles of Modern Company Law*, 7th edn (London: Sweet & Maxwell, 2003), pp.27–44.

[61] *Williams v Natural Life* [1998] 1 W.L.R. 830 HL at 838; D.A. Wishart, "The Personal Liability of Directors in Tort" (1992) 10 *Company and Securities Law Journal* 363, 365; S. Watson, "Who Hides Behind the Corporate Veil? Finding a Way out of 'The Legal Quagmire'" (2002) 20 *Company and Securities Law Journal* 198, 205. But cf. A. Borrowdale, "Liability of Directors in Tort—Developments in New Zealand" [1998] J.B.L. 96, 98–99.

themselves directors.[62] So the imposition of personal liability on directors could in substance detract from the policy goals of limited liability.[63] However, whether this is so depends on the question of what in fact are or should be the proper goals of limited liability.

Various commentators have argued that while limited liability of shareholders can be justified in relation to contract or voluntary creditors, different considerations arise in relation to involuntary tort creditors.[64] The essential problem in the context of tort creditors is that the company is able to externalise costs arising from torts, leading to a significant degree of risk of loss being borne by the tort victims themselves. This arises where although the company may be liable to pay damages, the doctrine of limited liability of shareholders means that the tort victims are in fact not compensated if the company does not have sufficient assets to satisfy the victims' claims. While contract creditors also bear a greater risk of loss under the limited liability doctrine, such creditors can bargain for compensation for assuming the greater risk via, for example, a higher rate of interest. Tort creditors are unable to do so for obvious reasons, and so the company's costs of undertaking activities that could give rise to tortious liability are externalised through the uncompensated transfer of risk to tort creditors.

The possibility for companies to externalise costs in this way can be problematical from the perspective of economic efficiency.[65] With reduced incentive to minimise tortious liability, companies may undertake excessively risky activities resulting in greater social cost (due to greater occurrences of tortious conduct and greater losses suffered by tort victims). Apart from the issue of efficiency, principles of corrective justice are defeated in circumstances where those who

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[62] C. Noonan and S. Watson, "Directors' Tortious Liability—*Standard Chartered Bank* and the Restoration of Sanity" [2004] J.B.L. 539, 542.

[63] See also Grantham, Attributing Responsibility to Corporate Entities" (2001) 19 *Company and Securities Law Journal* 168, 179; J.H. Armour, "Corporate Personality and Assumption of Responsibility" [1999] *Lloyd's Maritime and Commercial Law Quarterly* 246, 250; *Green Cartridge Co (Hong Kong) Ltd v Canon Kabushiki Kaisha* [1996] 2 H.K.C. 180 at 206, per Litton V.P., reversed on other grounds: *Canon Kabushiki Kaisha v Green Cartridge Co (HK) Ltd* [1997] 2 H.K.C. 1.

[64] H. Hansmann and R. Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1990–91) 100 *Yale Law Journal* 1879; Halpern, Trebilcock and Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 *University of Toronto Law Journal* 117, 145–147; D.W. Leebron, "Limited Liability, Tort Victims and Creditors" (1991) 91 *Columbia Law Review* 1565, 1601–1602; and see also Easterbrook and Fischel, "Limited Liability and the Corporation" (1985) 52 *University of Chicago Law Review* 90, 107, 117; Pettet, "Limited Liability" (1995) 48 *Current Legal Problems* 125, 152–154.

[65] See Hansmann and Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1990–91) 100 *Yale Law Journal* 1879, 1882–1883; Halpern, Trebilcock and Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 *University of Toronto Law Journal* 117, 145–147; Easterbrook and Fischel, "Limited Liability and the Corporation" (1985) 52 *University of Chicago Law Review* 90, 107; Pettet, "Limited Liability" (1995) 48 *Current Legal Problems* 125, 153.

profit from or cause the harmful activities do not need to bear the cost of such activities, with the victims left to bear the consequences themselves.[66] Even if there is some form of compulsory accident insurance scheme that would provide monetary compensation to the victims, this may not be adequate if the ability of companies to externalise costs defeats the deterrent objectives of tort law and leads to a greater occurrence of injuries. The greater occurrence of injuries is especially problematical for the victims since, from their perspective, perhaps no amount of monetary pay-out can in truth be adequate to compensate them for their serious physical injury or death.

As a result of such problems, various commentators have argued that there should be some scheme of unlimited liability for shareholders in relation to tort liabilities.[67] Others, however, have sought to defend the limited liability doctrine even in the context of tort creditors. A major line of defence is that an unlimited liability regime would lead to the loss of the benefits of limited liability to a significant extent (such as damage to the market for equity capital, or reduction in levels of investments), with the costs of such a regime outweighing the benefits derived from minimising externalities.[68] However, it is submitted that such arguments could only have potency, at best, were a blanket rule of unlimited liability for the company's torts to be imposed on all shareholders.[69] For present purposes though, the writer's thesis is the more modest one of refuting the use of company law doctrines as a shield against liability for directors involved in the tortious activity who would otherwise be liable in tort. Investors who are not actually involved in the company's decision-making and operations would accordingly have nothing to fear, and the impact on investment generally and on the capital markets should be minimal.

However, allowing for the imposition of tortious liability on director/shareholders involved in the tort could well lead to reduced investment by the company in certain activities—namely hazardous activities that could give rise to tortious liability. Yet this is precisely the policy goal that is sought to be achieved—i.e. a reduction of harmful activities causing loss to others. If it is thought that there is some activity that is socially desirable despite a high risk of harm caused to others, it may well be preferable for governmental intervention to

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[66] See also Pettet, "Limited Liability" (1995) 48 *Current Legal Problems* 125, 154; D.F. Jackson, *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation* (Sept 2004), Annexure T, p.420.

[67] See, e.g. Hansmann and Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1990–91) 100 *Yale Law Journal* 1879.

[68] For a summary, see Pettet, "Limited Liability" (1995) 48 *Current Legal Problems* 125, 154–157; and see also Bergkamp and Pak, "Piercing the Corporate Veil" (2001) 8 *Maastricht Journal of European and Comparative Law* 167, 184–187.

[69] For discussion of the impact on the investment decisions and the capital market in such a situation, see Pettet, "Limited Liability" (1995) 48 *Current Legal Problems* 125, 155; R.B. Thompson, "Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise" (1994) 47 *Vanderbilt Law Review* 1, 17–19.

be provided to promote such activities rather than having a general rule allowing company law doctrines to override the ordinary application of tort principles.[70]

From the perspective of efficiency then, the arguments in favour of allowing tort principles their usual scope of application without confinement by the doctrine of limited liability are on balance stronger. From the perspective of corrective justice and deterrence, it would seem morally right to allow tort principles to apply to impose liabilities on those involved in the commission of the tort.[71] If it is accepted that the legitimate purpose of the limited liability doctrine is to provide limited liability to shareholders with respect to contract creditors only and not tort creditors, then allowing personal liability to fall on directors/shareholders would have no impact on the proper scope of the limited liability doctrine.

Defenders of the primacy of corporate law doctrines have also argued, however, that allowing for greater tort liability on directors in relation to torts committed by the company erodes the separate entity principle and thereby undermines the foundations of company law.[72] Giving effect to the separate entity doctrine does to a significant extent entail modification of the application of the general law to persons who are acting through or under a corporate person. For example where a contract is entered into by an agent for the company, then the company is the party bound to the contract and not the shareholders or directors behind the company. The agent is not personally bound either pursuant to ordinary principles of agency law.[73] However the analysis in relation to tort principles is different. The company is a separate entity to its directors and shareholders, and a company can be liable without others also being liable. Yet the separate entity principle surely also means that the company can be liable in relation to the same circumstances where directors or others are personally liable. Where directors are made personally liable in relation to a tort where the company is also liable, personal liability is not imposed on the directors for the company's torts on the basis that they are directors of the company; rather they are liable since they themselves—as legal persons separate to the company—have committed the acts giving rise to tortious

[70] cf. Leebron, "Limited Liability, Tort Victims and Creditors" (1991) 91 *Columbia Law Review* 1565, 1577–1578. Even in this situation though, there should be some scheme ensuring compensation for tort victims, for it is questionable whether it is appropriate for the tort victims themselves to be the ones effectively subsidising the activity: Editorial Note, "Should Shareholders be Personally Liable for the Torts of Their Corporations: Note and Comment" (1966–67) 76 *Yale Law Journal* 1190, 1196.

[71] See also Thompson, "Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise" (1994) 47 *Vanderbilt Law Review* 1; Editorial Note (1966–67) 76 *Yale Law Journal* 1190, 1196–1197.

[72] See, e.g. Grantham and Rickett, "Directors' Tortious Liability" (1999) 62 *Modern Law Review* 133, 139; and see also Grantham, "Attributing Responsibility to Corporate Entities" (2001) 19 *Company and Securities Law Journal* 168, 179; R. Grantham, "Liability of Parent Companies for the Actions of the Directors and Their Subsidiaries" (1997) 18 *Company Lawyer* 138, 145–146, 148; Feasby, "Corporate Agents' Liability in Tort" (1999) 32 *Canadian Business Law Journal* 291.

[73] See Reynolds, *Bowstead and Reynolds on Agency* (2006), p.499.

liability.[74] Thus there is nothing inherent in the separate entity doctrine that leads to the conclusion that directors involved in the tort cannot themselves also be liable as separate entities to the company. The corollary is that imposing personal liability on directors does not inherently conflict with the separate entity doctrine.

It may be however that the separate entity argument gains greater weight when seen together with company law principles of attribution. On this approach (sometimes referred to as the "identification"[75] or "alter ego"[76] theory), it is said that where the acts of individuals are attributed to the company (via principles of attribution), then the individual is not acting in his own capacity but is to be treated as the company itself, and so the company, as a separate entity to the individual, is the only party which can be liable.[77] This view has perhaps been derived from statements of the courts identifying individuals with the company itself, with individuals being regarded as "the directing mind and will of the corporation, the very ego and centre of personality of the corporation".[78] Derivative of such concepts of identification is the organic theory of the company, which provides that where a corporate organ acts for the company, the act is one made by the company itself and not by the individual as an agent.[79]

At this juncture, it is useful to revisit the principles of attribution as set out in the important judgment of Lord Hoffmann in *Meridian Global Funds Management Asia Ltd v Securities Commission*.[80] It will be recalled that Lord Hoffmann stated that whether certain acts are to be regarded as the acts of the company initially depends on the primary rules of attribution, as set out in the corporate constitution or implied by principles of company law. Secondly, acts can be attributed to the company pursuant to general rules of attribution under the law—such as principles

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[74] *Standard Chartered Bank v Pakistan International (No.2)* [2003] 1 A.C. 959 HL at [23], [38]; and see also S. Watson and A. Willekes, "Economic Loss and Directors' Negligence" [2001] J.B.L. 217, 218–219; Anderson, "The Theory of the Corporation and its Relevance to Directors' Tortious Liability to Creditors" (2004) 16 *Australian Journal of Corporate Law* 73, 90–91, 95.

[75] See Noonan and Watson, "Directors' Tortious Liability—*Standard Chartered Bank* and the Restoration of Sanity" [2004] J.B.L. 539, 541.

[76] P. Watts, "The Company's Alter Ego—An Imposter in Private Law" (2000) 116 *Law Quarterly Review* 525.

[77] *Trevor Ivory v Anderson* [1992] 2 N.Z.L.R. 517 at 520, per Cooke P., at 527, per Hardie Boys J.; see also *King v Milpurrurru* (1996) 66 F.C.R. 474 at 494, 500; Grantham, Attributing Responsibility to Corporate Entities" (2001) 19 *Company and Securities Law Journal* 168, 178; Farrar, "The Personal Liability of Directors for Corporate Torts" (1997) 9 *Bond Law Review* 102, 102; Feasby, "Corporate Agents' Liability in Tort" (1999) 32 *Canadian Business Law Journal* 291, 305.

[78] *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] A.C. 705 HL at 713; and see *King v Milpurrurru* (1996) 66 F.C.R. 474 at 494.

[79] See H.A.J. Ford, R.P. Austin and I.M. Ramsay, *Ford's Principles of Corporations Law*, 12th edn (Sydney: LexisNexis Butterworths, 2005), para.7.070; Davies, *Gower's Principles of Modern Company Law* (2003), pp.129–175; Grantham, "Attributing Responsibility to Corporate Entities" (2001) 19 *Company and Securities Law Journal* 168, 170–178.

[80] *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 A.C. 500 PC (NZ) at 506–508.

of agency and vicarious liability. Thirdly, there will be situations where the above principles of attribution might not be appropriate in determining how a particular law applies to the company, and in such situations it may be necessary for the court to fashion a special rule of attribution to determine whether the act or state of mind of a particular individual should be attributed to the company for the purposes of that particular law.

Where the situation *only* involves the application of the second of the above category of rules of attribution—namely principles of attribution under the general law—there is no scope for the operation of the concept of a person acting as a corporate organ. So where an individual is acting as the agent of the company, then the individual is simply an agent, and the usual principles of agency law would be applicable. Whether an individual is acting as an agent or as an organ of the company would in general depend on the corporate constitution,[81] with the groups of persons given original authority to act for the company under the constitution regarded as organs of the company.[82] For example where original authority to carry on the business of the company is vested in the board of directors by the articles,[83] then the board would be regarded as a corporate organ and not an agent.[84] Under such articles, individuals who are delegated authority from the board to deal with the outside world in the business of the company should in the first instance be regarded as agents of the company.[85] Accordingly where individuals commit a tort through conduct carried out pursuant to such delegated authority, then the ordinary principles of agency and vicarious liability[86] would be the relevant principles in determining liabilities of both the company and the individual. Here, ideas of the corporate organ or acting as the ego of the company are not relevant, and accordingly the doctrine of separate entity and the identification theory cannot be relied upon to override the ordinary application of tort law principles in this situation.[87]

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[81] cf. *Meridian Global* [1995] 2 A.C. 500 PC (NZ) at 506.

[82] R.P. Austin, H.A.J. Ford, I.M. Ramsay, *Company Directors: Principles of Law and Corporate Governance* (Sydney, LexisNexis Butterworths, 2005), p.65. The corporate organs would generally be the board of directors and the members in general meeting.

[83] See, e.g. Companies (Tables A to F) Regulations 1985 (UK) Table A reg.70; Companies Ordinance (Hong Kong) Sch.1 Table A reg.82.

[84] *Automatic Self Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch. 34 CA.

[85] This view is consistent with the analysis in cases such as *Hely-Hutchinson v Brayhead Ltd* [1968] 1 Q.B. 549 CA (Civ Div); *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 1 Q.B. 480 CA. See also Noonan and Watson, "Directors' Tortious Liability" [2004] J.B.L. 539, 547.

[86] Note that apart from vicarious liability, the general law may also attribute the state of mind or conduct of an agent to the principal in particular circumstances such that the principal's liability may be regarded as direct liability rather than vicarious liability: see R. Stevens, "Why Do Agents 'Drop Out'?" [2005] *Lloyd's Maritime and Commercial Law Quarterly* 101, 103–104.

[87] See also Noonan and Watson, "Directors' Tortious Liability" [2004] J.B.L. 539, 545; *Standard Chartered Bank v Pakistan International (No.2)* [2003] 1 A.C. 959 HL at [22], per Lord Hoffmann, at [40], per Lord Rodger of Earlsferry; *Meridian Global* [1995] 2 A.C. 500

In some situations where the individual is acting as agent of the company, it may be that the agent's actions or state of mind could also be attributed directly (rather than vicariously) to the company. This could be so on the basis of the application of general principles regarding principals and agents,[88] or it could be so on the basis of application of Lord Hoffmann's third category of rules of attribution, namely special rules of attribution. In the former situation, again the concept of the corporate organ would not be relevant, as the relationship between the company and the individual, and the rights and liabilities thereof, are simply provided for by the ordinary principles of agency law. In the latter situation, though, it may be possible to invoke the concept of the corporate organ, as the special rules of attribution are devised specifically for the corporate context in treating the individual's acts or mental state as that of the company's. In such circumstances, the individual might be regarded as acting in dual capacities. So for example, in the *Meridian Global* case itself, the employee who purchased shares for the company would be acting as agent of the company in the acquisition of the shares, but the employee could be regarded as a corporate organ for the purpose of treating his state of mind as the company's in the application of the relevant statutory provisions (on disclosure of substantial shareholdings). Yet, although conceptually the employee could be regarded as a corporate organ in those circumstances, it is probably not necessary to do so as there is no need to adopt an anthropomorphic analysis to attribute the state of mind to the company. One could simply say, as the Privy Council did in the decision, that for the purposes of the statutory rule in question, the employee's state of mind will be attributed to the company. On this approach then, issues of the corporate organ and "alter ego" again disappear. Moreover, even if the individual is to be regarded as the corporate organ for the purposes of a particular statutory provision, this in itself does not mean that the individual cannot be regarded as the company's agent for other purposes in relation to the same acts—including any tortious liability arising from those acts. The direct attribution of the individual's state of mind and any invocation of the concept of the corporate organ is made only for the specific purpose of the statutory rule in question, and there does not appear to be any reason why the notion of the individual as corporate organ should override the individual's capacity as agent that would otherwise arise for other purposes. In the *Meridian Global* case, if the issue of the company's statutory disclosure obligations did not arise, then clearly the employee would simply have been regarded as an agent for the company in relation to the acquisition of the shares—and any contractual or tortious liabilities arising would be determined in accordance with general agency principles. This position should not be altered by the fact that there was subsequently a need to attribute the individual's state of mind to the company for the purposes of dealing with the company's disclosure obligations.

HL at 505; *Smorgon v Australia and New Zealand Banking Group Ltd* (1976) 134 C.L.R. 475 at 483, per Stephen J.

[88] See Stevens, "Why Do Agents 'Drop Out'?" [2005] *Lloyd's Maritime and Commercial Law Quarterly* 101, 103–104.

Where an individual is not acting as the agent of the company in any capacity, but is acting only in the capacity of a corporate organ, then it is not possible to treat the individual as simply an agent for the purposes of applying principles of the general law (including tort) to the parties. This situation arises where individuals' acts are attributed to the company under Lord Hoffmann's primary rules of attribution (and possibly also under certain applications of the special rules of attribution). In such circumstances, it could be argued that where the individuals are acting as the company itself, then only the company can be liable. However it is arguable that the imagery of the corporate organ, while apt to emphasise the company's direct liabilities for the conduct of persons acting in its name, has unjustifiably been allowed to lead a life of its own beyond its intended context when used to exculpate individuals for their own liability. As various commentators have pointed out, the courts developed the principles of attribution in the context of imposing liability on companies and not in relation to the question of directors' or others' own liabilities.[89] Thus principles of attribution and the metaphors of the corporate organ and individuals being the "very ego" of the company are not strictly relevant when looking at the liabilities of the individuals. Logically speaking, the mere fact that the acts of individuals have been imputed to the company to establish the company's liability does not necessarily mean that the individuals cannot themselves be liable. It is conceptually possible to treat the individual as acting only as the company with no external legal consequences attaching to the individual in his personal capacity, or alternatively it is possible for the individual's conduct to take on legal significance personally vis-à-vis outsiders in addition to attaching liabilities to the company. There is nothing from the mere fact of the individual being identified as the company for the purpose of attributing liabilities to the company which, as a matter of logic, dictates that the individual could not incur liabilities in dealings with outsiders.

Whether the individual, acting as or part of a corporate organ, should or should not be burdened with personal liabilities then depends on further factors. The question becomes whether it is appropriate as a matter of policy for individuals to escape liability. In matters of contract between the company and outsiders, it is appropriate, for example, for the separate entity doctrine (combined with primary rules of attribution) to mean that where the board has authorised the company to contract, then the members of the board would not be personally liable on the contract. It can well be accepted that a fundamental purpose of company

[89] Wishart, "The Personal Liability of Directors in Tort" (1992) 10 *Company and Securities Law Journal* 363, 365; Anderson, "The Theory of the Corporation and its Relevance to Directors' Tortious Liability to Creditors" (2004) 16 *Australian Journal of Corporate Law* 73, 90; Noonan and Watson, "Directors' Tortious Liability" [2004] J.B.L. 539, 544–545; Borrowdale, "Liability of Directors in Tort" [1998] J.B.L. 96, 105–106; C. Gosnell, "The Personal Liability of Corporate Agents: Who Should Bear Pure Economic Losses?" (1997) 55 *University of Toronto Faculty of Law Review* 77, 111. See also Watts, "The Company's Alter Ego" (2000) 116 *Law Quarterly Review* 525; N. Campbell and J. Armour, "Demystifying the Civil Liabilities of Corporate Agents" (2003) 62 *Cambridge Law Journal* 290.

law is to allow incorporators to shift contractual liabilities to the company and not themselves. Agents who contract for the company would generally not be personally liable.[90] Though neither the board nor its members (when acting as members of the board) are agents of the company, these points indicate that generally speaking there is no policy imperative to impose contractual liability on the directors in relation to the company's contracts.[91] With criminal liability, however, the courts have held that individuals who have committed the offence can be principal offenders notwithstanding that the acts were carried out on behalf of a company,[92] or alternatively individuals can be criminally liable as accessories where the company is itself the principal offender.[93] Thus the courts have either expressly or implicitly accepted policy considerations in not allowing individuals to use the corporate form to shield themselves from the criminal law.[94]

Similarly, in the context of tort liabilities, it is submitted that the separate entity and identification theories should not be applied in a way so as to exonerate individuals from liability where their conduct would otherwise be tortious under the general law. To the extent that the separate entity doctrine is justified on the basis that it supports the limited liability doctrine, the arguments discussed above against an extension of limited liability to protect individuals involved in the tort from tortious liability are equally applicable here. Moreover, the other advantages of the separate entity doctrine (perpetual succession, etc.) are in no way compromised by allowing tortious liability to be imposed on individuals. There is however a particular argument against directors' liability which needs to be assessed, namely the argument that directors are not efficient bearers of risk. If directors were to be liable to compensate the tort victims arising from their conduct in carrying out the activities of the company, the potential impact of such liability on their personal assets can be huge. As a result, directors might over-invest in safety measures or be overly cautious in not allowing the company to engage in the potentially harmful activities,[95] and furthermore individuals may

[90] Reynolds, *Bowstead and Reynolds on Agency* (2006), p.499.

[91] This is not to deny that there are specific situations where it may be appropriate to impose personal liability on directors, such as in situations of insolvent or wrongful trading.

[92] See, e.g. *Dellow v Busby* [1942] 2 All E.R. 439 KBD; *R. v Ovenell* [1968] 1 All E.R. 933 CA (Crim Div); and see generally W.T. Lim, "Corporations and the Devil's Dictionary: The Problem of Individual Responsibility for Corporate Crimes" (1989–90) 12 *Sydney Law Review* 311, 329–335.

[93] See, e.g. *Hamilton v Whitehead* (1988) 166 C.L.R. 121; *R. v Judges of the Australian Industrial Court Ex p. CLM Holdings Pty Ltd* (1977) 136 C.L.R. 235.

[94] See also Grantham, "Attributing Responsibility to Corporate Entities" (2001) 19 *Company and Securities Law Journal* 168, 177–178; Thompson, "Unpacking Limited Liability" (1994) 47 *Vanderbilt Law Review* 1, 7.

[95] Hansmann and Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1990–91) 100 *Yale Law Journal* 1879, 1929; Thompson, "Unpacking Limited Liability" (1994) 47 *Vanderbilt Law Review* 1, 19–20; Gosnell, "The Personal Liability of Corporate Agents" (1997) 55 *University of Toronto Faculty of Law Review* 77, 129; R. Grantham, "Limited Liability of Company Directors" [2007] L.M.C.L.Q. 362, 375–376.

be less prepared to take on the role of director. However, where directors are major shareholders and stand to benefit from the harmful activities, their position is no different from individuals carrying on their personal activities with risk of causing harm to others—that is, the degree of risk-aversion on the part of the directors would be the same as for any other individual generally. Where directors do not stand to benefit from the potentially tortious activities, then there *is* a possibility of such directors being particularly risk-averse in carrying out their functions as directors.[96] Nonetheless it may be that in reality this may not be a significant problem so long as insurance is available for the directors, or directors are able to bargain with the company to obtain compensation for their risk.[97] Two further points can be added in relation to this issue. First, even if directors would act more cautiously, it is not at all clear that greater safety measures by companies or less instances of the carrying on of harmful activities would be undesirable. Again if it is felt that certain harmful activities should be carried on because of their potential social benefits, then specific legislative intervention to promote such activities might be more appropriate. The second point is that the position of directors in this context is analogous to the position of other employees of the company. If directors are inefficient bearers of risk, then so too would be other employees. Unless the personal liability of agents in general is to be excluded, then it is difficult to justify on policy grounds preferential treatment for directors.[98]

Commentators such as Grantham have argued though that the separate entity doctrine should lead to directors escaping tortious liability when acting as the company on the grounds that, to allow otherwise would be "to deny the company any meaningful existence and to frustrate the central purposes for which the State recognises the corporate form".[99] With respect, however, the company's existence is not denied as the company can still be liable in the circumstances (based on principles of attribution), and the company's other functions and capacities as a separate entity are maintained. As for the purposes of company law, it can well be doubted whether the limited liability and separate entity doctrines were devised to allow individuals to evade tortious liabilities.[100] As pointed out by Pettet, the doctrines were introduced in the context of voluntary creditors

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[96] Thompson, "Unpacking Limited Liability" (1994) 47 *Vanderbilt Law Review* 1, 19–20.

[97] Hansmann and Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1990–91) 100 *Yale Law Journal* 1879, 1928–1932; Gosnell, "The Personal Liability of Corporate Agents" (1997) 55 *University of Toronto Faculty of Law Review* 77, 120–132.

[98] See also Anderson, "The Theory of the Corporation and its Relevance to Directors' Tortious Liability to Creditors" (2004) 16 *Australian Journal of Corporate Law* 73, 91.

[99] Grantham, Attributing Responsibility to Corporate Entities" (2001) 19 *Company and Securities Law Journal* 168, 179; and see also Grantham, "Liability of Parent Companies for the Actions of the Directors and Their Subsidiaries" (1997) 18 *Company Lawyer* 138, 145–146, 148; Grantham and Rickett, "Directors' Tortious Liability" (1999) 62 *Modern Law Review* 133, 139; R. Grantham, "Limited Liability of Company Directors" [2007] L.M.C.L.Q. 362, 387–388.

[100] See also Noonan and Watson, "Directors' Tortious Liability" [2004] J.B.L. 539, 543; Thompson, "Unpacking Limited Liability" (1994) 47 *Vanderbilt Law Review* 1, 39–40.

and not tort creditors.[101] Moreover, it has been argued above that the policy considerations for allowing imposition of tort liabilities on individuals responsible for the tort are stronger than allowing an extended scope to the limited liability doctrine. Grantham himself concedes that "in time", acceptance of the use of the corporate form to carve out exceptions from tortious liability of those acting for the company may "be rejected as a false step".[102] It is submitted that that time is now.

On the above analysis then, an approach to directors' liability that is derived from giving full effect to the general principles of joint tortfeasance can be justified as a matter of principle and policy. The following section analyses whether that is the correct approach under the existing case authorities.

Analysis of the precedents

As a matter of authority, it is submitted that in England and in common law jurisdictions relying on the English precedents, the correct position is that the principles of joint tortfeasance are applicable to directors.

In Australia, the Federal Court decisions[103] which favour the view that the directors' liabilities depend on special principles as shaped by company law doctrines rather than general principles of joint tortfeasors have relied upon the dicta of Gummow J. in *WEA International Inc v Hanimex Ltd*[104] as authority for that approach. Gummow J. had in that earlier case cited two Australian first instance decisions of *Kalamazoo (Aust) Pty Ltd v Compact Business Systems Pty Ltd*[105] and *Polaroid Corp v Sole N Pty Ltd*,[106] and the English Court of Appeal decision of *C Evans and Sons Ltd v Spriteband Ltd*.[107] However, it is submitted that none of these decisions stand as authority for the principle that principles of joint tortfeasance are not applicable to directors. In the *Kalamazoo* decision, Thomas J. simply set out the "direct and procure" test.[108] In *Polaroid Corp*, the court referred to English authority[109] applying the "direct and procure" test and held that, on the facts of the case, the director's active participation in the tortious conduct was sufficient to render him liable.[110] In *C Evans and Sons Ltd*, the court only dealt with the issue of whether it was necessary for a director to know that the acts were tortious or that he was reckless as to that fact before liability could attach to the director. The court had answered that question in the negative, but

[101] Pettet, "Limited Liability" (1995) 48 *Current Legal Problems* 125, 152.

[102] Grantham, "Attributing Responsibility to Corporate Entities" (2001) 19 *Company and Securities Law Journal* 168, 180.

[103] *King v Milpurrurru* (1996) 66 F.C.R. 474 at 494, per Beazley J.; *Microsoft v Auschina Polaris* (1996) 71 F.C.R. 231 at 241, per Lindgren J.

[104] *WEA International Inc v Hanimex Ltd* (1987) 17 F.C.R. 274 at 284.

[105] *Kalamazoo (Aust) Pty Ltd v Compact Business Systems Pty Ltd* [1990] 1 Qd R. 231.

[106] *Polaroid Corp v Sole N Pty Ltd* [1981] 1 N.S.W.L.R. 491.

[107] *C Evans and Sons Ltd v Spritebrand Ltd* [1985] 2 All E.R. 415 CA (Civ Div).

[108] *Kalamazoo* [1990] 1 Qd R. 231 at 127.

[109] *Reitzmann v Grahame-Chapman and Derustit* (1950) 67 R.P.C. 178.

[110] *Polaroid Corp* [1981] 1 N.S.W.L.R. 491 at 498.

the important point for present purposes is that nowhere in the judgment did the court state that principles of joint tortfeasors are irrelevant. In fact, there does not appear to be any authority in England where the courts have expressly stated that directors' liabilities are dependent on special principles different to the general principles in tort. Apart from the Federal Court decisions mentioned above, this has also generally been the position with the authorities in Australia.

Moreover the mere application of the specific "direct and procure" test does not establish that the courts have impliedly rejected tort principles of joint tortfeasors. The "direct and procure" test itself is consistent with the principles in *Credit Lyonnais Bank Nederland*,[111] discussed above, that secondary liability can attach to a person who solicits or incites another to commit a tort. The line of authorities in England and elsewhere adopting the "direct and procure" test can be traced to the decision of the House of Lords in *Rainham Chemical Works v Belvedere Fish Guano*[112] where Lord Buckmaster had stated that directors would not be personally liable for the company's tortious acts "unless ... they were acts expressly directed by them" or:

> "... [i]f a company is formed for the express purpose of doing a wrongful act, or if, when formed, those in control expressly direct that a wrongful thing be done".

Lord Buckmaster did not cite any authority for those comments and did not provide further analysis of those points. It is submitted that the only established principles upon which Lord Buckmaster could have relied for those statements are the principles of joint tortfeasors,[113] and accordingly courts which have subsequently used the term "direct or procure" are simply applying the general tort law principles of soliciting, inciting and authorising a tort as giving rise to secondary liability.

However, if the correct test of directors' liabilities is the "make the tort his own" or the "assumption of responsibility" test, then it could be accepted that impliedly the joint tortfeasor principles are not applicable to directors. The "make the tort his own" test was developed in Canada in the decision of *Mentmore Manufacturing Co Ltd v National Merchandising Manufacturing Co Inc*[114] as an alternative to the "direct and procure" test in order to give proper effect, so it was thought, to the company law doctrines of limited liability and separate entity. Under this test, there needs to be a greater degree of involvement in the tortious conduct than simply authorising or directing that the tortious acts be carried out

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[111] *Credit Lyonnais Bank Nederland* [1998] 1 Lloyd's Rep. 19 CA (Civ Div).

[112] *Rainham v Belvedere* [1921] 2 A.C. 465 HL.

[113] See the discussion above on joint tortfeasors (pp.112–115), and for early authorities in England, see *Petrie v Lamont* (1842) Car. & M. 93 at 96; 174 E.R. 424; *Lumley v Gye* (1853) 2 El. & Bl. 216; 118 E.R. 749 QB; *Wheatley v Patrick* (1837) 2 M. & W. 650; 150 E.R. 917; *Samson v Aitchison* [1912] A.C. 844 PC (NZ).

[114] *Mentmore Manufacturing Co Ltd v National Merchandising Manufacturing* (1978) 89 D.L.R. (3d) 195. See also *White Horse Distilleries v Gregson* [1984] R.P.C. 61 Ch D; *King v Milpurrurru* (1996) 66 F.C.R. 474 at 495–500, per Beazley J.

before the director would be liable, and so this test is a more difficult one to satisfy than the "direct or procure" test.[115] The "make the tort his own" test then is stricter and thus inconsistent with the joint tortfeasor principles which lead to liability for a person so long as he had solicited or procured the tortious acts to be committed. This test, however, has been criticised as being indeterminate and less than illuminating, as it is difficult to know what degree of involvement is required before it can be said that the director has made the tort his own.[116] Although the *Mentmore* test has been widely applied in Canada,[117] the weight of authority in England[118] and Australia[119] supports the application of the "direct and procure" test rather than the *Mentmore* test. The application of the "direct and procure" test in England and Australia indicates that the principles dealing with the liabilities of directors would be consistent with the general principles of joint tortfeasance.

That, however, still leaves the "assumption of responsibility" test, which is supported by the House of Lords decision in *Williams v Natural Life*[120] and by the New Zealand Court of Appeal in *Trevor Ivory v Anderson*.[121] These cases dealt with negligent misstatements made by directors on behalf of the company, and the

[115] Farrar, "The Personal Liability of Directors for Corporate Torts" (1997) 9 *Bond Law Review* 102, 108; Anderson, "The Theory of the Corporation and its Relevance to Directors' Tortious Liability to Creditors" (2004) 16 *Australian Journal of Corporate Law* 73, 81; *White Horse Distilleries v Gregson* [1984] R.P.C. 61 Ch D at 91–92; *Microsoft v Auschina Polaris* (1996) 71 F.C.R. 231 at 244.

[116] Farrar, "The Personal Liability of Directors for Corporate Torts" (1997) 9 *Bond Law Review* 102, 108; Austin, Ford and Ramsay, *Company Directors: Principles of Law and Corporate Governance* (2005), p.621; *Microsoft v Auschina Polaris* (1996) 71 F.C.R. 231 at 245; *Root Quality Pty Ltd v R & R Owen Nominees Pty Ltd* (1999) 177 A.L.R. 231 at [146].

[117] See *Scotia McLeod v Peoples Jewellers* (1995) 129 D.L.R. (4th) 711; *ADGA Systems v Valcom* (1998) 168 D.L.R. (4th) 351; and Anderson, "The Theory of the Corporation and its Relevance to Directors' Tortious Liability to Creditors" (2004) 16 *Australian Journal of Corporate Law* 73, 81.

[118] See *Rainham v Belvedere* [1921] 2 A.C. 465 HL; *Performing Right Society v Ciryl* [1924] 1 K.B. 1 CA; *Reitzmann v Grahame-Chapman* (1950) 67 R.P.C. 178; *Oertli v Bowman* [1956] R.P.C. 282 Ch D; *Wah Tat Bank v Chang Cheng Kum* [1975] A.C. 507 PC (Sing); *Mancetter Developments Ltd v Garmanson* [1986] Q.B. 1212 CA (Civ Div); *A P Besson Ltd v Fulleon Ltd* [1986] F.S.R. 319 Ch D; *Standard Chartered Bank v Pakistan International (No.2)* [2003] 1 A.C. 959 HL at [36]; *MCA Records v Charly Records* [2003] 1 B.C.L.C. 93 CA (Civ Div). The "make the tort his own" test was applied in *Hoover Plc v George Hulme (Stockport) Ltd* [1982] F.S.R. 565 Ch D; *White Horse Distilleries v Gregson* [1984] R.P.C. 61 Ch D. In *C Evans and Sons v Spritebrand* [1985] 2 All E.R. 415 CA (Civ Div), counsel had accepted that this test was correct and the court did not have to deal with the issue, however the court did confine the scope of the principles as set out in the *White Horse Distilleries* case.

[119] See *Microsoft Corp v Auschina Polaris* (1996) 71 F.C.R. 231 at 245; Austin, Ford and Ramsay, *Company Directors: Principles of Law and Corporate Governance* (2005), p.621.

[120] *Williams v Natural Life* [1998] 2 All E.R. 577 HL; and see also *Fairline Shipping Corp v Adamson* [1975] Q.B. 180 QBD.

[121] *Trevor Ivory v Anderson* [1992] 2 N.Z.L.R. 517.

approach of the courts in these decisions is that the directors are not necessarily liable for their negligent misstatements even though they were the persons who made the misstatements to the claimant and who failed to take reasonable care and skill in doing so. The director could only be liable if he had conveyed directly or indirectly to the claimant that he was assuming personal responsibility towards the claimant in the giving of advice to the claimant. In England, the decision in *Williams v Natural Life* remains good law and was not doubted in the later case of *Standard Chartered Bank v Pakistan International (No.2)*.[122] The question arises then as to whether the "assumption of responsibility" test is the sole test that should be applied generally to directors' tortious liabilities under the existing authorities. While the above decisions dealt with negligent misstatements, there has been a suggestion that the "assumption of responsibility" test applies as a general test of director's liability in relation to all torts and that despite a director's involvement in the tort, the director would not be liable unless he has assumed personal responsibility for the claimant's interests.[123] This view of the case law would effectively mean that this test now overrides the "direct and procure" test, and if this were the correct position under the common law, then clearly the ordinary tort principles of joint tortfeasors would not be applicable to directors.

However, it should now be clear in England at least that the requirement for an assumption of responsibility by the director before liability can attach is not one of general application to directors. The approach of the House of Lords in *Standard Chartered Bank v Pakistan International (No.2)*[124] is that the requirement for an assumption of responsibility would only be applied to directors where that requirement is relevant for the particular tort in question. Thus in that case, dealing with deceit, it was possible for the director to be personally liable for deceit carried out in the course of the company's activities without any need to establish that the director had personally assumed responsibility for the statements. This is so because "assumption of responsibility" is not an element required for the tort of deceit. The proper scope of the "assumption of responsibility" test in tort was recently reviewed by the House of Lords in *Customs and Excise Commissioners v Barclay Bank Plc*.[125] Under general tort law principles, the notion of "assumption of responsibility" is one of the tests applied in the tort of negligence to determine whether there exists a duty of care on the part of

122 *Standard Chartered Bank v Pakistan International (No.2)* [2003] 1 A.C. 959 HL.

123 See, e.g. Grantham and Rickett, "Directors' Tortious Liability" (1999) 62 *Modern Law Review* 133; Griffin, "Company Director's Personal Liability in Tort" (1999) 15 *Law Quarterly Review* 36.

124 *Standard Chartered Bank v Pakistan International (No.2)* [2003] 1 A.C. 959 HL at [21], [41]; and see also *Daido Asia Japan Co Ltd v Rothen* [2002] B.C.C. 589 Ch D at 596; F. Reynolds, "Personal Liability of Company Directors in Tort" [2003] *Hong Kong Law Journal* 51; Austin, Ford and Ramsay, *Company Directors: Principles of Law and Corporate Governance* (2005), pp.618–619; N. Campbell and J. Armour, "Demystifying the Civil Liability of Corporate Agents" (2003) 62 *Cambridge Law Journal* 290.

125 *Customs and Excise Commissioners v Barclays Bank Plc* [2007] 1 A.C. 181 HL.

the defendant,[126] predominantly but not exclusively,[127] in the area of negligent misstatements causing pure economic loss. Now conceptually it might be possible to say that every situation where a duty of care arises in negligence is one where the defendant assumes responsibility to another to take care, however Lord Hoffmann in *Customs and Excise Commissioners v Barclays Bank*[128] pointed out that the use of the concept would not be very illuminating in particular contexts where the question is not whether the defendant had assumed responsibility for the accuracy of a particular statement but a much more general responsibility for the consequences of his conduct. So for instance, in cases of conduct causing physical injury or property damage, reasonable foreseeability of harm is usually enough to generate a duty of care without a specific need to consider the issue of assumption of responsibility.[129] Moreover, even within the sphere of liability for pure economic loss, the House of Lords has made it clear in *Customs and Excise Commissioners v Barclays Bank*[130] that "assumption of responsibility" will not always be the crucial test determinative of the question of the existence of a duty of care. Thus there are situations where the circumstances would not readily yield to analysis in terms of voluntary assumption of responsibility, but where it may be appropriate to impose a duty of care, for example by application of the threefold test of foreseeability, proximity and fairness, justice and reasonableness.[131] With this understanding then of the scope of the "assumption of responsibility" test in tort generally, it can be seen that the approach in *Standard Chartered Bank*, above, means that for intentional torts and for cases of negligence not dependent on a personal assumption of responsibility by the defendant, it would not be relevant to consider whether the director had assumed personal responsibility to the claimant.

On the above analysis, application of principles of joint tortfeasance to directors is consistent with the English case authorities on directors' liabilities, properly

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[126] Whether as a way to establish the requisite relationship or degree of proximity which (coupled with reasonable foreseeability of loss) would be sufficient to give rise to a duty of care (see *Customs and Excise Commissioners v Barclay Bank* [2007] 1 A.C. 181 HL at 199, per Lord Hoffmann, at 210, per Lord Walker) or whether as a self-contained test, which if satisfied, removes the need to consider separately the issues of foreseeability, proximity and fairness, justice and reasonableness (see *Customs and Excise Commissioners v Barclays Bank* [2007] 1 A.C. 181 HL at 189–190, per Lord Bingham, at 214, per Lord Mance; *Henderson v Merrett Syndicates Ltd* [1995] 2 A.C. 145 HL at 181, per Lord Goff). See also Rogers, *Winfield and Jolowicz on Tort* (2006), pp.145–146.

[127] See, e.g. *Phelps v Hillingdon LBC* [2001] 2 A.C. 619 HL; *Watson v British Boxing Board of Control Ltd* [2001] Q.B. 1134 CA (Civ Div).

[128] *Customs and Excise Commissioners v Barclays Bank* [2007] 1 A.C. 181 HL at 200.

[129] See *Customs and Excise Commissioners v Barclays Bank* [2007] 1 A.C. 181 HL at 198, per Lord Hoffmann; *Caparo v Dickman* [1990] 2 A.C. 605 HL at 633, per Lord Oliver.

[130] *Customs and Excise Commissioners v Barclays Bank* [2007] 1 A.C. 181 HL at 190, per Lord Bingham, at 199–200, per Lord Hoffmann, at 204, per Lord Rodger, at 210, per Lord Walker, at 216, per Lord Mance.

[131] *Customs and Excise Commissioners v Barclays Bank* [2007] 1 A.C. 181 HL at 189–190, 194–195, per Lord Bingham, at 198–200, per Lord Hoffmann, at 204, per Lord Rodger, at 210, per Lord Walker, at 214–217, per Lord Mance.

understood. Lord Steyn in *Williams v Natural Life*[132] did appear though to reject an argument for the director's liability for negligent misstatement based on ordinary principles of joint tortfeasors. Faced with counsel's contention that the director had played a prominent part in the production of the misinformation to the claimants and that therefore the director was a joint tortfeasor with the company, Lord Steyn stated that "the argument is unsustainable".[133] However, his Lordship's comments are arguably confined to the type of situation that arose in that case, namely torts involving the element of assumption of responsibility. This interpretation of Lord Steyn's comments is supported by the views of the English Court of Appeal in *MCA Records v Charly Records*.[134] In that case, Chadwick L.J. observed that Lord Steyn's statements were not intended to set out any general proposition that a director could never be liable as a joint tortfeasor with the company. Chadwick L.J. stated further that, if that interpretation was wrong and Lord Steyn did intend to propound a more general proposition, then it would not be appropriate to follow Lord Steyn's view on that issue, for the statements were made in obiter and without reference to earlier House of Lords authorities.

In *MCA Records v Charly Records*[135] itself, in the context of a personal action against a director for the company's infringement of copyright, the court expressly accepted the view that directors can be liable pursuant to ordinary principles of joint tortfeasance. The test applied by the court was based on the general tests of secondary liability, namely that the director can be liable where he intended, procured and shared a common design that the tortious conduct should take place. This approach has now been followed in a number of decisions in England[136] and other common law jurisdictions.[137] In two recent decisions in Hong Kong[138] applying *MCA Records*, the courts have also

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132 *Williams v Natural Life* [1998] 2 All E.R. 577 HL.

133 *Williams v Natural Life* [1998] 2 All E.R. 577 HL at 585.

134 *MCA Records v Charly Records* [2003] 1 B.C.L.C. 93 CA (Civ Div) at 114.

135 *MCA Records v Charly Records* [2003] 1 B.C.L.C. 93 CA (Civ Div). See also *PLG Research Ltd v Ardon International Ltd* [1993] F.S.R. 197 Ch D (Patents Ct) at 238, per Aldous J., reversed on other grounds in *PLG Research Ltd v Ardon International Ltd* [1995] F.S.R. 116 CA (Civ Div).

136 *Koninklijke Philips Electronics NV v Princo Digital Disc GmbH* [2004] 2 B.C.L.C. 50 Ch D (Patents Ct). See also *Meretz Investments NV v ACP Ltd* [2007] Ch. 197 Ch D; *Società Esplosivi Industriali SpA v Ordnance Technologies (UK) Ltd (formerly SEI (UK) Ltd)* [2007] EWHC 2875 (Ch); [2008] 2 All E.R. 622 Ch D.

137 In Hong Kong, see *Yakult Honsha v Yakudo* [2004] 1 H.K.C. 630; *Tai Shing Diary Ltd v Maersk Hong Kong Ltd* [2007] 2 H.K.C. 23; *Guangzhou Green-Enhan Bio-Engineering Co Ltd v Green Power Health Products International Co Ltd* Unreported April 8, 2005 CFI HCA 4651/2002 and 2802/2003, HCMP 74/2004; *Reed Business Information Ltd v Rever Creative Press Ltd* Unreported June 14, 2007. CFI HCA 1157/2005 and 1157A/2005. In New Zealand, see *Lucas v Peterson Portable Sawing Systems Ltd* (2003) 57 I.P.R. 305.

138 *Yakult Honsha v Yakudo* [2004] 1 H.K.C. 630; *Tai Shing v Maersk* [2007] 2 H.K.C. 23.

affirmed the view set out in *C Evans and Sons v Spritebrand*[139] that a director can be liable even though he was not aware that the conduct would be tortious or was not reckless as to the actions being tortious. This approach is consistent with the general principles of joint tortfeasance discussed above (at pp.112–115).

In assessing directors' liabilities, many of the cases have not distinguished clearly between primary liability and secondary liability of directors. For conceptual clarity, it is necessary, however, to make the distinction, and a number of decisions have now recognised this point. Cases such as *Standard Chartered Bank*[140] and *Daido Asia Japan v Rothen*[141] involve situations of primary liability where all the elements of the tort can be established against the director. On the other hand, cases such as *MCA Records v Charly Records*[142] and *Yakult v Yakudo*[143] deal with situations of secondary liability pursuant to the principles in *Credit Lyonnais Bank Nederland*.[144] That the two grounds of liability of directors are distinct was expressly recognised by Lawrence Collins J. in the *Daido Asia* decision[145] and by Chadwick L.J. in *MCA Records*.[146] Accordingly, depending on the role of the directors in the tortious conduct, they could be liable as principal tortfeasors or as secondary tortfeasors, and where they are liable together with the company or others, the directors would be joint tortfeasors with the latter.[147]

It can be concluded from the above analysis that under English law, it is reasonably clear that: (1) primary tort liability can attach to a director when acting as agent of the company; and (2) secondary liability can also attach where the director has authorised, directed or procured the tortious conduct, or was party to a common design for the tortious actions to be carried out. There is also support for this approach in Hong Kong in recent decisions of the Court of First Instance[148]; however, there is less certainty in jurisdictions such as Australia, New Zealand and Canada. In Canada, although there is strong acceptance of the *Mentmore* test, which appears to apply a special principle of company law to the liability of

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139 *C Evans and Sons v Spritebrand* [1985] 2 All E.R. 415 CA (Civ Div).

140 *Standard Chartered Bank* [2003] 1 A.C. 959 HL.

141 *Daido Asia Japan v Rothen* [2002] B.C.C. 589 Ch D.

142 *MCA Records v Charly Records* [2003] 1 B.C.L.C. 93 CA (Civ Div). See also *PLG Research v Ardon* [1993] F.S.R. 197 Ch D (Patents Ct) at 238, per Aldous J., reversed on other grounds in *PLG Research v Ardon* [1995] F.S.R. 116 CA (Civ Div).

143 *Yakult Honsha v Yakudo* [2004] 1 H.K.C. 630.

144 *Credit Lyonnais Bank Nederland* [1998] 1 Lloyd's Rep. 19 CA (Civ Div).

145 *Daido Asia Japan v Rothen* [2002] B.C.C. 589 Ch D at [31].

146 *MCA Records v Charly Records* [2003] 1 B.C.L.C. 93 CA (Civ Div) at [26], [53]. See also *Oertli v Bowman* [1956] R.P.C. 282 Ch D at 297–298.

147 See also Austin, Ford and Ramsay, *Company Directors: Principles of Law and Corporate Governance* (2005), pp.617–622.

148 In Hong Kong, see *Yakult Honsha v Yakudo* [2004] 1 H.K.C. 630; *Tai Shing Diary Ltd v Maersk Hong Kong Ltd* [2007] 2 H.K.C. 23; *Guangzhou Green-Enhan Bio-Engineering Co Ltd v Green Power Health Products International Co Ltd* Unreported April 8, 2005 CFI HCA 4651/2002 and 2802/2003, HCMP 74/2004; *Reed Business Information Ltd v Rever Creative Press Ltd* Unreported June 14, 2007 CFI HCA 1157/2005 and 1157A/2005. In New Zealand, see *Lucas v Peterson Portable Sawing Systems Ltd* (2003) 57 I.P.R. 305.

directors, the courts have on some occasions also proceeded upon the basis that no distinction should be made between directors and other employees in relation to imposition of personal liability.[149] Accordingly the position in Canada cannot be regarded as being finally settled.[150] In New Zealand, the leading decision of *Trevor Ivory*, which sets out the "assumption of responsibility" test, has been described as "the first point of reference for any subsequent case on the liability of a director in tort",[151] but the precise scope of that decision is not altogether clear. The "assumption of responsibility" test has now been confined in England to cases where that element is relevant for determination of the issue of the director's duty of care, but whether the English approach would be applied in New Zealand is yet to be settled. In Australia, it has been argued above that the decisions expressly rejecting the ordinary application of joint tortfeasance principles to directors had proceeded upon an erroneous understanding of the English authorities, and furthermore that the weight of authority supports the "direct and procure" test, which is consistent with the ordinary principles of joint tortfeasors. There is scope then for Australian courts to expressly follow the English approach.[152] On the basis of the analysis of matters of principle and policy above (pp.118–130), it is submitted that the English approach should also be adopted in these various common law jurisdictions.

Even in England though, it is perhaps not entirely clear whether directors, when acting together through the board of directors as an organ[153] of the company are in any way shielded from liability. In relation to primary liability, the decision in *Standard Chartered Bank* dealt with a situation where the director was regarded as acting as an agent of the company rather than as a corporate organ,[154] and it could be argued that where directors are acting as a corporate organ, then personal liability cannot attach to the directors.[155] As for secondary liability, the English Court of Appeal in *MCA Records* took the view that a director would not be liable as a joint tortfeasor where the director simply carries out his constitutional role in the governance of the company by voting at board meetings.[156]

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[149] See Feasby, "Corporate Agents' Liability in Tort" (1999) 32 *Canadian Business Law Journal* 291, 295.

[150] See, e.g. *Strata Plan LMS 2643 v Harold Developments Ltd* [2007] B.C.J. 1639 at [26]; Feasby, "Corporate Agents' Liability in Tort" (1999) 32 *Canadian Business Law Journal* 291, 306.

[151] Borrowdale and Simpson, "Directors' Liability in Tort" (1995) 13 *Company and Securities Law Journal* 400, 400.

[152] See also *O'Brien v Dawson* (1942) 66 C.L.R. 18 at 32; and Austin, Ford and Ramsay, *Company Directors: Principles of Law and Corporate Governance* (2005), pp.618–619.

[153] See Austin, Ford and Ramsay, *Company Directors: Principles of Law and Corporate Governance* (2005), p.65.

[154] Noonan and Watson, "Directors' Tortious Liability" [2004] J.B.L. 539, 547.

[155] See Grantham, Attributing Responsibility to Corporate Entities" (2001) 19 *Company and Securities Law Journal* 168.

[156] *MCA Records* [2003] 1 B.C.L.C. 93 CA (Civ Div) at 116; and see also *Green Cartridge Co (Hong Kong) Ltd v Canon Kabushiki Kaisha* [1996] 2 H.K.C. 180 at 228, 241–242, reversed on other grounds *Canon Kabushiki Kaisha v Green Cartridge Co (HK) Ltd* [1997]

It is submitted, however, that the better view is that even where the directors are acting as a board and as a corporate organ, they could still be personally liable for the tort. In principle, liability may arise either as primary or secondary tortfeasor. However it may well be that in practice, the issue of secondary liability rather than primary liability would be more relevant. This is because the mere making of a decision authorising certain conduct may not itself be sufficient for the establishment of the elements of the particular tort as against the directors who made the decision. However the authorising of conduct could itself give rise to secondary liability. This view is actually supported by the decision in *T Oertli v EJ Bowman*,[157] where Roxburgh J. held that where the company was directed into a tortious policy, the directors who formulated the company's policy could be liable. In other words, those directors who approve of a particular tortious policy at a board meeting could be personally liable as secondary tortfeasors on the basis of authorising, or directing or procuring the tortious conduct. The comments against this approach in *MCA Records* by the Court of Appeal could be regarded as having greater authority than the decision of Roxburgh J.; however, the comments in *MCA Records* were arguably by way of obiter only as the decision did not turn on that issue. As a matter of principle, and as argued earlier in this article,[158] there is no logical requirement for directors' acts in the capacity of the company's organ to exclude the possibility of personal liability in tort. As a matter of policy, there is also no justification for carving out a safe harbour from personal liability where the directors act together via the board. For instance, if an executive director can be liable for authorising an employee or another party to commit a tort when the executive director is acting in the capacity of agent of the company, then equally the directors who achieve the same result via a board resolution should also be liable. While there may be some uncertainty as to the correctness of this view under the existing authorities, this approach is consistent with the general comments of Lord Buckmaster in *Rainham v Belvedere*,[159] that directors can be liable where they direct that the wrongful thing be done.

Conclusions

It has been argued in this article that directors' liabilities in relation to tortious conduct arising from the company's operations should be determined in accordance with the ordinary principles of joint tortfeasance rather than any special principles shaped by company law doctrines that might limit the liability of directors. Arguably this is the right approach as a matter of both principle and policy. Contrary to the views held by many, the concept of the company and the (legitimate) purposes of the company law doctrines of limited liability and separate entity are not undermined by acceptance of the possibility of directors' personal

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2 H.K.C. 1; *Yakult Honsha v Yakudo* [2004] 1 H.K.C. 630; *Tai Shing Diary Ltd v Maersk* [2007] 2 H.K.C. 23.

157 *Oertli v Bowman* [1956] R.P.C. 282 Ch D.

158 See "Analysis of principle and policy" above.

159 *Rainham v Belvedere* [1921] 2 A.C. 465 HL. See the text to fn.112 above.

liabilities under tort principles. Conversely, there are strong reasons for ensuring that the policy objectives of tort law are not defeated by the use (or abuse) of company law doctrines. A minimum requirement of corporate social responsibility is for external laws such as tort laws to be effectively enforced against companies, and accordingly it would be undesirable to allow individuals operating through a company to escape the consequences of their tortious acts purely on the basis that they are directors of the company. It has also been argued in this paper that this approach to directors' liabilities reflects the existing law in England, particularly in light of the decisions in *Standard Chartered Bank v Pakistan International (No.2)*[160] and *MCA Records v Charly Records*.[161] This approach has also now been expressly adopted in Hong Kong by first instance courts, and to the extent that the law is different or unsettled in other jurisdictions such as Australia, New Zealand and Canada, it is submitted that the English approach is to be preferred. The English Court of Appeal in *MCA Records v Charly Records*, above, did however qualify the application of principles of joint tortfeasors to directors to some extent by exempting directors from liability where they have simply voted on the board. It has been argued though that the better view is that regardless of whether directors are acting as agents or as the corporate organ, they can be liable so long as they come within the ordinary principles of joint tortfeasance. This accords with both principle and policy, and is arguably in line with the seminal House of Lords authority in *Rainham v Belvedere*.[162]

[160] *Standard Chartered Bank* [2003] 1 A.C. 959 HL.
[161] *MCA Records v Charly Records* [2003] 1 B.C.L.C. 93 CA (Civ Div).
[162] *Rainham v Belvedere* [1921] 2 A.C. 465 HL.

Involuntary Creditors and the Case for Accounting-based Distribution Regulation

David Kershaw*

Creditors; Distribution; Restrictions; Shareholders

Introduction

In UK academic and professional circles a consensus has recently emerged that the rules determining when companies may make distributions to shareholders are in need of reform. There are two primary drivers of this reform consensus. The first is that the rules are unnecessary to guard their regulatory constituency, namely adjusting creditors, who care little for the rules and in any event are capable of protecting themselves. According to this driver of reform, distribution rules prevent the company from opportunistically exploiting creditors by returning legal capital[1] to shareholders. However, as English law's minimum capital requirements are zero for private companies and insignificant for public companies the company may have limited capital for the distribution rules to prevent being returned. It follows, therefore, that only those creditors who can adjust their terms of trade to the actual capitalisation of the firm can benefit from the distribution restrictions. If adjusting creditors neither rely upon these rules nor view them as a useful protective device then the case for their continued application is weak. This article refers to this driver of reform as the "constituency driver". The second driver of reform is that distribution regulation's reliance on accounting-based tests means that changes in accounting standards may unintentionally distort capital markets by preventing financially healthy and solvent companies from issuing dividends. Affected companies may, as a result, experience an increase in their cost of equity capital and shrinkage in their potential pool of investors as these companies are no longer attractive investment options for those investors who require regular and predictable dividends. These distortions are, it is argued, unnecessary. They can be removed while at the same time protecting creditors' interests through a regulatory

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[1] The term legal capital is not a term used by the cases addressing distributions or in any of the Companies Acts. It is used here, as elsewhere, to refer to the capital amount that is subject to distribution regulation.

approach that is not directly connected to the company's financial statements and which would allow distributions where directors certify the solvency of the company at the time of the distribution and for a period thereafter. This article refers to this driver of reform as the "distortion driver".

This article considers these two drivers of reform from the perspective of the involuntary, non-adjusting creditor. According to the *constituency driver* involuntary creditors are not protected by the distribution rules and therefore have nothing to lose through their reform. According to the *distortion driver* creditors, including involuntary creditors, are as well protected by the solvency certification approach. It follows, therefore, that involuntary creditors would be indifferent to reform that replaces the current regime with a solvency-based approach. This article takes issue with these claims. It argues that involuntary creditors obtain distinct and tailored benefits from the current distribution regime. These benefits have been underweighted and unexplored as a result of a tendency in the literature to conflate the regulation's ostensible function with its effects; when its effects in practice are more diffuse than the original conception of function. Although the rules were conceived as part of the capital maintenance doctrine and although their functional "best fit" may well be to prevent the return of legal capital to shareholders, in application the rules have had broader effects and have generated unintended constituencies including, in several respects, the involuntary creditor. Following the identification of these benefits, this article considers the *distortion driver* and asks whether a solvency certification provides equivalent protection for involuntary creditors. It argues that on balance the solvency certification approach would diminish the protection provided to involuntary creditors by the current distribution regime.

The constituency driver

The logic of capital maintenance

English law has long had rules regulating when companies can make distributions of assets to their shareholders. Basil Yamey, writing in 1941, distinguished between pre-1889 and post-1889 case law.[2] The former, exemplified by *Exchange Banking Co (Flitcroft's Case), Re*,[3] required that a distribution could not be made out of capital which, strictly speaking, meant that the distribution could not result in an accounting reduction of the capital account[4] to an amount below the legal capital entry. Legal capital at this time consisted of the aggregate nominal value of the issued shares. Yamey notes in this regard that:

[2] B. Yamey, "Aspects of the Law Relating to Company Dividends" (1941) *Modern Law Review* 273.

[3] *Exchange Banking Co (Flitcroft's Case), Re* (1882) L.R. 21 Ch. D. 519 CA.

[4] The term "capital account" refers here to shareholders' equity which consists both of the legal capital amount (effectively the amount paid for the shares) together with any undistributed profits and less any prior losses.

> "... [C]ompany directors in the period before 1889 were confronted by a rigid rule forbidding any dividend payment which would have reduced the remaining assets below the figure of the company's nominal paid-up capital."[5]

The "reason" for this was stated by Jessel M.R. to be that:

> "There is a statement [in the memorandum of association] that capital shall be applied for the purposes of the business, and on the faith of that statement, which is sometimes said to be an implied contract with creditors, people dealing with the company give it credit. The creditor, therefore, I may say gives credit to that capital, gives credit to that company on the faith that the representation that the capital shall only be applied for the purposes of the business, and he has, therefore, a right to say that the corporation shall keep its capital and not return it to the shareholders, though it may be a right which he cannot enforce otherwise than by a winding up order."

For post-1889 case law, however, the criterion for making a distribution was merely the generation of profit. The questions of relevance became, first, who was the arbiter of whether a profit had been made: the courts, directors or the accounting profession; and, secondly, what was the time period within which profits had to be made. The case of *Lee v Neuchatel Asphalte Co*[6] and its progeny gave considerable deference to the board's determination of profit even where the approach taken was contrary to the accounting best practice of the time. This resulted in distributions being held to be legal where, for example, the profit calculation did not take account of depreciation in fixed asset values.[7] Subsequent case law also held that profits generated in one financial year could be distributed even though, together with the results of previous financial years, the company had an accumulated loss.[8] Both these types of distribution, although held to be legal, could result in a reduction in the capital account below the legal capital entry.

The European Union's Second Directive reinstated the pre-1889 focus on ensuring that a distribution is not made to shareholders that would result in a reduction of the capital account entry. The preamble to the Second Directive provides:

> "... that provisions should be adopted for maintaining the capital, which constitutes the creditor's security, in particular by preventing any distribution thereof by distribution to shareholders where the latter are not entitled to it".[9]

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[5] There is some uncertainty as to what the courts meant by reference to capital. The better position it is submitted is that it was nominal issued share capital not paid-up share capital: see Cotton and Lopes L.JJ.'s judgments in *Lee v Neuchatel Asphalte Co* (1889) L.R. 41 Ch. D. 1 CA.

[6] *Lee v Neuchatel* (1889) L.R. 41 Ch. D. 1 CA.

[7] *Lee v Neuchatel* (1889) L.R. 41 Ch. D. 1 CA.

[8] *Ammonia Soda Co v Chamberlain* [1918] 1 Ch. 286 CA.

[9] Second Directive 77/91 on the coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within

Post-Second Directive UK scholarship typically refers to distribution regulation as part of the capital maintenance doctrine. However, neither the Directive's provisions nor the UK rules implementing the Directive contain any specific requirement to "maintain capital". Rather, the rules set forth two accounting-based tests to determine whether a distribution can be made. In the United Kingdom the first of these rules, applicable to private and public companies, requires that a distribution can only be made to the extent that a company's accumulated realised profits less previous distributions exceeds its accumulated losses less amounts written off in any formal capital reduction (the "accumulated profits test").[10] The second test, applicable only to public companies, requires that a distribution can only be made to the extent that net assets exceed the aggregate nominal value of the issued shares and the company's undistributable reserves, which includes any share premium (the "net assets test").[11] Structurally at least,[12] the net assets test results in a reaffirmation of the pre-1889 UK distribution regulation: legal capital[13] becomes an explicit factor in the determination of the dividend. The net profits test has the same effect due, most importantly, to the accumulation requirement and the accounting standards' requirement to depreciate fixed assets.[14]

Recent scholarship has sought "to elucidate the function of these rules": what they do in fact and who, if anyone, they benefit.[15] For Professor Armour, in accord with the Second Directive's preamble, distribution rules are viewed as restrictions "on the return of capital to shareholders"[16]; the net profits test, he submits, embodies[17] the capital maintenance rule. Extending the functional inquiry, for

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the meaning of the second paragraph of art.58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent [1977] OJ L26/1.

10 Companies Act (CA) 2006 s.830.

11 CA 2006 s.831.

12 The capital threshold under the post-1980 regime is, in effect, the amount agreed to be paid for the shares, whereas the pre-1889 threshold was aggregate nominal value, i.e. share capital.

13 In contrast to the pre-1889 meaning of legal capital, legal capital post-Second Directive becomes in effect what is agreed to be paid for the shares including aggregate issued nominal share capital and the share premium account.

14 Financial Reporting Standard 15, Tangible Fixed Assets (ASB, 1999), paras 77–102.

15 J. Armour, "Share Capital and Creditor Protection: Efficient Rules for a Modern Economy" (2000) 63 M.L.R. 355, 355. J. Armour, "Legal Capital: An Outdated Concept?' (2006) 7 *European Business Organization Law Review* 5; J. Rickford et al., "Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance" (2004) 15 *European Business Law Review* 919 (Interdisciplinary Group Report); E. Ferran, "Creditors' Interests and 'Core' Company Law" (1999) 20 *Company Lawyer* 314. See also, P.O. Muelbert and M. Birke, "Legal Capital: Is there a Case Against the European Legal Capital Rules?" (2002) 3 *European Business Organization Law Review* 695; W. Schoen, "The Future of Legal Capital" (2004) *European Business Organization Law Review* 429.

16 Armour, "Legal Capital" (2006) 7 *European Business Organization Law Review* 5, 11, 12.

17 Armour, "Legal Capital" (2006) 7 *European Business Organization Law Review* 5, 8–9.

Armour the inability to return capital to the shareholders reduces the scope for post-contractual opportunism by the company to transfer value from creditors to shareholders.[18] According to this understanding, at the time of contracting creditors incorporate into their assessment of the risk and required return of their investment the legal capital of the company. If, following the consummation of the contract, the company is able to return legal capital, or an amount representing legal capital in the accounts, to the shareholders then the terms of the agreement are unilaterally altered by the company to the detriment of the creditor. From this perspective, the distribution rules should be understood as providing collective terms for preventing such opportunism.

If distribution regulation's function is to prevent legal capital from being returned to shareholders, the extent to which it protects creditors in practice is necessarily dependent on the level of a particular company's legal capital. If a company is not required to have and maintain more than an insignificant amount of legal capital then there may be very little for the distribution rules to prevent being returned. Pursuant to English company law there is no minimum capital requirement for private companies and whereas there is a minimum allotted share capital amount for public companies of £50,000[19] there is no requirement for public or private companies to maintain a minimum funded equity cushion.[20] Distribution regulation may, therefore, protect an insignificant equity contribution from being returned to shareholders. This means that distribution rules do not protect absolutely, they only protect relatively: relative to a particular company's capitalisation. From this perspective *adjusting* creditors are the only creditor constituency that can be protected by the rules. If the legal capital threshold below which distributions cannot be made may for some companies be effectively zero, then the distribution rules do not provide a *general* creditor protection function. Adjusting creditors, on the other hand, can rely on, or attribute value to, the capitalisation level in light of the effect of the rules: adjusting creditors can incorporate this information into their decision as to whether or not and on what terms to do business with the company. They can rely on *both* the actual legal capital level and the rules that prevent its distribution. Adjusting creditors are, therefore, distribution regulation's natural constituency. In relation to non-adjusting creditors, Armour concludes that:

> "... because the maintenance of capital doctrine does not specify the *level* at which the restrictions on distributions is to be set, it can only protect involuntary creditors when *coupled* with a minimum capital requirement".[21]

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[18] Armour, "Legal Capital" (2006) 7 *European Business Organization Law Review* 5, 12–13.

[19] CA 2006 ss.761, 763.

[20] If the net assets of the company fall below half of its share capital, the company must call a general meeting to consider the situation. No action is required to be taken (CA 2006 s.656).

[21] Armour, "Share Capital and Creditor Protection" (2000) 63 M.L.R. 355, 368 [original emphasis].

More recently Armour notes that:

> "... [F]or non-adjusting creditors a restriction on the return of capital to shareholders is by itself of little assistance. This is because if creditors do not adjust, the optimal level of capitalisation for shareholders is zero."[22]

If the level of capitalisation is, in fact, set above zero in a particular company then the rules will provide some protection for involuntary creditors. However, as such protection is fortuitous such creditors are not deemed a regulatory constituency. An interdisciplinary group of lawyers and accountants (the "Interdisciplinary Group"), who recently argued strongly in favour of reforming the distribution rules, also view reliance by adjusting creditors as an important way of making sense of the distribution rules:

> "*Thus* creditors may *rely* on this amount of assets being present to satisfy their claims, unless it has been reduced by trading. Even if it has been reduced in this way, they may *rely* on the amount of the original capital fund being replenished before assets may be returned to shareholder" [emphasis added].[23]

For the Interdisciplinary Group it follows that involuntary creditors should have limited concern about the reform of capital maintenance regulation as, "by definition ... [neither] involuntary or casual creditors *rely* on the levels of capital maintained by the companies concerned" [emphasis added].[24]

Through this framework the effectiveness of the regulation depends upon adjusting creditor attention to actual capitalisation levels and the subsequent adjustment of their terms of trade to reflect both such levels and the distribution restriction. If in practice adjusting creditors place no or little reliance upon legal capital levels at the time of contracting then, from a creditor protection perspective, the rules are ineffective. The Interdisciplinary Group, for example, supports the conclusion that, "there is very little, on balance, to be said in favour of the present regime" with the observation that, "there is very considerable doubt whether creditors *rely* on it significantly in practice" [emphasis added].[25] Indeed, both Armour and the Interdisciplinary Group establish convincingly that distribution regulation in its current mandatory form provides insignificant benefits to adjusting creditors. To the extent that distribution prohibitions linked to legal capital are valued by adjusting creditors they are capable of building them into their contractual arrangements with companies. From the adjusting creditors'

[22] Armour, "Legal Capital" (2006) 7 *European Business Organization Law Review* 5, 12.
[23] Interdisciplinary Group Report, "Reforming Capital" (2004) *European Business Law Review* 919, 928.
[24] Interdisciplinary Group Report, "Reforming Capital" (2004) *European Business Law Review* 919, 932.
[25] Interdisciplinary Group Report, "Reforming Capital" (2004) *European Business Law Review* 919, 947.

perspective, to the extent these rules exist at all they should be default rules which may, in some circumstances, allow parties to economise on contracting costs.[26]

When viewed through the lens of the Second Directive's objective to "maintain" capital, the constituency and reform logic of the above argument is compelling. The problem with the argument, however, is that its logic is connected not to the actual effects of the regulation itself but the stated purpose or function of the regulation: to maintain capital. What the distribution rules can do and who they can protect has come to be understood through the restrictive lens of company law's conceptual order of things: as part of the *capital maintenance* doctrine. In application, however, rules are inevitably over-inclusive. Even assuming that the distribution rules were designed to protect creditors by maintaining capital vis-à-vis shareholders, in practice the rules' over-inclusive application has generated effects and protected constituencies beyond the boundaries of the original objective. This is not, of course, to dispute the fact that the existing rules, in conjunction with applicable accounting standards, do maintain (vis-à-vis shareholders) the legal capital accounts of UK companies and that the potential insignificance of the capital contribution for UK companies means that adjusting creditors are the only creditors who can adjust to *this firm specific variable*. The argument here is that protection of legal capital vis-à-vis shareholders is but one aspect of what the distribution rules do in practice and only one of the ways in which the rules can benefit creditors. If there is a capital maintenance doctrine then distribution regulation would relate to it diagrammatically as follows:

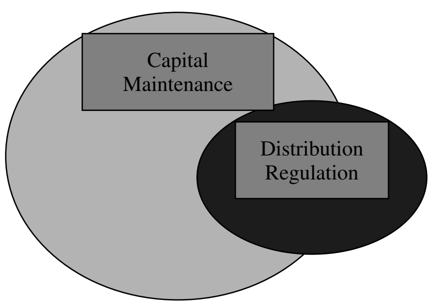

Figure 1

The United Kingdom's current distribution rules allow distributions to shareholders to the extent that both net assets exceed share capital and undistributable

[26] On the problems with the argument that a collective term economises on contracting costs see Armour, "Legal Capital" (2006) 7 *European Business Organization Law Review* 5, 22.

reserves[27] and accumulated realised profits exceed accumulated realised losses.[28] Both tests do indeed function to ensure that legal capital is not distributable to shareholders. That is not, however, all that they do. By looking at these rules without the lens of the capital return function, we can ask simple but probing questions about the effects of the rules. The net assets distribution test involves several components. Broadly understood it prevents distributions until asset value has been generated in excess of all existing liabilities in addition to legal capital. From this perspective, we must also ask: how do applicable accounting standards on the recognition of liabilities protect adjusting and non-adjusting creditors when incorporated into the distribution tests? For the accumulated net profits test the relevant question is: how do applicable accounting standards on the recognition of realised profits and losses protect adjusting and non-adjusting creditors when incorporated into the distribution test? The next section sets forth how non-adjusting involuntary creditors may benefit from distribution rules that rely on accounting-based tests.

Protection for involuntary creditors through distribution regulation

There are two ways in which, in theory, the regulation of the distribution of company assets to shareholders could protect the interests of involuntary creditors. The first type of protection relates to those individuals who have already become involuntary creditors. Here regulation can *increase* the likelihood that involuntary creditors will be compensated in full and incentivise the company to compensate the claimant quickly. The second type of protection involves disincentivising investment decisions that produce involuntary creditors or incentivising the taking of appropriate safety precautions in relation to such investments to prevent injury. Here the *constituency* of involuntary creditors is protected by reducing the probability that one of us will become an involuntary creditor. Existing UK distribution regulation provides protections for involuntary creditors in both of these respects.

Protecting existing creditors If any amounts *actually* or *potentially* owed by the company to involuntary creditors either decreases net assets or increases accumulated realised losses, the extent to which the company may make a distribution will be reduced by the amount of the relevant involuntary creditor liability or loss entry. Whether this affects the ability of the company to make the distribution it wishes to make will depend on the size of the liability or loss entry and the value of existing assets and accumulated realised profits.

Pursuant to UK generally accepted accounting principles (UK GAAP) and international accounting standards (IAS), a company's financial statements in both the balance sheet and through the profit and loss account must take account of potential as well as actual liabilities. Currently the probability that a liability

[27] CA 2006 s.831, which applies only to public companies.
[28] CA 2006 s.830.

will have to be paid in the future determines how it is accounted for in the financial statements. Under current UK Financial Reporting Standards, as well as the applicable International Accounting Standards and International Financial Reporting Standards,[29] the treatment of a potential liability depends on whether it is dealt with as a *provision* or as a *contingent liability*, where a liability that must be provisioned is more probable than a contingent liability. If a liability is treated as a provision then the liability is reported on the balance sheet and flows through the profit and loss account. If the liability is deemed a contingent liability it is not recorded on the balance sheet or in the profit and loss account, however, a note to the financial statements will disclose information about such potential liability. The distribution rules note generally that provisions are to be taken account of in determining the amount of any distribution[30] and specifically that provisions are treated as liabilities for the purpose of the net assets test[31] and realised losses for the accumulated profits test.[32]

The UK accounting standard on provisions and contingent liabilities is set forth in Financial Reporting Standard 12, Provisions, Contingent Liabilities and Contingent Assets. FRS 12 mirrors International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets, which is applicable to the consolidated accounts of UK listed companies. According to FRS 12, a provision, which is defined as "a liability that is of uncertain timing and amount",[33] must be recognised[34] when: a company has a "present obligation" arising from a "past event"; it is more likely than not that "economic benefits" must be transferred by the company to settle the obligation[35]; and where a "reliable estimate" of the amount of the obligation can be made.

A present obligation includes both legal and constructive obligations. Legal obligations include those arising from contract, legislation or operation of law.[36] Constructive obligations may arise, among others, from a pattern of past practice or the creation of an expectation in third parties.[37] An involuntary creditor such as a person injured by company products or activities, with a product liability

[29] The standards issued by the International Accounting Standards Board (IASB) are International Financial Reporting Standards. The IASB has also adopted the standards issued by its predecessor the Board of International Accounting Standards Committee which are known as International Accounting Standards (IAS).

[30] CA 2006 s.836(1)(b).

[31] CA 2006 s.831(3).

[32] CA 2006 s.841(2).

[33] Financial Reporting Standard, Provisions, Contingent Liabilities and Contingent Assets (ASB, 1998), p.3, para.2. CA 1985 Sch.4 para.89 defines a provision as a liability that is likely to be incurred or certain to be incurred but uncertain as to amount. Regulations in this regard will be issued pursuant to s.396 of the CA 2006.

[34] Financial Reporting Standard, Provisions, Contingent Liabilities and Contingent Assets (1998), p.4.

[35] The probability standard in relation to the transfer of economic benefits test is defined as "the probability that the event will occur is greater that the probability that it will not" (FRS 12 para.23).

[36] FRS 12 para.2.

[37] FRS 12 para.2.

or tort claim, would be owed a *legal obligation* for the purposes of FRS 12. Clearly, in many instances, whether or not a company is liable for such person's injuries may be the subject of dispute. Any legal claim made by such person may well be subject to a vigorous defence by the company. In such contentious circumstances could one say that a "present obligation" is owed? FRS 12 addresses this issue directly[38] by using the example of a lawsuit.[39] In such circumstances a present obligation is owed where "taking account of all available evidence, *it is more likely than not* that a present obligation exists at the balance sheet date" [emphasis added].[40] FRS 12 notes that "available evidence" would include expert opinion regarding the likely outcome of the litigation. Accordingly, even where the company's litigation and public posture adamantly denies any responsibility to an involuntary creditor, as far as the company's financial statements are concerned accounting standards force the company to take a more impartial view of its potential liability exposure.

The above example postulates a specific involuntary creditor who makes a claim against the company which the company refutes. However, a *present obligation* may arise from the company's past activities even where a specific person has not made a claim or has not even been identified at the time the financial statements are issued. In this regard FRS 12 notes that:

> "... [I]t is not necessary, however, to know the identity of the party to whom the obligation is owed—indeed the obligation may be to the public at large."[41]

Accordingly, providing all other conditions are satisfied, FRS 12 may force a company to take account of potential liabilities to involuntary creditors, even when those creditors themselves are not aware, at the time the financial statements are issued, that they have been injured or who is responsible for the injury. GlaxoSmithKline, for example, provisions for "unasserted claims" in relation to products that have a "history of claims". They calculate the required provision according to the *incurred but not reported* actuarial technique.[42]

The amount of the potential liability that must be recorded as a provision must be the best estimate that can be made, which FRS 12 defines as the:

> "... amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time".[43]

Accordingly, if the probability of a legal obligation and the probability of payment to settle that obligation are both greater than 50 per cent then the net assets of the company will be reduced by an amount equal to the best estimate of such

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[38] FRS 12 paras 15 and 16.
[39] FRS 12 para.16.
[40] FRS 12 para.15.
[41] FRS 12 para.20.
[42] Note 27 to GlaxoSmithKline 2006 Annual Report's financial statements, at *http://www.gsk.com/investors/reps06/annual-report-2006.pdf* [Accessed December 5, 2008].
[43] FRS 12 para.37.

payment. Such an amount will also be recorded as an expense in the company's profit and loss account, reducing any profit or increasing the loss in the current financial year. It is a realised loss for the purpose of calculating the distribution.[44] This is the case even in relation to those creditors who are yet to realise that they have been injured or yet to realise who is responsible.[45]

Currently, while the claims of involuntary creditors who have a "more probable than not" claim are taken directly into account by the financial statements, those potential involuntary creditor claims that fall below either of the 50 per cent thresholds receive only indirect acknowledgement through a disclosure note in the financial statements. These potential liabilities to these creditors do not reduce net assets or increase realised losses. However, recent reform proposals set forth in IASB Exposure Draft IAS 37, Provisions, Contingent Liabilities and Contingent Assets and the ASB's Financial Reporting Exposure Draft (FRED) 39 Provisions, Contingent Liabilities and Contingent Assets propose that even where the probability that economic benefits will have to be transferred to settle the liability is less than 50 per cent, the liability should be recorded in the financial statements rather than, as is currently the case, being disclosed in the notes to the financial statements.[46] The IASB and ASB exposure drafts propose that the lower probability of payment will be incorporated in the amount of the recorded liability.[47] If such an approach is adopted by the IASB and the ASB both higher and lower probability creditors will receive recognition by the financial statements, increasing the scope for existing and potential involuntary creditor claims to decrease net assets and distributable profits.

UK and IASB Accounting Standards, therefore, require companies to account for claimants that have not successfully obtained an award of damages or even for persons who are not yet aware that they are claimants. By linking distribution rules to accounting standards the distribution rules are required to take account of involuntary creditors' interests. In instances where the size of the provision is considerable, or the existing net asset and accumulated realised profits position is weak, the involuntary creditor debt will prevent the distribution of funds out of the company.

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[44] CA 2006 s.841(2).

[45] One might argue that given the interpretative flexibility in relation to such accounting judgments that provisions are unlikely to reflect the true value of involuntary creditor claims. In theory the audit function should ensure that provisions reflect an objective and fair assessment of existing and potential liability. However, as this author has argued elsewhere, pressures on auditors to acquiesce to management's preferred accounting treatments may not be effectively counterbalanced by UK auditor independence regulation (D. Kershaw, "Waiting for Enron: The Unstable Equilibrium of Auditor Independence Regulation" (2006) 33 *Journal of Law and Society* 388). To the extent that auditors are not robust in their confrontations with management regarding provisioning the benefits of accounting-based distribution regulation for involuntary creditors are undermined. Importantly the regulatory failure here is in the regulation of the audit function.

[46] Exposure draft of proposed amendments to IAS 37, Provisions, Contingent Liabilities and Contingent Assets, paras 22–26.

[47] Exposure draft of proposed amendments to IAS 37 para.23.

The important question, however, is whether this link between the accounting rules on provisioning and distribution regulation actually protects involuntary creditors' interests by increasing the probability, or to the extent to which, they will be compensated. It is submitted that it does so in two distinct ways. First, where provisioning for the involuntary creditor liability results in a retention of funds, at least in the short to medium term, this reduces the probability of insolvency. While it is true that the company may not be able to identify and exploit profitable opportunities with these funds, and that any investment could be wasted, until the point in time where the invested funds generate losses in excess of the value of the investment, the company's assets available to settle the involuntary debt exceed what would have been available had the distribution taken place. Secondly, shareholders have incentives after the incurrence of debt, including involuntary debt, to alter the risk profile of their investments by making riskier investments thereby decreasing the value of existing debt and increasing the value of the equity investment.[48] While managers may not share the same incentives as shareholders in this regard, as Armour points out, the extent to which executive compensation arrangements improve the alignment of managerial and shareholder interests, the incentives for managers to expropriate value from debtholders also increases.[49] These incentives to expropriate value increase as the funds the shareholders have invested in a company decrease, as they have less to lose and more to gain from riskier investments.[50] As the value of their shares necessarily decreases by the amount of any received distribution, the extent to

[48] Armour, "Share Capital and Creditor Protection" (2000) 63 M.L.R. 355, 360. Consider, for example, a company which has assets of £500 consisting of £250 of equity investment and a loan of £250 at a 10% interest rate. If it invests £500 in US treasury stock at a 10% annual return, at the end of one year there is 100% chance of a payment of £550. The expected value of both the equity and the debt would be £275. If, however, the company following receipt of the loan invests the funds in a risky project which has a 50% chance of a payment of £2,000 and a 50% of 0, the value of the debt decreases to £137.50 (50% of £275 plus 50% of 0). However, the value of the equity increases to £862.50 (50% of [£2,000–£275] plus 50% of 0). A similar example is set forth in J.H. Choper, J.C. Coffee and R.J. Gilson, *Cases and Materials on Corporations* (Aspen: 2004), p.220.

[49] Armour, "Share Capital and Creditor Protection" (2000) 63 M.L.R. 355, 360. The extent to which manager and shareholder interests are aligned appears to have improved markedly over the past decade. See M.J. Conyon and G.V. Sadler, "How Does US and UK CEO Pay Measure Up?" (2005), working paper on file with the author.

[50] Choper, Coffee and Gilson, *Cases and Materials on Corporations* (2004), drawing on the seminal work of Black and Scholes (F. Black and M. Scholes, "The Pricing of Options and Corporate Liabilities" (1973) 81 *Journal of Political Economy* 637), describe this incentive structure more formally in terms of option pricing theory, where shareholders are viewed as holders of an option to purchase the company from the debt holders when the option is in the money (the value of the company exceeds the value of the debt). They note that "option pricing theory provides that increasing the variability of the [value of the] underlying asset increases the value of the option". As the value of an option is never less than zero, a valuation of the option will ignore the negative value of probability outcomes that would value the underlying asset (in our case the value of the company) at less than the exercise price of the option. Therefore, although increased variability in company value may increase

which provisioning for involuntary creditor debt prevents a distribution or part thereof, it reduces the shareholders' incentives to expropriate value from *existing* involuntary creditors.

The effect of linking distribution rules to the company's financial statements only provides relative protection for involuntary creditors. However, this relative protection makes good sense. It does not prevent distributions per se; it only does so when the company enters the margins of accounting bad health. Some scholars rightly note that it is problematic to rely on accounting-based tests to determine the legitimacy of distributions as there may be considerable disparity between a company's real and accounting well being.[51] To deny involuntary creditors protection on these grounds would, however, be to deny them what sophisticated voluntary creditors choose to rely on. Financial covenants in the United Kingdom, for example, are often linked to accounting based targets.[52] Although direct distribution restrictions are more common in the United States than in the United Kingdom,[53] indirect distribution restrictions such as broadly defined accounting-based net worth provisions[54] are often included in UK debt contracts and have largely the same effect.[55] Commentators note correctly that such financial covenants make more sense when calibrated according to shareholder equity at the time the creditor enters into a relationship with the company rather than legal capital as provided by the current distribution rules.[56] Importantly,

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the range of negative as well as positive outcomes, the valuation of the shares can ignore the extent to which the negative outcomes fall below the exercise price (value of the company is less than the value of the debt). As risk is a function of the variance in an asset's expected return (see H. Hansmann and R. Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1991) *Yale Law Journal* 1879, 1882–1883) the option holder, in this case the shareholder, is incentivised to increase the risk profile of the asset, namely, the company's investments. Choper et al. note, however, that the option pricing analogy is qualified as shareholders actually have wealth tied up in the company that could be lost if the return on the investment is negative. It follows, therefore, that, "shareholders' incentives to act like option holders increases as the value of their [shares] decreases" (Choper et al., *Cases and Materials on Corporations* (2004), p.221).

[51] Interdisciplinary Group Report, "Reforming Capital" (2004) *European Business Law Review* 919, 938.

[52] D. Cirtron, "The Incidence of Accounting Based Covenants in UK Public Debt Contracts: An Empirical Analysis" (1995) 25 *Accounting and Business Research* 139 noting that 30% of analysed public debt contracts contained accounting-based covenants.

[53] C. Leuz, D. Deller and M. Stubenrath, "An International Comparison of Accounting Based Payout Restrictions in the United States, United Kingdom and Germany" (1998) 28 *Accounting and Business Research* 111, 115.

[54] Leuz et al. note that the accounting definition of net worth is "the aggregate of paid-up share capital, specific reserves (e.g. share premium, capital redemption) as well as the accumulated profit and loss account" (Leuz et al. "An International Comparison of Accounting Based Payout Restrictions in the United States, United Kingdom and Germany" (1998) 28 *Accounting and Business Research* 111, 120).

[55] Leuz et al., "An International Comparison of Accounting Based Payout Restrictions in the United States, United Kingdom and Germany" (1998) 28 *Accounting and Business Research* 111, 120.

[56] Armour, "Legal Capital" (2006) 7 *European Business Organization Law Review* 5, 16.

however, the protection that the accounting standards on provisioning provide for involuntary creditors is independent of whether the distribution restriction uses legal capital or shareholder equity/net worth at the date of the contract.

Protecting the constituency As is well known, one effect of limited liability is that when a rational company assesses the expected value[57] and the required return from an investment no account need be taken of possible losses in excess of the value of the company. To use Professor Leebron's example of a biotechnology investment:

> "... [I]f shareholders enjoy limited liability, there is no chance that the shares are worth less than zero—even though, for example, there may a 0.1% chance that a dangerous organism will escape causing extensive injury and legally triggering mammoth corporate liability."[58]

Such negative returns are externalised on to third parties unless such third parties take account of such costs in the terms on which they do business with the company. Adjusting creditors could, for example, increase their required return from the business relationship with the company to reflect the actual rather than the distorted risk and expected return of the company's investments. Involuntary creditors by definition, however, are not ex ante in a position to force the company and its shareholders to internalise the costs that are, or could be, imposed on them by the company's investments. If such externalities are realised the involuntary creditor bears these costs. This leads Hansmann and Kraakman to conclude that limited liability incentivises shareholders "to spend too little on precautions to avoid accidents" and "encourages overinvestment in hazardous industries".[59] Limited liability, therefore, increases the likelihood that company investment decisions will *produce* involuntary creditors and it increases the likelihood that business activities that have a high probability of producing involuntary creditors will take place through thinly capitalised limited liability companies. Hansmann and Kraakman note further that these:

> "... perverse incentives ... are exacerbated ... if [the shareholder] can withdraw her capital from the firm prior to the time when tort liability attaches".[60]

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[57] Leebron defines expected value as follows:

> "the expected future value of each outcome is the probability of each outcome multiplied by its value; the expected future value of the investment is the sum of all such expected values for each possible outcome" (D.W. Leebron, "Limited Liability, Tort Victims and Creditors" (1991) 91 *Columbia Law Review* 1565, 1570).

[58] Leebron, "Limited Liability, Tort Victims and Creditors" (1991) 91 *Columbia Law Review* 1565, 1571.

[59] Hansmann and Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1991) *Yale Law Journal* 1879, 1882–1883.

[60] Hansmann and Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1991) *Yale Law Journal* 1879, 1884.

If a shareholder can withdraw funds prior to the time liability attaches then, in making or directing the investment decision, the risk of losing any or all of the investment is diminished and the incentive to ignore possible costs externalised on to involuntary creditors is thereby increased. The current UK distribution rules, however, dampen these perverse incentives. By linking the distribution test to accounting rules that take account of involuntary creditor liabilities a considerable time before suit is brought and liability attaches, even in some cases before the claimant is aware they have been injured, the window of opportunity for shareholders to receive a return on their investment through a distribution is considerably attenuated and the incentives to make perverse investment decisions thereby reduced.[61] Accordingly, current distribution rules contribute to reducing the constituency of involuntary creditors by weakening the incentive to take investment decisions which do not take full account of the costs that may be imposed on non-consenting third parties.

The extent to which distribution regulation can weaken these incentives is a function of whether non-distribution mechanisms can be deployed to transfer company assets to the shareholders. Such mechanisms would include, for example, interest and principal payments, management fees or related party transactions whereby the prices paid for goods and services exceed their market value. Outside of ordinary course debt, however, there are some limits on the extent to which such transfers can be made effectively without risk of challenge. Corporate law, corporate insolvency law and accounting regulation all operate to place restraints on such transfers. Payments made for products, services or debt that greatly exceed market value in a thinly capitalised company that is technically insolvent[62]—as a result of the provision entry in the accounts—run the risk of being caught by the wrongful trading prohibition in s.214 of the Insolvency Act 1986 and in such a company may well be in breach of a director's duty of care[63] and the subjective duty to promote the success of the company.[64]

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[61] See C. Leuz, "The Role of Accrual Accounting in Restricting Dividends to Shareholders" (1998) 7 *European Accounting Review* 579, 580 making this argument. See W. Schoen, "The Future of Legal Capital" (2004) 5 *European Business Organization Law Review* 429, 447 suggesting a similar argument.

[62] Typically courts have applied a cash flow basis of insolvency under s.214 (See P. Davies, "Directors Creditor Regarding Duties" (2006) 7 *European Business Organization Law Review* 301). However, s.214(6) certainly could accommodate such behaviour in the context of a balance sheet insolvent company.

[63] CA 2006 s.174. See *Colin Gwyer & Associates Ltd v Palmer* [2002] EWHC 2748 (Ch). See also *MDA Investment Management Ltd (No.1), Re*; sub nom. *Whalley v Doney* [2003] EWHC 2277, relying on *Liquidator of West Mercia Safetywear Ltd v Dodd* [1988] 4 B.C.C. 30, where Park J. held that:

> "... [W]hen a company, whether technically insolvent or not, is in financial difficulties *to the extent that its creditors are at risk*, the duties which the directors owe to the company are extended so as to encompass the interests of the company's creditors as a whole, as well as those of the shareholders" [emphasis added].

[64] CA 2006 s.172.

Importantly, in a thinly capitalised company the probability of insolvent liquidation is high and the possibility of suit by a liquidator-controlled company significant. Accounting regulation requires broad disclosure about related party transactions pursuant to Financial Standard 8: *Related Party Disclosures*[65] that would enable the liquidator and affected involuntary creditors to identify suspect transactions. Furthermore, the incentive counterbalance provided by the current distribution rules receives support from s.423 of the Insolvency Act 1986 that allows an involuntary creditor, as the victim of the undervalue transaction,[66] or the liquidator to petition the court to restore the company's position to what it would have been had the undervalue transaction not taken place.[67] The petitioner must demonstrate that the transaction was intended to put assets beyond the reach of the involuntary creditor.[68] This provision is, arguably, particularly useful in relation to mechanisms such as excessive interest and other types of transfer pricing and management fees where the market value of the product or service is available using industry comparisons. To the extent that such payments can be presented as exorbitant they may be subject to ex post challenge. Accordingly, whilst these transfer mechanisms do undermine the incentive counterbalance provided by the United Kingdom's distribution rules, as there are limits on the effectiveness of such mechanisms the incentive counterbalance of UK distribution regulation continues to have traction. Existing distribution regulation, therefore, operates as a disincentive to corporate actions that produce involuntary creditors.

Assessing significance This article submits that the United Kingdom's current distribution rules provide regulatory benefits for involuntary creditors. However, the question remains whether these benefits are significant enough to be taken into account in the debate about the effectiveness and possible reform of the distribution rules. We have seen that in relation to *existing* involuntary creditors the protection is triggered only as the company approaches the margins of accounting good health and, when triggered, offers only a variable increase in the probability of being paid and a variable decrease in the probability that the existing value of the debt will be opportunistically expropriated. In relation to small claims against large companies this benefit is surely insignificant. As the size of the claim as a proportion of a company's net worth or accumulated profitability increases, the variable protection provided by the rules will also increase. In relation to the *constituency of involuntary creditors* we have seen that the extent to which current distribution rules counterbalance the incentives not to take full account of the potential costs an investment imposes on involuntary creditors varies as a function of: the net asset value of the company making the investment decision; and

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[65] Financial Reporting Standard, Related Party Disclosures (ASB, October 1995).

[66] Insolvency Act 1986 s.424(1)(c). Where the company is being wound up an involuntary creditor action would require leave of the court (s.424(1)(a)). The liquidator of the company can bring such an action pursuant to s.424(1)(b).

[67] Insolvency Act 1986 s.423(2)(a).

[68] Insolvency Act 1986 s.423(3)(a).

the availability and effectiveness of non-distribution mechanisms for transferring assets to shareholders.

In assessing the contemporary significance for involuntary creditors of these distribution rule effects account must be taken of alternative stand-alone protections that are in place and also those that law reform could put in place. For example, product liability insurance is taken out by most companies although there is no mandatory requirement to do so or to obtain a specified amount of coverage. Indeed in most instances insurance cover will satisfy the claim in full.[69] Only in instances where external cover is not taken or is inadequate or unavailable[70] will these regulatory benefits make a difference.

From a reform perspective, more effective protections of involuntary creditors' interests than those provided by distribution regulation can readily be envisaged.[71] Mandatory product liability insurance[72] with minimum coverage ratios depending on company turnover, or market capitalisation, or risk-based industry type would be one approach.[73] A no-fault state funded compensation system, such as provided in New Zealand,[74] would be a more comprehensive and radical option. Alternatively, involuntary creditors could be given priority over voluntary creditors in bankruptcy which would increase the extent to which existing involuntary creditors are compensated by insolvent companies and provide voluntary creditors with strong incentives to ensure that corporate actions did not produce involuntary creditors. It seems clear that such reform options would so outweigh the benefits distribution regulation provides for involuntary creditors as to render them insignificant. Importantly, however, there is no indication whatsoever that such reforms in the United Kingdom are being considered or that they are politically viable.[75] Theoretical but unrealistic protections do not trump erratic and variable but existing benefits.

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[69] Brian Cheffins, *Company Law* (1997), p.507.

[70] Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991), p.61 suggesting that insurance may not always be available for smaller companies.

[71] Professor Enriques and Macey argue, for example, that "society can find more efficient and less costly ways to protect involuntary creditors—such as piercing the veil of misbehaving close corporations" (L. Enriques and J. Macey, "Creditors versus Capital Formation: The Case Against The European Legal Capital Rules" (2001) 86 *Cornell Law Review* 1165, 1185).

[72] Easterbrook and Fischel, *The Economic Structure of Corporate Law* (1991), p.60.

[73] Involuntary creditors in the UK are provided with a degree of protection by the Third Party (Rights Against Insurers) Act 1930 which ensures that the insurance claim of an insolvent insured is transferred to the creditor to prevent other creditors having any claim to the insurance proceeds.

[74] See I. Campbell, *Compensation for Personal Injury in New Zealand: Its Rise and Fall* (Auckland: Auckland University Press, 1996). On whether this system is truly a no-fault system see C. Flood, "New Zealand's No-Fault Accident Compensation Scheme: Paradise or Panacea" (2000) 8 *University of Alberta Health Law Review* 3.

[75] Ferran, "Creditors' Interests and 'Core' Company Law" (1999) 20 *Company Lawyer* 314, 323 notes that:

> "... [T]the historical evidence of insolvency law reform in the United Kingdom suggests that proposals along these lines are unlikely to receive a favourable welcome."

In relation to the distribution rule effects which counterbalance limited liabilities' incentive to ignore costs imposed on involuntary creditors, we have seen that non-distribution mechanisms will enable well-advised parties to take some of the generated cash out of the company prior to injury, the victim's awareness of injury, or claim. Furthermore, even where the distribution rules coupled with the law of directors' duties, accounting disclosure standards and the regulation of undervalue transactions create foreseeable difficulties in this regard, the parties may still choose to make the investment. After all, at the time of the investment the involuntary creditor and the company's insolvent liquidation leading to s.214 and breach of duty claims and challenge to undervalue transactions are all mere probabilities. On the other hand, as a counterbalance to these skewed incentives distribution rule effects occupy an empty room. English law is wedded to a commitment to separate legal personality that provides no scope for piercing the veil to hold shareholders, even a 100 per cent shareholder, liable to involuntary creditors *because they are involuntary creditors*.[76] No mandatory regulatory mechanism, such as mandatory insurance or a priority in bankruptcy rule counteracts these skewed incentives.[77] Involuntary creditors as a constituency continue to get a poor deal from the regulatory settlement that enables business to be conducted through the corporate form.[78] Furthermore, this assessment of significance for involuntary creditors must be placed in the context of the significance of the distribution rules for adjusting creditors. How effective are these provisions in actually protecting adjusting creditors from credit default? The nature of the regulatory benefits themselves are identical to those identified above in relation to existing involuntary creditors: by limiting the ability of companies to distribute funds to shareholders they provide qualified reduced bankruptcy risk[79] and reduce the shareholders'/managers' incentives to expropriate value through excessive risk taking. As noted above, the extent of the benefit, and the price that adjusting creditors would be willing to pay for this benefit, varies according to the company's capitalisation. In contrast, the benefit for involuntary creditors varies as a function

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[76] *Adams v Cape Industries Plc* [1991] 1 All E.R. 929 CA (Civ Div).

[77] It would counteract these incentives by incentivising insurers or voluntary creditors, respectively, to monitor investment implications for the involuntary constituency. Of course they may, dependent on the corporate activity, be subject to external regulatory checks such as product and health and safety regulation. However, the costs of regulatory sanctions imposed on the company do not alter the fact that externalities below the value of the company can be ignored.

[78] Hertig and Kanda note that, "to date ... almost no specialized measures to protect involuntary creditors have been adopted anywhere". They offer the following explanation for "this lacuna":

> "since tort victims do not know they will become victims, they have little incentive to lobby for corporate law reform before they are injured. After injury, however, it may be too late to lobby for reform because their damages are fixed, and they can no longer benefit from a change in the law" (G. Hertig and H. Kanda, "Creditor Protection" in Kraakman et al. (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: OUP, 2004).

[79] Armour, "Share Capital and Creditor Protection" (2000) 63 M.L.R. 355, 367.

of the size of the claim relative to the company's accumulated net profit or net asset status. That is, for adjusting as well as for involuntary creditors the extent to which distribution regulation provides protection is a function of an external variable rendering those benefits erratic and uneven in application. As noted above, several scholars recognise that these adjusting creditor benefits are indeed variable in application and, accordingly, argue that the rules should either be default rules or left to private ordering to incorporate them into debt agreements.[80] This makes sense where creditors can adjust to make use of, and pay for, the rules only where they make a difference. But for involuntary creditors to abolish them is to remove any scope for their beneficial application. To make the rules default rules is to render their beneficial application dependent on the unconnected good fortune of adjusting creditor election.

The distortion driver

Distortion and the solvency solution

If distribution regulation protects only those creditors who can adjust to a company's actual legal capital and if, in practice, those adjusting creditors do not value distribution protection organised around the legal capital threshold then the case for reform is straightforward. If, however, as is submitted by the second part of this article, a case is made that the distribution rules provide variable but at times significant benefits for involuntary creditors then an alternative case for reform must be made. Although *not* accepting that distribution rules offer significant benefits for involuntary creditors, the Interdisciplinary Group's analysis of distribution regulation offers such an alternative case.[81]

Accounting regulators in promulgating accounting standards are concerned to ensure that accounting information produced by companies is, among others, reliable as well as relevant and useful for both shareholders in holding management to account and investors when considering whether to invest in or lend money to the company.[82] Accounting regulators may not have regard to the implications of those standards for the ability of companies to make distributions, yet, as we have seen, current distribution regulation is directly dependent upon those accounting standards. This can result in changes to accounting standards that generate more relevant, reliable and useful financial statements but which distort the application of distribution regulation. In the worst case this can inhibit solvent and successful companies from making distributions where such distributions would not threaten creditor interests. The distribution constraints placed upon such companies may increase their cost of capital because this results in them losing the community of

[80] Armour, "Share Capital and Creditor Protection" (2000) 63 M.L.R. 355, 378.

[81] Interdisciplinary Group Report, "Reforming Capital" (2004) 15 *European Business Law Review* 919.

[82] Accounting Standards Board, Statement of Principles for Financial Reporting (ASB, 1999).

investors who, for tax, liquidity or other reasons, require regular and predictable dividends.

The primary reason for this distortion is that the standard accounting practice of accrual accounting accounts for transactions not cash flows. Entries are made in the balance sheet and the profit and loss account at the time an obligation is incurred or an amount is agreed to be paid; this may differ significantly from the timing of cash outflows to satisfy those obligations or cash inflows to pay for products delivered or services rendered. Accordingly, companies may be required to recognise a liability or a loss entry that results in a weak financial position from the viewpoint of the financial statements even though at that point in time its cash flows and probable solvency are very healthy. The Interdisciplinary Group's primary example in this regard is the consequences of accounting for defined pension deficits under Financial Reporting Standard 17: Retirement Benefits. Under this Standard the company must recognise on its balance sheet defined benefit pension deficits calculated on an actuarial basis.[83] As has been widely reported,[84] many companies have recently found their pension funds to be in considerable deficit. The recognition of these liabilities has had a significant detrimental impact on many companies' balance sheets, in worst cases placing them in technical insolvency[85] with assets less than liabilities. These companies, however, may remain cash-strong and successful companies who would have no difficulty in paying debts today and as they arise in the foreseeable future. As creditors are concerned with being paid, regulations that prevent asset distributions to shareholders when this creditor concern is in no way jeopardised appear pernicious and require justification.[86]

According to the Interdisciplinary Group, the distortions generated are not justified by the benefits provided by existing distribution regulation, which they view as largely ineffective as a creditor protection device.[87] Consistent with Armour's position set forth above, the Interdisciplinary Group views the ability of creditors to rely on and adjust to the existing distribution rules in light of a company's legal capital as crucial to the rules having practical value.[88] The fact, therefore, that the available empirical evidence suggests that they are not in practice

[83] FRS 17: Retirement Benefits (ASB, 2000), para.37.

[84] "Pension deficits almost equal company profits", *Financial Times*, February 21, 2003.

[85] Interdisciplinary Group Report, "Reforming Capital" (2004) 15 *European Business Law Review* 919, 960.

[86] It is important to understand, however, that regardless of distribution regulation, FRS 17 may drive dividend reduction in cash flow positive companies where available funds are used to address the deficit. Other pressures encourage companies to clean up these deficits, for example, possible downgrades from credit rating agencies (see LEX, "A Pension Deficit Disorder", *Financial Times*, February 8, 2003). In many instances current distribution regulation may not, therefore, be a "but for" cause of the dividend reduction.

[87] Interdisciplinary Group Report, "Reforming Capital" (2004) 15 *European Business Law Review* 919, 931–933.

[88] Interdisciplinary Group Report, "Reforming Capital" (2004) 15 *European Business Law Review* 919, 932 noting that:

> "... [E]vidence to the [Company Law Review] was to the effect that little, if any, importance was attached by such creditors to debtors' actual levels of share capital".

"relied upon by creditors"[89] (and certainly not by involuntary creditors)[90] renders them of "insufficient value"[91] to justify the distribution distortions they generate. The Group argues that a creditor's "core" interest is in a company's solvency—its ability to satisfy the creditors' obligations.[92] Involuntary creditors' interests are, they note, "essentially a fair prospect of solvency".[93] The solution, therefore, is to disconnect distribution regulation from the financial statements.[94] The focus of regulation, they submit, should be on ensuring that companies have the flexibility to make distributions when the company's immediate and future solvency is not in question. Accordingly, a company should be permitted to make a distribution provided that directors can certify the solvency of the company for the foreseeable future:

> "The directors should be required to reach the view that *for the reasonably foreseeable future, taking account of the company's expected prospects in the ordinary course of business, it can reasonably be expected to meet its liabilities.*"[95]

If, however, as is argued in the second part of this article, existing distribution regulation provides certain protections for existing as well as the constituency of potential involuntary creditors, this assessment of the costs and the benefits of the existing rules is altered: do these identified benefits—particularly in light of the limited protection provided to involuntary creditors generally—justify the existing rules in spite of the identified distortions? At a minimum, the ease with which the Interdisciplinary Group moves from distortion to reform is problematised by these involuntary creditor benefits: if distortions are created from creditor protection rules that in practice do not benefit any creditors, then reform is imperative; but if some weak creditors such as involuntary creditors do benefit then we may be more hesitant in our acceptance of the case for reform; more demanding of the case that distortions are generated and that their consequences for UK companies are significant.

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[89] Interdisciplinary Group Report, "Reforming Capital" (2004) 15 *European Business Law Review* 919, 982.

[90] Interdisciplinary Group Report, "Reforming Capital" (2004) 15 *European Business Law Review* 919, 932 noting that "nor by definition do involuntary or casual creditors rely on the levels of capital maintained by the companies concerned" and fn.174 noting that "involuntary creditors ... do not rely on capital reserves".

[91] Interdisciplinary Group Report, "Reforming Capital" (2004) 15 *European Business Law Review* 919, 982.

[92] Interdisciplinary Group Report, "Reforming Capital" (2004) 15 *European Business Law Review* 919, 967.

[93] Interdisciplinary Group Report, "Reforming Capital" (2004) 15 *European Business Law Review* 919, fn.174.

[94] In reaching this solvency determination the Interdisciplinary Group recognise that regard will be had to the accounts; but whether a distribution can be made under this approach would no longer be dependent on the application of an accounting formula ("Reforming Capital" (2004) 15 *European Business Law Review* 919, 980).

[95] Interdisciplinary Group Report, "Reforming Capital" (2004) 15 *European Business Law Review* 919, 979.

There is, however, no obstacle placed in the path of the Interdisciplinary Group's cost–benefit analysis for reform if their solvency certification reform proposal provides equivalent protection for involuntary creditors as is provided currently under the existing regime. If that is the case, the distortions would be removed while the level of protection would be unaltered and involuntary creditors would be indifferent to reform.

Would a solvency test undermine current involuntary creditor protections?

From the perspective of the involuntary creditor constituency, the question is whether the adoption of such a solvency standard would detrimentally affect the protection which, it is argued above, is provided by the United Kingdom's current distribution rules. Consider a public pharmaceutical company with significant positive cash flow which is able to meet its debts when due and, subject to the problem set forth below, expects to meet these debts when due for the foreseeable future. This company is, however, aware that certain of its now withdrawn pregnancy healthcare products may cause congenital liver problems for the children whose mothers took the product during their pregnancy. However, those affected are unlikely to experience any symptoms until they reach puberty. These *long-tail* claims may well destroy the company when they are made in 10 to 15 years' time. Current provisioning rules would require that a provision is recorded on this year's balance sheet putting the company in technical insolvency and preventing any distribution. They do not, however, affect the company's current or medium-term ability to pay its debts. Would a solvency certification approach allow a dividend?

Consider for example, the recently introduced solvency-based test for capital reductions for private companies. Pursuant to s.641 of the Companies Act 2006, a private company may reduce its share capital[96] by passing a special resolution approving the reduction which is supported by a solvency statement made by all the directors to the effect that the company can pay its debts at the time of the statement and as they fall due over the following year.[97] In the context of the above hypothetical, it is clear that where the latent liability exposure would not have any affect on the company's cash flow or solvency for 10 to 15 years, a solvency approach for distributions which requires a short-term, fixed time solvency statement would allow a distribution where the current rules would not. The introduction of such a solvency approach for distribution regulation would, therefore, represent a deterioration in the protection provided to involuntary creditors by the current distribution rules. The Interdisciplinary Group, however, propose a broader *principles-based* time-frame that asks the directors to certify solvency in the *reasonably foreseeable future*. In theory, this would, along with the current distribution rules, restrict the distribution if a reasonable director would foresee no way of avoiding insolvency 10 or 15 years in the future.

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[96] Pursuant to CA 2006 s.610(4) for the purposes of the capital reduction procedures the "share premium" is treated as part of the "share capital".

[97] CA s.643.

The adoption of a principles-based approach to the time period to which the solvency certification applies increases the exposure that directors have to ex post sanction resulting from a court process brought by a liquidator (*as compared with* their exposure under a fixed time period certification): will the court, who will assess the legality of the dividend with the knowledge that the company has failed, take a more expansive view of what was reasonably foreseeable at the time of the dividend? Will the court judge reasonableness with the hindsight of failure? This potential exposure could lead directors to take a risk-averse position and refuse to give the solvency certification where there are possible and significant long-tail claims. In theory, this could render a solvency test more protective of involuntary creditors than the current rules (that require provisioning where the probability of payment is 50 per cent or more) if risk-averse directors refuse to pay dividends where the possibility of paying a future claim is less than 50 per cent.[98]

This incentive for directors to be conservative is, however, significantly mitigated in relation to long-tail claims by three factors. First, although there may be serious concerns about long-term solvency, it may, given the company's product line and research and development activity, be reasonable for a director to conclude that the company would be in a position to negotiate and settle future claims, even if at the time the claims are made in the future this turns out not to be the case. Such a solvency assessment is a business judgment and UK courts have typically treated such judgments deferentially.[99] Furthermore, a carefully crafted record supporting the assessment of reasonableness of the certification is likely to deter many a liquidator from deploying its limited funds on further litigation.

Secondly, directors making a distribution decision are faced with the immediate concern that unhappy shareholders may remove them versus a probability of future liability.[100] Similarly, directors who are shareholders may be swayed with the incentive of immediate funds versus probabilistic future liability. Importantly, in relation to unlawful dividends the present value of a director's future liability is less under a *reasonably foreseeable future* solvency-based test than it is under the current distribution rules. The reason for this is that if the distribution is illegal under the current distribution rules then director liability is effectively strict unless

[98] As a solvency-based test will take account of contingent liabilities within the specified time-frame (see CA 2006 s.643(2)), replacing the current rules with a solvency test will increase the protection for those potential involuntary creditors who have less than a 50% chance of receiving compensation (i.e. they represent contingent liabilities) because the current accounting rules on contingent liabilities mean that such claims do not reduce net assets or increase realised losses. Paradoxically, therefore, a solvency-based test will increase protection for those involuntary creditors less likely to be compensated and decrease it for those more likely to be compensated. If the approach in FRED 39 is brought into effect, this paradox will disappear. The author would like to thank Eva Micheler for assisting him in seeing this point.

[99] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] A.C. 821 PC (Aus).

[100] In this regard Professor Schoen notes that compared to a solvency standard relying on accounting-based tests "makes it easier for managers to refuse to make distributions to the shareholders in times of crisis": Schoen, The Future of Legal Capital" (2004) *European Business Organization Law Review* 429, 446.

made on the basis of inaccurate accounts which permitted the distribution and in relation to which the directors took reasonable care to secure their accurate preparation.[101] Under the existing rules, a director who makes an illegal dividend based on *accurate* accounts discounts his future liability, therefore, only by the probability of insolvency (resulting in the liquidator bringing an action on behalf of the company for breach of duty). A director who makes a dividend under a solvency-based approach *which he believes is illegal* discounts his future liability not only by the probability of insolvency but also by the probability that a plausible (although in the director's opinion false) argument that the solvency statement was reasonable will have either settlement value[102] or be accepted by the court.

Thirdly, the actual time-frame within which directors have to think about solvency under a *reasonably foreseeable future test* may be curtailed by the limitation periods applicable to any action that could be brought against the director in relation to an unlawful dividend. Any action based on breach of trust[103] would be subject to a six-year limitation period[104] unless it can be demonstrated that the directors acted fraudulently.[105] Actions based upon breach of duty of care are also subject to a six-year limitation period.[106] This period may be extended if it can be demonstrated that the company was not aware of the breach until a date subsequent to the unlawful dividend,[107] in which case it will be extended

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[101] *Kingston Cotton Mill Co (No.2), Re* [1896] 1 Ch. 331 Ch D; *Leeds Estate, Building and Investment Co v Shepherd* (1887) L.R. 36 Ch. D. 787 Ch D.

[102] Settlement value here means that the liquidator will accept less than the claimed amount without a court process as she is aware that there is some risk that the court will accept the "reasonableness" argument made by the director resulting in no award.

[103] See *Flitcroft's Case* (1882) L.R. 21 Ch. D. 519 CA suggesting that an action for unlawful dividend is based on breach of trust. Under the current distribution law, the basis for director liability is a conceptual blend of trust law and the duty of care. Whereas trust is the regularly articulated basis of authority the law contains an element of fault that belongs to the law of negligence. Under a solvency-based approach, the courts could continue to determine liability on a breach of trust basis: a dividend issued under an inaccurate solvency statement would be an unlawful dividend which would amount to a breach of trust. However, the solvency approach alters the logic of the liability analysis in a way that would suggest the basis of liability will become the duty of care alone. Under current distribution law a dividend that does not comply with the accumulated net profits tests and the net assets test *is* an unlawful dividend. The determination of whether or not the directors are at fault and, therefore, liable does not alter the fact the dividend is unlawful. That is, there is a breach of trust but liability may be waived for that breach if the director is not at fault. In contrast, under the solvency approach the existence of the directors' fault (i.e. the making of solvency statement when there were no reasonable grounds to make that statement) determines whether or not the dividend was unlawful. This may mean that breach of trust fades into the background as the basis of director liability under a solvency standard.

[104] Limitation Act 1980 s.21(3). See generally, the Court of Appeal's judgment in *Gwembe Valley Development Co Ltd v Koshy* [2003] EWCA Civ 1048.

[105] Limitation Act 1980 s.21(1)(a).

[106] Limitation Act 1980 s.2. See *Gwembe Valley* [2003] EWCA Civ 1048.

[107] Limitation Act 1980 s.14A(4).

to three years from that date. However, given that the board of the directors is the primary agent of the company and would have unanimously[108] approved of the solvency statement, it is unlikely that the company will benefit from this extension.[109] In relation to breach of duty, pursuant to s.32(2) of the Limitation Act 1980 the six-year period will not run if the directors are found to have deliberately concealed the breach, and they will be deemed to have deliberately concealed the breach if they *deliberately* breach the duty "in circumstances that are unlikely to be discovered for such time". While under the hypothetical case of the pregnancy healthcare drug the breach will certainly not be discovered for some time, the burden of demonstrating a *deliberate* breach is a very high one, that is unlikely to be fulfilled in a company that can make a plausible, even if *unreasonable*, long-term business case that the involuntary creditor obligations will be met. Arguably, therefore, the law of limitation periods reduces an open-ended "reasonably foreseeable future" solvency test to six years. Accordingly, a solvency test, whether based on *either* a fixed time period as in capital reductions under the Companies Act 2006 *or* based on solvency for the reasonably foreseeable future as proposed by the Interdisciplinary Group, could enable distributions to be made where there exist substantial long-tail claims that the current regime would prohibit. The constituency of involuntary creditors, were they capable of acting collectively, would, therefore, object to these reform proposals.

Conclusion

If the function of UK distribution regulation is to maintain the legal capital account as an undistributable reserve, then its natural constituency is the adjusting creditor. Recent commentary operating through this capital maintenance lens has demonstrated that if the function of distribution regulation is to protect adjusting creditors then it is ineffective and unnecessary: to the extent sophisticated creditors rely on such protections they could negotiate for them in the absence of mandatory provision. At best, such provisions should be optional: available for those who wish to opt in. However, the focus on legal capital circumvents a broader consideration of the beneficial effects of the distribution rules for involuntary creditors. Linking distribution regulation to company financial statements provides tailored and proportionate benefits for involuntary creditors which increase the probability that their claims will be satisfied and decreases the probability that they will become claimants in the first place. Replacing these rules with a solvency-based standard

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[108] The solvency statement under s.643 of the CA 2006, for example, requires that "each of the directors" makes the solvency statement.

[109] Considering the attribution of a state of mind to the company Jennifer Payne argues, interpreting *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 A.C. 500 PC (NZ), that:

> "... [I]n short where a state of mind needs to be attached to the company that state of mind needs to arise from a board resolution or the unanimous agreement of the shareholders": J. Payne, "Unjust Enrichment, Trusts and Recipient Liability for Unlawful Dividends" (2003) 119 *Law Quarterly Review* 583.

will provide a lower level of protection for involuntary creditors, particularly long-tail claimants.

None of this means that proposals to abolish existing rules and to replace them with a solvency test are mistaken. It may indeed be the case that the disadvantages of the existing rules could be so burdensome for UK companies that they outweigh the costs reform would impose on involuntary creditors. This article's submission is more modest: the consensus about reform has been reached without taking account of certain of distribution regulation's most important practical effects. The ordering category of "capital maintenance" has got in the way of a broader consideration of the regulation's effects and the distributional consequences of reform.

Walford v Miles in Japan: Lock-in and Lock-out Agreements in Sumitomo v UFJ

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Contract terms; Contractual negotiations; Enforcement; Interim injunctions; Japan; Measure of damages

On October 1, 2005, a merger in Japan culminated in the launch of the then world's largest financial group by assets.[1] In the background, a prolonged two-year legal battle was unfolding among three of Japan's "Big Four" banking groups over a lock-in agreement (i.e. an agreement to negotiate a contract in good faith with each other) and a lock-out agreement (i.e. an agreement excluding third parties from a contract negotiation). This article will outline the sequence of events, set out the legal issues involved, examine the decisions of the courts, and compare them with the decisions of the English courts in cases such as *Walford v Miles*.[2] The issues discussed include whether lock-in and lock-out agreements are binding and enforceable, in what circumstances an interim injunction may be obtained to restrain the breach of a lock-out agreement, what is the measure of damages for the breach of lock-in and lock-out agreements and the enforceability of a clause on break-up fees.

Sequence of events

On May 21, 2004, UFJ Holdings Inc (UFJ) (now part of the Mitsubishi UFJ Financial Group, MUFG) concluded a basic accord with Sumitomo Trust & Banking (Sumitomo) to sell their trust banking unit to Sumitomo. The basic accord contained a lock-in agreement and a lock-out agreement. In spite of those agreements, UFJ decided to open full merger talks with Mitsubishi Tokyo Financial Group (Mitsubishi) (now part of MUFJ) on July 14, 2004. Sumitomo

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[1] Mitsubishi UFJ Financial Group (MUFG) with total assets of about ¥190 trillion (then $1.6 trillion, €34 trillion), created by the merger of Mitsubishi Tokyo Financial Group and UFJ Holdings Inc.

[2] *Walford v Miles* [1992] 2 A.C. 128 HL.

contended that the lock-out agreement was legally binding and filed a motion for an interim injunction in a bid to prevent UFJ from including its trust banking unit in the merger negotiations with Mitsubishi. On August 30, 2004, the Supreme Court affirmed the lower court's decision to dismiss the motion. Sumitomo then filed a fresh lawsuit seeking an injunction as a final remedy restraining UFJ from negotiating with third parties until the end of June 2005.[3] Later, Sumitomo added a claim for damages for the breach of the lock-in and lock-out agreements. When the full merger between UFJ and Mitsubishi had taken place, Sumitomo dropped its demand for an injunction. As regards the remaining damages claim, the Tokyo District Court allowed no recovery on February 13, 2006. Sumitomo lodged an appeal. On November 21, 2006, the two sides accepted a settlement proposal of the Tokyo High Court. The timetable of those events with other relevant facts is as follows.[4]

Year 2004

- May 21: UFJ concluded a basic accord with Sumitomo with a view to selling their trust banking unit to the latter, which contained lock-in and lock-out agreements.
- July 14: UFJ opened full merger talks with Mitsubishi, scrapping the basic accord with Sumitomo.
- July 16: In a bid to prevent UFJ from including their trust banking unit in the merger talks with Mitsubishi, Sumitomo sought from the Tokyo District Court an interim injunction restraining UFJ from negotiating with third parties until the end of March 2006.
- July 27: Tokyo District Court granted an interim injunction.[5]
- August 11: The Tokyo High Court vacated the injunction.[6]
- August 13: UFJ and Mitsubishi concluded a basic accord on their merger.
- August 30: The Supreme Court affirmed the High Court's decision.[7]
- October 28: Sumitomo sought an injunction as a final remedy restraining UFJ from negotiating with third parties until the end of June 2005.

Year 2005

- February 18: UFJ and Mitsubishi concluded a final contract for merger.

[3] Though Sumitomo had failed in their motion for an interim injunction, they apparently thought that their case might be found more persuasive in the proceedings for a final remedy, which would be more extensive than the interlocutory proceedings for the interim injunction.
[4] It has been compiled based on the information from various newspaper reports as well as law reports.
[5] Reported in 1708 *Shoji Homu* 22. All law reports for the Japanese court decisions mentioned in this article are in Japanese.
[6] Reported in 1708 *Shoji Homu* 23.
[7] Reported in 58-6 *Minshu* 1763 (*Minshu* is the official law report dedicated to the decisions of the Supreme Court).

- March 7: Sumitomo added a claim for damages for the breach of the lock-in and lock-out agreements in the sum of ¥100 billion (then $850 million, €710 million), in case their demand for an injunction was rejected.
- September 12: The Tokyo District Court proposed a settlement whereby UFJ was to pay Sumitomo some ¥10 billion. Both sides turned down the proposal.
- September 28: In another attempt to mediate a settlement, the court proposed UFJ pay Sumitomo some ¥5 billion.
- October 1: UFJ and Mitsubishi merged to become MUFG.
- October 19: The other attempt of settlement failed. Around this time, Sumitomo decided to drop their demand for an injunction.

Year 2006

- February 13: The Tokyo District Court dismissed Sumitomo's damages claim.[8]
- February 24: Sumitomo appealed to the Tokyo High Court, reducing their damages claim to ¥10 billion.
- November 21: Sumitomo and MUFG accepted a settlement proposal by the Tokyo High Court, with MUFG agreeing to pay Sumitomo ¥2.5 billion (then $21.4 million, €16.6 million).

As apparent from the foregoing account, there were two cases involved: the first concerning an interim injunction and the second concerning an injunction and damages as final remedies. The first was concerned only with the lock-out agreement while the second with both the lock-in and lock-out agreements. Various issues involved in this series of events will be analysed in the remaining part of this article.

Whether the lock-in and lock-out agreements were legally binding

The preliminary issue which had to be determined before deciding whether there was a case for granting an interim injunction or awarding damages was whether the lock-in and lock-out agreements were legally binding.[9]

[8] Reported in 1928 *Hanrei Jiho* 3.

[9] The present article does not deal with the company law aspects of lock-in and lock-out agreements. But it should be noted that even if the content of those agreements is so unfair to one side that the representative director who has concluded them is in breach of his duty of good care (art.644 of the Civil Code (Japan)) to his company, it is not material to the enforceability of the agreements since the representative directors' power of representation is comprehensive in Japanese law (art.349(4)(5) of the Company Act (Japan)). It has been suggested though that if the other party knew or ought to have known the breach of the duty of good care, the agreements may be held unenforceable under the general principle of good faith (art.1(2) of the Civil Code): Michihito Iseda, "Validity of Deal Protection Provisions in M&A Agreements" (in Japanese) (2005) 47(2) *Kanazawa Law Review* 59, 87, 88.

The lock-out agreement

The lock-out agreement contained in the basic accord between Sumitomo and UFJ provided[10]:

> "Each party shall refrain from directly or indirectly entering into negotiations with third parties and/or supplying them with information concerning transactions which may conflict with the purposes of this accord."

The Supreme Court in the first case proceeded on the basis that this agreement was legally binding. The Tokyo District Court in the second case more expressly held that it was legally binding. The duration of the basic accord, and hence of the lock-out agreement contained therein, was between May 21, 2004 and the end of March 2006. But nothing in the decisions of the Supreme Court and the Tokyo District Court indicate that those courts considered it to be material whether the duration was specified.

The lock-in agreement

The basic accord between Sumitomo and UFJ contained the following terms[11]:

> "*Article 8(1)*
> Each party shall negotiate in good faith, conclude a basic agreement on the detailed terms of integration by the end of July 2004, and conclude a final agreement of integration as soon as practicable.
> *Article 12*
> Each party shall negotiate in good faith if questions arise as to the issues which are not dealt with in this accord or as to the provisions of this accord."

It was the agreement in art.8(1) which the Tokyo District Court in the second case held was legally binding. In so ruling, the court distinguished it from the agreement in art.12 and characterised it as something different from what it called a "comprehensive agreement to negotiate in good faith". The court's reasoning on this point is not totally clear but it would seem that a simple agreement to negotiate in good faith would not be sufficient to be legally binding. The court found that the agreement in art.8(1) purported to set in motion the preparations and negotiations to accomplish the planned integration, noting its complexity compared with simpler transactions such as a sale of a piece of property.

It may be noted that art.8(1) does indeed set a specific deadline for a particular intermediate stage of negotiations. Aside from that, however, it is not much more specific than art.12. In the following analysis, the agreement in art.8(1) will be referred to as the lock-in agreement.

[10] The original is in Japanese. The translation is by the present author.
[11] The original is in Japanese. The translation is by the present author.

Whether the agreements ceased to be legally binding by the material points in time

UFJ argued that even if the lock-in and lock-out agreements were legally binding when they were concluded, they had ceased to be so by the material points in time. The point in time material to the interim injunction was, in accordance with the principle of Japanese civil procedure, the final day of the hearing. The point in time material to the relief of damages was the day when UFJ scrapped the agreements to open full merger talks with Mitsubishi. The decisions of the courts will be examined below.

The Tokyo High Court in the first case

Accepting the UFJ's argument, the Tokyo High Court in the first case concluded that by the final day of the hearing (August 10, 2004), the lock-out agreement had ceased to be legally binding. It came to this conclusion, holding that the circumstances indicated that the relationships of trust between Sumitomo and UFJ had been destroyed by then and that they could no longer be expected to continue their negotiations to reach a final agreement. On this basis, the court refused to grant an interim injunction restraining the breach of the agreement.

The correctness of this ruling has been questioned.[12] A lock-out agreement would become meaningless if it ceased to be legally binding merely because the trusting relationships between the parties have been harmed since such a result would be inevitably brought about if either party has started negotiations with third parties, the very thing a lock-out agreement seeks to prevent.

The Supreme Court in the first case

On appeal, the Supreme Court held that in principle a lock-out agreement ceased to be legally binding when it could no longer reasonably be expected for a final agreement to be reached even if the parties kept on negotiating. The court did not clarify the legal basis of this principle. It is widely accepted, though not expressly provided in the Civil Code,[13] that a legal obligation is extinguished when its purpose has proven unattainable, as where a doctor's obligation to treat a patient is extinguished when the patient has died before receiving the treatment. This theory is probably the basis of the principle laid down by the Supreme Court, although the impossibility of attaining the purpose of a lock-out agreement is not as clear as the example of the dead patient.

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[12] Masaru Shintani, a commentary on the decision of the Supreme Court on August 30, 2004 (in Japanese) 1206 *Kinyu Shoji Hanrei* (The Financial and Business Law Precedents) 58, 60.

[13] The Japanese Civil Code provides for a number of ways in which a legal obligation is extinguished, such as performance (art.474 et seq.), set off (art.505 et seq.) and novation (art.513 et seq.).

The court applied the principle to the present case and, unlike the High Court, found that the lock-out agreement remained legally binding. The Supreme Court admitted that the possibility of a final agreement being reached was now very low but found it still too early to conclude that no such possibility remained, noting the fluid circumstances surrounding the negotiations.

The Tokyo District Court in the second case

Unlike the first case, the second case was concerned with both the lock-in and lock-out agreements. UFJ argued that even if those agreements had been legally binding, they had ceased to be so on July 13, 2004: the day before they scrapped them to open full merger talks with Mitsubishi. Responding to this argument, the Tokyo District Court laid down the same principle as did the Supreme Court in the first case and applied it to both the lock-in and lock-out agreements. The court thus held that in principle those agreements ceased to be legally binding when it could no longer reasonably be expected for a final agreement to be reached even if the parties kept on negotiating.

The Tokyo District Court also came to the same conclusion as the Supreme Court as regards the application of the principle to the present case, though the relevant point in time when the binding effect had to be determined was different. It thus held that on the day UFJ scrapped the lock-in and lock-out agreements, they remained legally binding since it could not be concluded at that time that no possibility remained for a final agreement to be reached. In so finding, the Tokyo District Court gave a few more reasons than the Supreme Court which had, as seen above, just cited the fluidity of the circumstances surrounding the negotiations. Thus the Tokyo District Court refused to conclude that no possibility remained for a final agreement to be reached merely because UFJ had unilaterally terminated negotiations with Sumitomo. The court instead looked into the reason UFJ turned to Mitsubishi. Noting that UFJ had thought only Mitsubishi would be able to save them from their worsening financial situation, the court held that UFJ should have explained their situation to Sumitomo and made an effort to obtain a better deal from them before turning to Mitsubishi: without making such an effort, UFJ could not be heard to say that no possibility remained for a final agreement to be reached with Sumitomo. We can glean from this reasoning how in the view of the court the lock-in agreement should operate in tandem with the lock-out agreement.

An interim injunction to enforce the lock-out agreement (in the first case)

As seen earlier in the sequence of events, an interim injunction was sought in the first case to enforce the lock-out agreement. It was granted by the Tokyo District Court but vacated by the Tokyo High Court. An appeal from the Tokyo High Court was dismissed by the Supreme Court. The denial of an interim injunction effectively cleared the way for UFJ and Mitsubishi to merge as illustrated by the fact that the merger had taken place before the hearing for an injunction as a final remedy had not been completed. It is precisely because such a development was feared that Sumitomo sought an injunction as an interim remedy in the first place.

Since an interim injunction may greatly harm the respondent's interests, to obtain one in Japan, the petitioner must make a prima facie case that the right sought to be preserved by the injunction exists and that it calls for preservation.[14] We will examine those two elements below.

Whether the right sought to be preserved exists

As we have seen above, the Supreme Court found that the lock-out agreement was legally binding and remained so on the final day of hearing. It meant that the court recognised as existing Sumitomo's right to demand exclusive negotiations, the right which Sumitomo sought to preserve by an injunction.

In the first case, Sumitomo did not plead the lock-in agreement. An interim injunction, even if granted, would not therefore have preserved the right to demand good-faith negotiations. It would have meant that UFJ could have simply kept saying "No thanks" to deals with Sumitomo until the injunction expired and then restart talks with Mitsubishi. A petitioner seeking an interim injunction would therefore be well advised to plead lock-in as well as lock-out agreements unless he simply needs time to assess whether it is worth starting the negotiations with the respondent or unless the respondent cannot afford to wait for the expiry of the injunction to start negotiations with third parties.

Whether the right calls for preservation

To make a prima facie case that his right calls for preservation, the petitioner must demonstrate that he would suffer a considerable loss or face an imminent danger should the right not be preserved by an interim injunction.[15] In the present case, the Supreme Court found that Sumitomo failed to make this case.

In so finding, the Supreme Court gave three reasons: even if an injunction were granted, the chances were low for a final agreement to be reached between Sumitomo and UFJ; the extent of the loss Sumitomo would suffer from the denial of an injunction was such that it could be compensated for after it had materialised; the loss UFJ would suffer would be significant if they were restrained from negotiating with third parties for a long period until the end of March 2006 as demanded by Sumitomo. Three points may be worth making of those findings.

First, in estimating Sumitomo's loss, the Supreme Court distinguished two types of loss: the loss of the profit which Sumitomo would have earned if they had reached a final agreement with UFJ and the loss caused by the repudiation of their expectation that they would reach a final agreement with UFJ by keeping out third parties. The court held that the loss Sumitomo would suffer from the denial of an injunction was not equivalent to the first type of loss since the basic accord did not guarantee

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[14] Civil Preservation Act (Japan) art.13.

[15] Civil Preservation Act art.23(2).

that a final agreement was to be reached. The court found that it rather consisted of the second type of loss and observed that its extent was such that it could be compensated for afterwards. As will be examined below, the quantification of damages Sumitomo suffered after an injunction was denied was the principal subject of the second case and the way Sumitomo framed its claim in that case seemed influenced by the Supreme Court's view distinguishing the two types of loss.

Secondly, the Supreme Court took into account the extent of the loss UFJ would suffer if an injunction were granted. It had been disputed whether, in deciding whether to grant an interim injunction, regard may be had to the loss the respondent would suffer. The Supreme Court in the present case sided with the view of the majority of commentators and the lower courts in the previous cases. Others maintain that no regard should be had to the loss the respondent would suffer, saying that the loss to the respondent would be sufficiently taken care of by the security which the petitioner is required to provide by the discretion of the court.[16] It is interesting to observe that the Tokyo District Court which had granted an injunction earlier in the present case indeed ordered Sumitomo to provide security as a condition precedent to executing the injunction.[17]

Thirdly, in taking into account the loss UFJ would suffer, the Supreme Court noted the length of the period for which Sumitomo sought to restrain UFJ. It was for about one-and-a-half years. It does seem too long in today's fast-moving business environment. It has been suggested that the court could have granted an injunction reducing its length of period by discretion.[18]

Although in the present case, the Supreme Court found that Sumitomo failed to make their case, it should be noted that the court's ruling did not deny as a matter of principle that on appropriate facts an interim injunction might be granted to restrain the breach of a lock-out agreement.

Damages for the breach of lock-in and lock-out agreements (in the second case)

As seen earlier in the sequence of events, after the refusal of an injunction as an interim measure of protection (the first case), Sumitomo sought an injunction as a final remedy (the second case). As the merger talks between UFJ and Mitsubishi advanced, Sumitomo added a claim for damages for the breach of the lock-in and lock-out agreements. After the merger of UFJ and Mitsubishi, Sumitomo dropped the petition for an injunction, leaving the damages claim to be heard.

As we have seen above, the Tokyo District Court found that the lock-in and lock-out agreements were legally binding and remained so when UFJ scrapped them. They were therefore in breach of the agreements and were liable for damages. We will consider the measure of damages below. In Japanese law, damages for a breach of contract generally cover the loss which would in the ordinary course

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[16] Civil Preservation Act art.14.

[17] The ruling of Tokyo District Court on July 27, 2004.

[18] Shintani, a commentary on the decision of the Supreme Court on August 30, 2004 (in Japanese) 1206 *Kinyu Shoji Hanrei* (The Financial and Business Law Precedents) 58, 64.

of events arise from the breach[19] as well as the loss which has arisen in special circumstances to the extent the party in breach foresaw or could have foreseen the circumstances.[20] This two-limb remoteness rule should sound familiar to the common law readers since Japanese law took it from the English decision in *Hadeley v Baxendale*.[21] In Japan, this rule is often shortened to the expression that damages are recoverable for the loss reasonably attributable to the breach. This article will hereinafter use the latter expression.

The following analysis will consider what constitutes such loss in the context of breach of lock-in and lock-out agreements. Our main focus of examination is the ruling of the Tokyo District Court in the second case. But we will start with restating the view expressed by the Supreme Court in the first case which distinguished two types of loss.

The Supreme Court in the first case

It will be recalled that the Supreme Court held in the first case that the loss which Sumitomo suffered from UFJ's breach of the lock-out agreement was not equivalent to the loss of the profit which Sumitomo would have earned if they had reached a final agreement with UFJ. The court held that it rather consisted of the loss caused by the repudiation of Sumitomo's expectation that they would reach a final agreement with UFJ by keeping out third parties.

This view was expressed in the context of determining whether the case for obtaining an interim injunction had been made out. As such, it is strictly not binding on the lower courts as the test for determining the recoverable losses. But as will be seen below, it seems to have influenced the way Sumitomo framed their damages claim in the second case.

The Tokyo District Court in the second case

In the second case, the Tokyo District Court did not break down the types of loss as did the Supreme Court in the first case and simply reiterated the general principle that damages were recoverable for the loss reasonably attributable to breach. We will examine below the court's reasoning as to how it applied to the breach of lock-in and lock-out agreements. Our analysis will follow the order in which Sumitomo advanced its claim for damages with respect to three alternative counts of loss.

The loss of the profit which Sumitomo would have earned from a final agreement with UFJ As their primary claim, Sumitomo sought damages in the

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[19] Civil Code art.416(1).

[20] Civil Code art.416(2).

[21] *Hadeley v Baxendale* (1854) 156 E.R. 145 Ex Ct. The only other provision in the Japanese Civil Code which has its origin in English law is art.526, which provides that a contract is deemed to be concluded when an acceptance of an offer has been dispatched.

sums of ¥100 billion as a part of the total loss of the profit (some ¥233 billion in their estimate) which they would have earned if a final agreement had been reached with UFJ. Being aware of the view of the Supreme Court which distinguished the two types of loss, Sumitomo characterised this loss as representing the loss caused by the repudiation of their expectation that they would reach a final agreement with UFJ. To support that characterisation, Sumitomo argued that it would have been highly likely for a final agreement to be reached with UFJ if UFJ had adhered to the agreements. They also maintained that UFJ knew that if they violated the lock-in and lock-out agreements, a final agreement would not be reached and that Sumitomo would suffer the loss of profit. UFJ on their part contended that they would not be liable for more than the costs Sumitomo incurred in preparing the integration, which in their estimate would not exceed several hundred million yen.

The Tokyo District Court rejected Sumitomo's claim on the ground that the loss of profit was not reasonably attributable to the UFJ's breach. In so holding, the court observed that the chances for a final agreement to be reached were not high even if UFJ had adhered to the lock-in and lock-out agreements, noting that no specific terms of a final agreement had yet to emerge even among the persons in charge of the negotiations.

The loss of profit as multiplied by the likelihood in percentage terms of a final agreement being reached if UFJ had adhered to the lock-in and lock-out agreements Sumitomo alternatively claimed damages in the sums equivalent to the profit they would have earned had a final agreement been reached with UFJ as multiplied by the likelihood in percentage terms of the final agreement being reached if UFJ had adhered to the lock-in and lock-out agreements. This claim, too, was dismissed by the Tokyo District Court for not being reasonably attributable to the breach. The court noted that the profit which Sumitomo would have earned could not be envisaged since no specific terms of a final agreement had emerged.

The sum which the court finds reasonable as representing the loss of profit In yet another alternative claim, Sumitomo sought damages for the loss of profit requesting the court to quantify it in accordance with art.248 of the Code of Civil Procedure (Japan). It provides that the court may award damages in the sums it finds reasonable in the light of all the submissions made and the evidence taken in the hearing if it finds that a loss has resulted but that proving its amount is difficult due to its nature. Sumitomo made this submission again on the premise that the loss caused by the repudiation of their expectation that a final contract would be reached was represented by the loss of the profit which they would have earned from a final agreement.

The Tokyo District Court held that art.248 was not applicable in the present case and dismissed the claim. The court considered that this provision was only applicable in the cases where a loss had actually resulted. In this regard, the court repeated that Sumitomo did not suffer the loss of profit as a result of UFJ's breach of the lock-in and lock-out agreements. It also held that the task of proving the specific loss caused by the repudiation of their expectation would not be too difficult but fell short of indicating how to do it. Sumitomo would have leapfrogged Mitsubishi if it had acquired the trust banking unit of UFJ and have taken the position as the sector leader in Japan. It is hard to see that the specific loss caused by the repudiation of this expectation would not be difficult to prove.

Other losses In the end, the Tokyo District Court decided to award no damages on the ground that Sumitomo failed to properly plead and prove the loss reasonably attributable to the breach. They only based their pleadings on the loss of the profit they would have earned had a final agreement been concluded, which the court found were not legally attributable to UFJ's breach of the lock-in and lock-out agreements.

The decision can be explained by the general principle of the Japanese civil procedure under which each party has the responsibility of pleading and proving the facts which support their respective claims and defences. Some commentators questioned[22] the wisdom of the tactics Sumitomo took in pleading only the losses based on the profit they would have earned had a final agreement been concluded. In fact, according to a newspaper report,[23] in the preceding year, the court had proposed a settlement in the sum of some ¥5 billion, an amount far smaller than the loss claimed by Sumitomo.

Sumitomo framed their damages claim also in tort.[24] But it was also rejected since the remoteness rule for tort is the same as for the breach of contract in Japanese law.[25]

It should be noted that the court did not rule out as a matter of principle the recovery of the loss of the profit which would be earned if a final agreement had been concluded. It rather denied on the facts of the present case that the loss of profit was reasonably attributable to the breach of the lock-in and lock-out agreements. The material facts were that the likelihood of a final agreement being reached was not high and that no specific content of the final agreement had yet to emerge even among the persons in charge of negotiations. Having said this, it would be rare in practice for recovery to be allowed for the loss of profit in the cases of breach of lock-in and lock-out agreements since the precise quantification of the loss would be difficult without specific terms of a final agreement.

Appeal to the High Court and settlement

Sumitomo appealed to the High Court, reducing their damages claim to several billions of yen. UFJ, now having merged with Mitsubishi to become part of

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[22] e.g. Kazumasa Otsuka, a commentary on the present case (in Japanese) 659 (2006) *Ginko Homu* 56; Shuya Nomura, a commentary on the present case (in Japanese) 1780 *Kinyu Homu Jijo* 75, 78.

[23] The *Nikkei* newspaper, morning edition, October 8, 2005, p.1 (in Japanese).

[24] The Japanese tort law is modelled on the French system of a unitary concept of tort encompassing all kinds of losses, as opposed to the English model of applying diverse rules to different kinds of losses.

[25] e.g. the ruling of the Grand Court of Judicature (the Supreme Court in the pre-Second World War period) May 22, 1926 (5 *Daishin-in Minshu* 386).

MUFG, totally denied their liability. They argued that the lock-in and lock-out agreements had ceased to be binding when they repudiated them since turning to Mitsubishi was the only choice UFJ had to save themselves from their worsening financial position. MUFG were aware that their argument was not consistent with the Supreme Court's view expressed in the first case which acknowledged that UFJ would be liable for the loss caused by the repudiation of Sumitomo's expectation. But counsel for UFJ thought that a different decision might be taken in the second case as the proceedings would be more extensive than the interlocutory proceedings in the first case in which no witnesses had been examined.[26]

On the first date for oral arguments, the judge suggested that Sumitomo's claim was still exorbitant. It prompted Sumitomo to reduce their claim further to ¥10 billion as part of their estimated loss of ¥15 billion.[27] On the second date for oral arguments, Sumitomo explained that their estimated loss of ¥15 billion consisted, inter alia, of the loss caused by the repudiation of their expectation that a final agreement would be reached, consultancy fees and costs of creating a company to receive the trust banking unit of UFJ.

On November 21, 2006, the two sides finally put an end to their legal battle by accepting a court-mediated settlement in which MUFG agreed to pay to Sumitomo ¥2.5 billion, the sum suggested by the court. It is far less than Sumitomo's original claim for ¥100 billion and is equivalent to only 0.83 per cent of the estimated price of UFJ's trust banking unit. It is not clear what test the Tokyo High Court applied to come up with this figure. Sumitomo may have spent more in legal expenses but accepted the settlement to prevent the prolonged court battle from harming their corporate image. MUFG on their part concluded that the court's suggestion of a specific sum had made it easier for them to explain to their shareholders the benefit of settling the case.[28]

What losses are recoverable after all?

The settlement of the claim has left us with two indications from the courts to determine what losses are recoverable for the breach of lock-in and lock-out agreements.

Thus the Supreme Court's view was that the loss caused by the repudiation of the expectation that a final agreement would be reached would be recoverable while the loss of the profit which would be earned if a final agreement were concluded would not be recoverable. But this view was expressed in the context of determining whether the case for granting an interim injunction was made out. As such, it is strictly not binding with respect to the issue of what losses were recoverable for the breach of lock-in and lock-out agreements.

It was the Tokyo District Court which squarely faced that issue. The test pronounced by the court was none other than the general remoteness test, i.e. the

[26] The *Nikkei* newspaper, evening edition, November 28, 2006, p.5 (in Japanese).

[27] The *Nikkei* newspaper, evening edition, November 28, 2006, p.5. The *Nikkei* newspaper, morning edition, November 22, 2006, p.4 (in Japanese).

[28] The *Nikkei* newspaper, morning edition, November 22, 2006, p.4.

loss reasonably attributable to the breach is recoverable. Although the Supreme Court's view of bifurcating losses seems to have influenced the way Sumitomo framed their claim, it was not expressly adopted by the Tokyo District Court. But it will be rare in practice for recovery to be allowed of the loss of the profit which would be earned if a final agreement were concluded since the precise quantification of the loss will be difficult without specific terms of the final agreement.

Our main concern should therefore be the quantification of the loss caused by the repudiation of expectation. Some commentators suggest that it should increase on an incremental basis as the negotiations make progress towards a final agreement[29] since the expectation of both parties will be raised as they come closer to a final contract. On the other hand, the negotiating parties should know that their talks may end in failure until they have come to the point where the conclusion of a final contract is all but certain. It is submitted therefore that no damages should be awarded where the breach occurs at the early stage of negotiations. It may also be pointed out from a different angle that the loss caused by the repudiation of expectation will be greater in the cases where there are both lock-in and lock-out agreements than in the cases where there is only a lock-in agreement or a lock-out agreement because if the two agreements operate in tandem, the chances of reaching a final agreement will be greater.

A clause on break-up fees

The court battle between Sumitomo and UFJ was unusually bitter by Japanese standards. A lesson learnt by the Japanese companies from this saga is the importance of attaching a clause on break-up fees to lock-in and lock-out agreements. The agreements between Sumitomo and UFJ were not supported by such a clause, in line with the traditional practice in Japan. Negotiations for business integrations in Japan have scarcely been called off after a basic agreement has been concluded.[30] But an increasing shareholder activism in today's corporate climate means that company directors have to take a more aggressive stance than before to seek better deals. There is therefore a growing likelihood that lock-in or lock-out agreements are flouted. Inserting a clause on break-up fees in response to that tendency will be useful to safeguard legal certainty. Already in the present case, the basic accord between UFJ and Mitsubishi contained such a clause. It has been reported[31] that other firms have started to follow suit.

A clause on break-up fees will be generally enforceable since parties to a contract are allowed to set liquidated damages in Japanese law. The court may neither increase nor decrease the sum specified by the parties.[32] It has been held

[29] e.g. Masami Okino, a commentary on the present case (in Japanese) 1291 (2005) *Jurist* 68.

[30] The only reported case of that kind is the judgment of the Tokyo District Court on January 26, 2003 (1157 *Hanrei Times* 267).

[31] The *Nikkei* newspaper, morning edition, November 22, 2006, p.4.

[32] Civil Code art.420(1).

that this is so irrespective of the amount of actual loss caused by the breach.[33] Exceptionally, liquidated damages are outlawed or restricted in certain contracts such as employment contracts and some sorts of consumer contracts[34] to protect the parties of weaker bargaining power. Furthermore, if liquidated damages are considered to be excessive, the court may refuse to enforce it[35] on the ground of public policy.[36] A clause on break-up fees for lock-in or lock-out agreements may therefore be unenforceable if the amount set is considered excessive. But how much will be considered excessive remains to be seen. According to newspaper reports, in the basic accord between UFJ and Mitsubishi, the break-up fee was set at ¥210 billion, a sum equivalent to 30 per cent of the contract price. In other instances, break-up fees were set at three times the cost of preparation for integration.[37] Those sums will not be considered excessive unless the duration of exclusive negotiations under the lock-out agreements is disproportionately long.

Comparison with English law

Before concluding this article, we will compare and contrast the decisions of the Japanese courts in *Sumitomo v UFJ* with the English equivalent.

The enforceability of a lock-in agreement

The House of Lords in *Walford v Miles*[38] refused to imply a lock-in agreement from an express lock-out agreement, finding a lock-in agreement to be inherently inconsistent with the position of negotiating parties. Where there is an express lock-in agreement, the Court of Appeal in *Petromec Inc v Petroleo Brasileiro SA*[39] held in dicta that it was enforceable in certain circumstances such as where it was contained in an otherwise enforceable agreement and the loss for its breach was easily ascertainable. But the court admitted that whether the termination of any negotiations was brought about in good or bad faith would be difficult to say.

The Tokyo District Court seemed less hesitant to find a lock-in agreement enforceable. Although it denied effect to a simple agreement to negotiate in good faith, it gave effect to an agreement which purported to set in motion the preparations and negotiations to accomplish a complex deal. Behind this more sanguine attitude towards a lock-in agreement lies the general duty of good faith, although it should be noted that the courts in *Sumitomo v UFJ* did not rely on

[33] The ruling of the Grand Court of Judicature on July 26, 1922 (1 *Minshu* 431) ; the ruling of the Osaka District Court on November 16, 1962 (339 *Hanrei Jiho* 36).
[34] e.g. art.15 of the Labour Standards Act (Japan), arts 6 and 30(3) of the Instalment Sales Act (Japan) (the principal statute concerning consumer credit transactions).
[35] The ruling of the Grand Court of Judicature on March 14, 1944 (23 *Minshu* 147) ; the ruling of the Nagoya High Court on January 30, 1970 (21 *Kakyuu Minshu* 155).
[36] Civil Code art.90.
[37] The *Nikkei* newspaper, morning edition, November 22, 2006, p.4.
[38] *Walford v Miles* [1992] 2 A.C. 128 HL.
[39] *Petromec Inc v Petroleo Brasileiro SA* [2005] EWCA Civ 891.

it but on the specific duties arising out of the lock-in and lock-out agreements. The general duty of good faith is provided in art.1(2) of the Civil Code, which says that the rights must be exercised and the obligations be performed in good faith. This good-faith requirement permeates the Japanese contract law, unlike the English counterpart.[40] It is extended by the case law even to the pre-contract stage of negotiations.[41] The negotiating parties' basic freedom to advance their own interests is therefore restricted by the good-faith requirement even in the absence of a lock-in or lock-out agreement. Thus there is a case in which a dentist looking for premises for his clinic paid the seller of a condominium under construction a small amount of money and inquired about the power capacity of a room in it. The seller, without confirming with the dentist, changed the power capacity so that the room could be used as a dental clinic. Later, the dentist refused to buy the room as he was short of funds. He was held liable to pay damages, albeit in a reduced amount by virtue of contributory negligence, for the breach of the duty to negotiate with care, a duty which the court held stemmed from the requirement of good faith.[42] The legal basis of such liability is considered to be quasi-contractual since a contract has not yet come into existence and at the same time the parties are not totally strangers to each other.[43] Since a general duty of good faith exists at the pre-contractual stage of negotiation, it is a short step to affirm the enforceability of a lock-in agreement.

The enforceability of a lock-out agreement

The House of Lords in *Walford v Miles* held that lock-out agreements were unenforceable unless the duration was limited to a specified period of time. In a subsequent case, *Pitt v PHH Asset Management*,[44] the Court of Appeal held that a lock-out agreement confined to a period of 14 days was enforceable.

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[40] e.g. In *Walford v Miles* [1992] 2 A.C. 128 HL at 138, Lord Ackner said:

> "... [T]he concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations."

[41] Some academics have developed the notion of the pre-contractual duty of good faith further and suggested a theory under which the liability of negotiating parties increases incrementally as the negotiations make progress, though this theory has been attacked by others as it could lead to the inappropriate result that no contractual negotiations could be terminated without paying some amount of damages.

[42] The ruling of the Supreme Court on September 18, 1984 (1137 *Hanrei Jiho* 51).

[43] The characterisation of the claim as quasi-contractual as opposed to tort gives the claimant two benefits: first, the prescription period is 10 years (art.167 of the Civil Code), which is longer than the three-year period in tort claims (art.724 of the Civil Code); secondly, the burden of proving the negligence of the defendant is imposed on the defendant whereas it rests with the claimant in tort claims. With respect to the latter point, it must be noted that liability for the breach of contract is generally fault-based under Japanese law (in common with many civil law systems) unlike the common law systems under which strict liability is the norm.

[44] *Pitt v PHH Asset Management* [1994] 1 W.L.R. 327 CA (Civ Div).

As we have seen, the Japanese Supreme Court assumed, and the Tokyo District Court expressly held, that a lock-out agreement was legally binding. Neither court treated as material whether the duration of the agreement was limited. The concern of the Japanese courts was rather with the question whether the agreement remained binding at the material points in time. The Supreme Court held that it would cease to be binding when it could no longer reasonably be expected that a final agreement would be reached even if the parties kept on negotiating. The Tokyo District Court adopted the same test and further held that the state of mind of the repudiating party was not conclusive. But there remains uncertainty over the precise application of this test to individual cases.

It may be said that the Japanese decisions are better in that where parties have clearly manifested their intention to be bound by a lock-out agreement, effect will be given to it. On the other hand, the English decisions are better in that, where the lock-out agreement is not confined to a limited duration, the parties will not be left uncertain as to when they can start negotiating with third parties.

Assessment of damages

The Japanese courts in *Sumitomo v UFJ* found the lock-in and lock-out agreements enforceable while the House of Lords in *Walford v Miles* found the lock-out agreement unenforceable. Therefore, the basis of liability was contractual in *Sumitomo* whereas it was misrepresentation in *Walford*. The Japanese courts in *Sumitomo* thus purported to protect what in English law is called the expectation interest. The House of Lords in *Walford*, on the other hand, protected the reliance interest. It might then be thought the Japanese courts would award a greater measure of damages than the English courts. Damages awarded in *Walford* were indeed small: only the wasted expenses in the sum of £700 were awarded notwithstanding that the plaintiffs claimed £1 million on the basis that the business to be sold was worth £3 million and the expected price of the final contract was £2 million. But the sums suggested in the settlement proposals in *Sumitomo* by the Tokyo District Court and the Tokyo High Court were, as we have seen, by no means large relative to the size of the transaction.

This is, it is submitted, because the loss caused by the breach of a lock-out agreement would not amount to much beyond the cost of negotiations and because the specific loss reasonably attributable to the breach of a lock-in agreement is difficult to ascertain. Longmore L.J. in *Petromec Inc v Petroleo Brasileiro SA* acknowledged that it was impossible to assess any loss caused by the breach of a lock-in agreement since it could never be known whether good-faith negotiations would have produced an agreement at all or what the terms of any agreement would have been if it would have been reached. The Japanese courts in *Sumitomo v UFJ* also failed to produce clearer guidance than to suggest that the bulk of the recoverable damages was for the loss caused by the repudiation of the expectation that a final agreement would be reached.

Conclusion

Many legal systems will face difficult issues over lock-in and lock-out agreements. Different systems may take varying approaches but it is hoped that the analysis of the Japanese case of *Sumitomo v UFJ* in this article has offered readers something useful in considering the same issues under their own legal systems. The issues which may arise include whether and for how long lock-in and lock-out agreements are binding and enforceable, whether and under what circumstances an injunction, interim or final, may be granted to restrain the breach of those agreements, what is the measure of damages for the breach, and whether a clause on break-up fees for those agreements are enforceable. Comparative studies should be a useful exercise to develop theories to deal with those issues.

British Business Law

Consumer Sales and Credit Transactions

Editor: David Oughton

Consumer protection; Directives; EC law; Implementation; Misleading advertising; Unfair commercial practices

The end of an era—implementing the Unfair Commercial Practices Directive in the United Kingdom: punctual criminal law gives way to a general criminal/civil law standard

Introduction

The Unfair Commercial Practices Directive (Directive 2005/29)[1] marks a major shift in the regulation of advertising and marketing practices in the United Kingdom. It moves away from the traditional pattern of punctual criminal law standards and introduces general clauses and reliance on injunctions. Criminal law powers remain, but should be used less frequently because of a range of policy initiatives aimed at targeting enforcement on the worst offenders. Whether this will be the case in practice is discussed below. This article charts the choices made by the UK Government when implementing the Directive and discusses the likely impact of those changes. First, the landscape before implementation is described.

The United Kingdom is well known for its reliance on self-regulation in the advertising sector.[2] Even after the implementation of the Misleading Advertising Directive[3] self regulation rather than the use of injunctions remained the predominant method of dealing with complaints about advertising. Nevertheless, criminal laws have also played an important role, particularly where the practices are false or misleading. Trade descriptions prosecutions have regularly occupied our magistrates' courts. For example in 2004 local trading standards officers made

[1] Directive 2005/29 concerning unfair business-to-consumer commercial practices in the internal market and amending Directive 84/450, Directives 97/7, 98/27 and 2002/65 and Regulation 2006/2004 (Unfair Commercial Practices Directive) [2005] OJ L149/22.

[2] See Advertising Standards Authority (ASA) at *http://www.asa.org.uk/asa/* [Accessed December 8, 2008].

[3] Directive 84/450 relating to the approximation of the laws, regulations and administrative provisions of the Member States concerning misleading advertising [1984] OJ L250/17; see now [1997] OJ L290/18; implemented by Control of Misleading Advertisements Regulations 1988 (SI 1988/915).

4,692 prosecutions.[4] Many of these in the advertising area would be under the Trade Descriptions Act 1968 if they related to goods and services or Pt III of Consumer Protection Act 1987.[5] However, there were many more often very specific criminal laws, which had to be reviewed and in many cases repealed in the light of the Directive's maximal harmonisation approach and the Government's choice to repeal rather than amend this legislation. Many of these statutes were very technically drafted; one might even describe their structure as rather ugly. The Trade Descriptions Act 1968 is a good example of the rather technical form of much of this legislation. It also highlights another problem; namely that while most of these rules invoked strict liability (such as the provisions relating to goods), those concerning services required a mens rea of knowingly or recklessly making the statement. Even where there was strict liability, prosecutors were often faced with a due diligence defence that could be difficult to challenge; the criminal law's high burden of proof (beyond reasonable doubt) and strict canons of construction[6] also complicated matters. Moreover it has long been questioned whether the criminal law was the right way to deal with regulatory offences.[7] However, somehow it seemed to work. Probably because the bulk of the work was undertaken at low cost in the magistrates' courts where Trading Standards officers have the right of standing and the finer points of legislative interpretation and procedure would be only rarely taken when traders had the resources and motivation to instruct specialist lawyers.

Thus the move away from specific criminal laws offered by the Unfair Commercial Practices Directive was welcomed by many. The Office of Fair Trading (OFT) had long lobbied for a general duty to trade fairly[8] and the Government had noted that the omission of such a general clause was one obstacle to its claiming to lead the world in consumer protection.[9] This change has also come at an important stage in the reformulation of consumer protection enforcement policy. The Hampton Report had recommended increased emphasis be placed on advice and that enforcement be better targeted; although it did also recognise that some sanctions were not a sufficient deterrent.[10] Macrory proposes an overhaul of sanctions and enforcement policy for regulatory offences including a wider arsenal including monetary administrative penalties, statutory notices, enforceable undertakings and undertakings plus (a combination of an enforceable undertaking with an administrative financial penalty) with an emphasis also on restorative

[4] Source: CIPFA Trading Standards Statistics 2004 cited in Macrory, *Regulatory Justice: Making Sanctions Effective* at p.17, available at *http://www.berr.gov.uk/files/file44593.pdf* [Accessed December 8, 2008].

[5] See Howells and Weatherill, *Consumer Protection Law* (Ashgate, 2005), Ch.8, and in more detail Bragg, *Trade Descriptions* (OUP, 1991).

[6] A good example is *Link Stores Ltd v Harrow LBC* [2001] 1 W.L.R. 1479 QBD (Admin).

[7] Tench, *Towards a Middle System of Law* (Which?, 1981).

[8] See, for example, *A General Duty to Trade Fairly* (OFT, 1986).

[9] *Comparative Report on Consumer Policy Regimes* (DTI, 2003), p.33.

[10] Hampton, *Reducing administrative burdens: effective inspection and enforcement*, available at *http://www.berr.gov.uk/files/file22988.pdf* [Accessed December 8, 2008].

justice.[11] Local government enforcement has also been the subject of the Rogers Review, with fair trading being set as a national priority.[12] As regards legislative reform the work in the area of unfair commercial practices is seen as a forerunner of a broader simplification agenda in the consumer law field.[13]

Work on implementing the Directive began early and has been intensive. Academic reports were commissioned on the *Impact of Adopting a Duty to Trade Fairly*[14] and *An Analysis of the Application and Scope of the Unfair Commercial Practices Directive*.[15] Consultation papers were published in both 2005[16] and 2007.[17] Other material such as reports from various workshops can also be found on the department of Business, Enterprise and Regulatory Reform (BERR) webpages.[18] Despite or perhaps because of this detailed preparation the United Kingdom was late in implementing the Directive. The Consumer Protection from Unfair Trading Regulations and Business Protection from Misleading Marketing Regulations were laid before Parliament on March 3, 2008 and came into force on May 26, 2008.

Interpretation of Unfair Commercial Practices Directive

This article will look at three aspects of the implementation process—interpretation, simplification of the law and enforcement.

This is not the place to rehearse all the intricacies of the Directive.[19] However, it is worth reminding ourselves of the broad contours of the Directive. Practices

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[11] Macrory, *Regulatory Justice: Making Sanctions Effective*, available at *http://www.berr.gov.uk/files/file44593.pdf* [Accessed December 8, 2008]. See Regulatory Enforcement and Sanctions Act 2008.

[12] Rogers, *National enforcement priorities for local authority regulatory services*, available at *http://archive.cabinetoffice.gov.uk/rogersreview/upload/assets/rogersreview/rogers_review_2007.pdf* [Accessed December 8, 2008].

[13] BERR, *Simplification Plan 2007* at pp.13–14, available at *http://www.berr.gov.uk/files/file42767.pdf* [Accessed December 8, 2008].

[14] Available at *http://www.berr.gov.uk/consumers/buying-selling/ucp/Transposition/page29909.html* [Accessed December 8, 2008].

[15] Available at *http://www.berr.gov.uk/consumers/buying-selling/ucp/Transposition/page29909.html* [Accessed December 8, 2008].

[16] *The unfair commercial practices (UCP) directive: consultation implementing the EU directive on unfair commercial practices and amending existing consumer legislation*, available at *http://www.berr.gov.uk/consultations/page15310.html* [Accessed December 8, 2008].

[17] *Implementation of the Unfair Commercial Practices Directive: Consultation on the draft Consumer Protection from Unfair Trading Regulations 2007*, available at *http://www.berr.gov.uk/consultations/page39674.html* [Accessed December 8, 2008].

[18] *http://www.berr.gov.uk/consumers/buying-selling/ucp/Transposition/page29909.html* [Accessed December 8, 2008]

[19] See Howells, Micklitz and Wilhelmsson, *European Fair Trading Law* (Ashgate, 2006); Weatherill and Bernitz (eds), *The Regulation of Unfair Commercial Practices under EC Directive2005/29* (Hart, 2007); Stuyck, Terryn and Dyck, "Confidence through fairness? The new Directive on unfair business-to-consumer commercial practices in the internal market" (2006) 43 *Common Market Law Review* 107, and Collins (ed.), *The Forthcoming EC Directive on Unfair Commercial Practices* (Kluwer, 2004).

are unfair if contrary to the requirements of professional diligence they materially distort the economic behaviour of the average consumer[20] so that they appreciably impair the consumer's ability to make an informed decision and thereby cause him to take a transactional decision he would not otherwise have taken.[21] This is further refined to include misleading actions[22] and omissions[23] as well as aggressive practices.[24] There is also an annex of 31 practices considered unfair in all circumstances.

Some general comments can be made about this general structure from the UK perspective. Although academic commentators have made the point that the English legal system is used to general provisions and the values of fairness are increasingly influencing English law,[25] at least in the consumer law context; nevertheless, there has never been the sort of general duty to trade fairly found in many continental countries.[26] A general clause based on misleading conduct is familiar, but one using the abstract notion of unfairness was unknown to UK trade practices law, even if it is less demanding than a fairness standard that had at one time been floated in European circles.[27] The liability for misleading omissions is a new innovation and having a general provision through which to sanction aggressive practices is likely in practice to be one of the real steps forward in consumer protection brought about by the Directive. The specific provisions found in Annex 1 to the Directive often map on to existing rules, but are drafted in a more condensed form than is traditional in UK legislation.

One of the controversial features of the Directive was its reference to the average consumer which obviously keyed into a line of controversial European Court decisions.[28] Often one detects the court used the average consumer standard to attack national (usually German) laws that seemed more concerned to prevent competition. In fact the court has shown itself willing to accept legitimate consumer protection goals.[29] The Directive seeks to address concerns of the consumer movement by stating that when a commercial practice is directed to a particular

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[20] Unfair Commercial Practices Directive art.5.

[21] Unfair Commercial Practices Directive art.2(e).

[22] Unfair Commercial Practices Directive art.6.

[23] Unfair Commercial Practices Directive art.7.

[24] Unfair Commercial Practices Directive arts 8–9.

[25] Available at *http://www.berr.gov.uk/consumers/buying-selling/ucp/Transposition/page29909.html* [Accessed December 8, 2008].

[26] Schulze and Schulte-Nölke providing an *Analysis of National Fairness Laws Aimed at Protecting Consumers in Relation to Commercial Practices*, available at *http://europa.eu.int/comm/consumers/cons_int/safe_shop/fair_bus_pract/green_pap_comm/studies/unfair_practices_en.pdf* [Accessed December 9, 2008].

[27] Green Paper on European Union Consumer Protection (COM)2001 531 final.

[28] See, inter alia, *Verband Sozialer Wettbewerb eV v Clinique Laboratoires SNC et Estée Lauder Cosmetics GmbH* (C-315/92) [1994] E.C.R. I-317; *Estée Lauder Cosmetics GmbH & Co OHG v Lancaster Group GmbH* (C-220/98) [2000] E.C.R.I-117; *Gut Springenheide GmbH and RudolfTusky v Oberkreisdirekyto des Kreises Steinfurt—Amt für Lebensmittelüberwachung* (C-210/96) [1998] E.C.R. I-4657. For discussion see Radeidah, *Fair Trading in EC Law* (Europa, 2005).

[29] *R. Buet and Educational Business Services (EBS) v Ministère Public* (C-382/87) [1989] E.C.R. 1235; *Oosthoek's Uitgeversmaatschappij* (C-286/81) [1982] E.C.R. 4575.

group of consumers the standard is that of the average member of that group. More controversially this average member of the group standard applies to a general practice which the trader could reasonably be expected to have foreseen would particularly affect a clearly identifiable group of consumers who are particularly vulnerable to the practice or the underlying product because of their mental or physical infirmity, age or credulity. Although the reasonable foreseeability criterion and the need for the group to be clearly identifiable provide some protection for traders, it remains perplexing to see how the reference to credulity can be squared with the basic choice of an average consumer standard.

It remains unclear from the Directive whether these variations from the average consumer standard to take account of the group targeted or particular vulnerability apply to all provisions or just the general unfairness test. From the drafting of the legislation it would seem it only applies to the general unfairness test, but it is widely assumed that the Commission intended it to apply to all instances when the average consumer is mentioned. Indeed any other interpretation would simply force more reliance on to the general clause. This may have practical significance in the United Kingdom as mens rea is required for criminal prosecution under the general unfairness standard. One can anticipate this will be subject to litigation. At first the United Kingdom sought a way to emphasise that the average consumer should be interpreted in the same way throughout by using the phrase "typical consumer", which was defined by reference to this variable standard.[30] This was subsequently dropped after lobbying by industry who wanted the wording to stick more closely to the Directive, for fear that every practice would need to be judged from the perspective of the average member of a vulnerable group.[31] The Government also acceded to the request to have a definition of the average consumer. The Directive had no such definition, but Recital 18 took:

> "... as a benchmark the average consumer, who is reasonably well informed and reasonably observant and circumspect, taking into account social, cultural and linguistic factors as interpreted by the Court of Justice".

The Regulations, however, include only the first half of this quote, namely "his being reasonably well informed, reasonably observant and circumspect".[32] It is useful to include a definition, but the failure to include reference to social, cultural and linguistic factors—which had been lobbied for so hard at the European level by the consumer movement—can only be seen as evidence of effective business lobbying. However, any court that comes to interpret the provision will have to construe it so as to comply with the Directive's intention as evidenced by the Recitals.

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[30] See *Implementation of the Unfair Commercial Practices Directive: Consultation on the draft Consumer Protection from Unfair Trading Regulations 2007*, pp.14–15, available at *http://www.berr.gov.uk/consultations/page39674.html* [Accessed December 8, 2008].

[31] *Government Response to the Consultation on Draft Consumer Protection from Unfair Trading Regulations* available at *http://www.berr.gov.uk/consumers/buying-selling/ucp/Transposition/page29909.html* [Accessed December 9, 2008].

[32] Consumer Protection from Unfair Trading Regulations reg.2(2).

For the most part the Regulations adopt the increasingly common technique of simply copying out the Directive's provisions. The interesting questions arise as to how to deal with maximum harmonisation (section C) and enforcement (section D). However, a few points of interest might be noted. Commercial practice is defined to cover sale or supply both to or from consumers. The reference to "or from" (which is not in the Directive) is needed to cover situations where consumers are selling goods to a trader (for example a car as part of a part-exchange) or where a trader advertises to buy second-hand goods or antiques and the trader behave unfairly. Although the words "or from" are not included on the face of the Directive, commentators have argued the Directive should be understood to include these matters.[33] If the matter is outwith the Directive then Member States would be free to legislate on it although there may be debates about the constitutionality of including it in regulations made under secondary legislative powers intended to allow for compliance with EU obligations.

Also, the Government accepted it should refer to consumers in the plural in the definition of commercial practice as the Directive does. However, it was clear that it covered one-off events and referred to the rule in the Interpretation Act 1978 whereby the singular is to be interpreted as including the plural and vice versa (in the absence of a contrary intention).[34]

As noted above the ASA has played a long-established role in regulating advertising and this is intended to continue with reg.19(4) requiring enforcement authorities to have regard to the desirability of encouraging control of unfair commercial practices by such established means as it considers appropriate. The Government has said that ASA and Phone Pay Plus are appropriate codes. It has also noted the concerns expressed if the Banking Code is not deemed such an appropriate means and has stated the OFT intends to work to develop a mechanism for potential qualifying bodies to achieve established means status. This will most likely have two parts, requiring that the code both provides sufficient protection against the full range of unfair commercial practices and has an effective mechanism to deliver compliance.[35] The ASA would have preferred the approach of the Control of Misleading Advertisements Regulations 1988 under which the OFT could require those established means be used and given a reasonable opportunity to deal with the complaint.

Simplification

Given that the objective of having a general fairness clause was an ambition long held by enforcement authorities and the consumer movement, it is not surprising

[33] Wilhelmesson, "Scope of the Directive" in *European Fair Trading Law* (2006), p.55.

[34] *Government Response to the Consultation on Draft Consumer Protection from Unfair Trading Regulations* available at *http://www.berr.gov.uk/consumers/buying-selling/ucp/Transposition/page29909.html* [Accessed December 9, 2008].

[35] *Government Response to the Consultation on Draft Consumer Protection from Unfair Trading Regulations* available at *http://www.berr.gov.uk/consumers/buying-selling/ucp/Transposition/page29909.html* [Accessed December 9, 2008].

that the Unfair Commercial Practices Directive was warmly welcomed. As usual it seemed that Europe was able to deliver what could not be achieved in domestic consumer policy. The sting in the tail, however, was the maximal harmonisation provision,[36] which requires the removal of any provisions of national law which are more protective of the consumer within the scope of the Directive.[37] The present author has questioned the need and desirability for maximal harmonisation (in particular without a safeguard clause) and doubted whether it will bring about the benefits to the internal market that its advocates suggest.[38] This debate is now over in this context and has now moved to the field of contract law.[39] It is important that the new regime is made to work for the protection of consumers.

The Government has taken its maximal harmonisation duty seriously. In part this fits in with its simplification agenda which was set out in *Extending Competitive Markets: Empowered Consumers, Successful Business*[40] and in which the rationalisation of trade practices law is seen as a major step on which further reforms can be built.[41] The 2005 Consultation noted that two major reasons why the existing laws had to be amended were to ensure that prohibitions did not apply unless a transactional decision test was satisfied and to introduce amendments to prescriptive mandatory pre-contractual information requirements given that art.7 only allowed these where there was an invitation to purchase.[42] Following up on work done by academics,[43] the Consultation set out the options for dealing with a wide range of measures that were potentially affected[44] and provided a lengthy annex of measures not considered to be affected.[45] Of the legislation that was not

[36] In more detail, see Micklitz, "Minimum/Maximum Harmonisation and the Internal Market Clause" in *European Fair Trading Law* (2006).

[37] Of course several important issues such as matters of taste and decency lie outside the scope of the Directive.

[38] Howells, "The Rise of European Consumer Law—Whither National Consumer Law?" (2006) 28 *Sydney Law Review* 63.

[39] Green Paper on the Review of the Consumer Acquis COM(2006) 744 final. The Commission is now using the language of targeted maximal harmonisation in the contract law field. See now Proposal for a Consumer Rights Directive COM(2008) 614 final.

[40] *Extending Competitive Markets: Empowered Consumers, Successful Business* (DTI, 2004).

[41] BERR, *Simplification Plan 2007*, available at *http://www.berr.gov.uk/files/file42767.pdf* [Accessed December 8, 2008].

[42] See *The unfair commercial practices (UCP) directive: consultation implementing the EU directive on unfair commercial practices and amending existing consumer legislation*, p.57, available at *http://www.berr.gov.uk/consultations/page15310.html* [Accessed December 8, 2008].

[43] See *An Analysis of the Application and Scope of the Unfair Commercial Practices Directive*, available at *http://www.berr.gov.uk/consumers/buying-selling/ucp/Transposition/page29909.html* [Accessed December 8, 2008].

[44] See *The unfair commercial practices (UCP) directive: consultation implementing the EU directive on unfair commercial practices and amending existing consumer legislation*, Ch.12, available at *http://www.berr.gov.uk/consultations/page15310.html* [Accessed December 8, 2008].

[45] See *The unfair commercial practices (UCP) directive: consultation implementing the EU directive on unfair commercial practices and amending existing consumer legislation*, Annex

seen as only being marginally affected, the options were said to be the removal of specific provisions, possible creation of parallel regimes or the repeal of core provisions of domestic consumer law. In the end this last "clean slate" option was selected.[46] Of the 29 laws assessed in detail the Government has repealed provisions in 22 of them, believing the new Consumer Protection from Unfair Trading Regulations will provide similar or greater protection. The others were considered to fall outside the scope of the Directive or benefit from exclusions from maximal harmonisation, such as those for financial services or immovable property.

Given the maximal harmonisation approach, desire for simplification and the criticism of parallel regimes introduced in other areas of consumer law when implementing EC Directives,[47] the option of clearing the decks rather than making already patchwork and cumbersome legislation even more complicated was understandable. This consigns to history such foundations of UK consumer protection relating to marketing as the Trade Descriptions Act 1968 and Pt III of the Consumer Protection Act 1987, with the Code of Practice on Price Indications having a new status as mere guidance.

The new legislation needs to be tested and one suspects that, given the ways in which English lawyers and courts dissect legislation, there may be situations when the new regime is found wanting. Some interesting insights into the types of problems that might emerge can be gained from reading the notes of a workshop comparing enforcement under the new regime and the old laws.[48] The workshop looked at a limited number of case studies. One involved a false price indication on the front of a photo print processing envelope. The question was raised whether a misleading indication of discount would fall within art.6(1)(d) of the Directive. In addition groups looked at trade descriptions offences involving situations where consumers were falsely informed their property needed damp proofing and prize scams. Again a question was raised as to whether a prize would be considered a product, despite the existence of item 31 in Annex 1. The final case study was of using aggressive practices to sell beds to the elderly. This area of aggressive practices was thought to be one area where the new Regulations would bring a substantive improvement. However, some of the examples show the risk that not every unfair practice might be caught by the new regime.

A, available at *http://www.berr.gov.uk/consultations/page15310.html* [Accessed December 8, 2008].

[46] See *Implementation of the Unfair Commercial Practices Directive: Consultation on the draft Consumer Protection from Unfair Trading Regulations 2007*, pp.12–13, available at *http://www.berr.gov.uk/consultations/page39674.html* [Accessed December 8, 2008].

[47] See implementation of unfair terms in Unfair Terms in Consumer Contracts Regulations 1999 (SI 1999/2083), which has been subject to proposals for reform by the Law Commission in *Unfair Terms in Contacts,* Law Com.292, Scot Law Com.1999 (Cm.6464, 2005) and for consumer sales Consumer Protection—The Sale and Supply of Goods to Consumers Regulations 2002 (SI 2002/3045) amending existing legislation.

[48] Available at *http://www.berr.gov.uk/files/file32096.pdf* [Accessed December 9, 2008].

Enforcement

The pre-existing law had been largely enforced though criminal sanctions, with trade descriptions offences being regularly brought by trading standards officers in the magistrates' courts. Although criminal offences exist under the new regime and will continue to be used for some serious offences, one might anticipate the impact of Hampton,[49] the Enforcement Concordat[50] and the Regulators' Compliance Code[51] will be to place increased emphasis on the seeking of undertakings or injunctions. An important concern was that this might make it too expensive for local authorities to deliver justice if they had to use lawyers to bring action in the civil courts. BERR had proposed giving trading standards officers standing in the county courts so long as they have been properly trained, but this was opposed by the Association of District Judges and their view was endorsed by the Master of the Rolls. After consultation the Government hopes to overcome these objections and make a future amendment to Pt 8 of the Enterprise Act 2002 that contains the relevant powers on undertakings and injunctions. This will be very important to the practical impact of the new regime as Trading Standards officers are likely to continue to be the main enforcers. This will be essential if there is to be a move towards civil injunctions as the primary remedy. At a seminar held at the University of Manchester on June 6, 2008 entitled "Farewell Trade Descriptions Act 1968",[52] it became clear that Trading Standards officers had had very different experiences with injunctions and those that had encountered problems were intending to prefer to continue using their criminal powers. This will be an economic necessity if trading standards officers are not given rights of audience in the county court.

The injunction has, through the influence of European law, become a fixture of consumer protection in the United Kingdom. The logic of the new enforcement environment would suggest that civil law enforcement should be preferred to the criminal law in most instances. Some enforcement authorities have had good experiences using their civil powers, but it remains necessary to embed this change of culture. The powers are now found in Pt 8 of the Enterprise Act 2002 which implements the EU Injunctions Directive.[53] There are also specific injunction powers in some specific legislation that implemented earlier EU Directives that required injunctions be available.[54]

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[49] See Hampton, *Reducing administrative burdens: effective inspection and enforcement*, available at *http://www.berr.gov.uk/files/file22988.pdf* [Accessed December 8, 2008].

[50] For current position see *http://www.berr.gov.uk/whatwedo/bre/inspection-enforcement/implementing-principles/regulatory-compliance-code/enforcement/page46822.html* [Accessed December 9, 2008].

[51] Available at *http://www.berr.gov.uk/bre/inspection-enforcement/implementing-principles/regulatory-compliance-code/page44055.html* [Accessed December 9, 2008].

[52] To mark the retirement of Richard Bragg, whose book *Trade Descriptions* (OUP, 1991) was the most authoritative work on the old law.

[53] [1999] OJ L172/12.

[54] For example, Unfair Terms in Consumer Contracts Regulations 1999 (SI 1999/2083) reg.12.

The Government debated whether the new Regulations needed to have their own injunctions regime, but ultimately opted to include it as a community infringement under the Enterprise Act 2002. This Directive is added to the list of relevant EU Directives in Sch.13 to the 2002 Act and a new power is added to require defendants to provide proof of factual claims, as required by the Directive. This is a tidier solution, the only problem being that the collective harm requirement under the Enterprise Act 2002 is not found in the Unfair Commercial Practices Directive and so there might not be full implementation. The assumption is that this collective harm test is not a very high hurdle. The OFT guidance on Pt 8 of the Enterprise Act 2002 states at para.3.8:

> "**Collective interests of consumers**
> Part 8 is not a means of pursuing individual redress. It applies only to an infringement which harms the collective interests of consumers. It follows that the breach must affect, or have the potential to affect, consumers generally or a group of consumers. This must be established by the evidence gathered by the enforcer. The evidence must demonstrate how a particular infringement has, or may in the future have, an adverse effect upon consumers. It may include an assessment of the importance of the practice or provision in question or of the prevalence and likely impact of the infringement. Some isolated breaches may not be harmful to the collective interest of consumers. However, examples of individual consumer harm may be used as evidence. There is no obligation to establish a specific number of individual consumer complaints or incidents of infringement."

This seems to foresee that some isolated breaches will not harm the collective interest and so technically the Unfair Commercial Practices Directive, which does not have this limitation, might not be properly implemented. However, it will be rare that injunctions will be sought in practice in such isolated circumstances. Another interesting question is in relation to enforcement of reg.4, which prohibits code owners promoting unfair commercial practices in a code of conduct. There is no criminal offence relating to this and so presumably enforcement will be through injunctions, but as the Directive does not require this (art.10 merely encourages codes of conduct) there may be a question mark about this possibility.

Under the Enterprise Act 2002 there are a number of regulators in addition to the OFT and trading standards officers that can bring actions as well as the consumers association Which?. The Government was pressed by brand owners and those representing brand and intellectual property rights to give business standing to take injunctions out against copycat packaging. The Government decided not to extend standing to businesses, but will review this after three years.

The Regulations also include a number of criminal offences. The majority of these follow the traditional pattern in UK criminal law of adopting strict liability with a due diligence defence.[55] Strict liability offences are therefore introduced

[55] Cartwright, *Consumer Protection and the Criminal Law* (Cambridge University Press, 2001).

for misleading actions,[56] misleading omissions,[57] aggressive practices[58] and all bar two of the practices set out in Sch.1.[59] The two exceptions are those relating to advertorials[60] and exhortations to children.[61] Breach of the general unfairness clause is an offence[62] but not of strict liability; mens rea of knowingly or recklessly engaging in an unfair commercial practice is required. A practice engaged in without regard to whether it contravenes the requirement of professional diligence will be deemed reckless.[63]

Penalties for breach of consumer law are notoriously low. On summary conviction in the magistrates' court the fine can be up to the statutory maximum (£5,000) and on indictment in the crown court there can be a fine or imprisonment not exceeding two years or both. The lack of an imprisonment option in magistrates' court has been questioned and will be reviewed after three years.

Enforcement authorities (in England and Wales the OFT and Trading Standards authorities) are placed under a duty to enforce the Regulations.[64] This does not, however, mean they are placed under an obligation to take action against every breach. They can use their discretion, but they must not neglect their responsibilities.

There was much discussion about whether there should be a private right of action for damages.[65] This has been shelved, while the Law Commission look into the matter.[66] Such an action is nevertheless desirable. Even where individual damages are limited it can be important if combined with a class action procedure which is on the agenda of both the EU and UK governments.[67]

Conclusions

The Unfair Commercial Practices Directive was a bold piece of legislation combing a sweeping general clause with a maximal harmonisation approach. The United Kingdom has embraced this as part of an agenda for simplifying

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[56] Consumer Protection from Unfair Trading Regulations reg.9, except where this takes the form of a misleading commitment to comply with a code of conduct.

[57] Consumer Protection from Unfair Trading Regulations reg.10.

[58] Consumer Protection from Unfair Trading Regulations reg.11.

[59] Consumer Protection from Unfair Trading Regulations reg.12.

[60] Consumer Protection from Unfair Trading Regulations Sch.1 para.11.

[61] Consumer Protection from Unfair Trading Regulations Sch.2 para.28.

[62] Consumer Protection from Unfair Trading Regulations reg.8(2).

[63] Consumer Protection from Unfair Trading Regulations reg.8(2).

[64] Consumer Protection from Unfair Trading Regulations reg.19.

[65] Ireland has included such a right: see s.74 of the Irish Consumer Protection Act 2007.

[66] See Law Commission's Preliminary Advice, *A private right of redress for unfair commercial practices?* available at *http://www.lawcom.gov.uk/1197.htm* [Accessed December 9, 2008].

[67] See *Representative Actions in Consumer Protection Legislation* (Department of Trade and Industry, 2006), available at *www.berr.gov.uk/files/file31886.pdf* [Accessed December 9, 2008]. See also EU Green Paper on Consumer Collective Redress COM(2008) 794 final, available at *http://ec.europa.eu/consumers/redress_cons/greenpaper_en.pdf* [Accessed December 9, 2008].

consumer law. Only the future will tell whether the level of protection has been increased—although new powers to act against aggressive practices will undoubtedly be valuable. Whether a European approach is adopted that maintains the openness of the general provisions or fine distinctions are drawn in national litigation, as occurred under the Trade Descriptions Act, remains to be seen. Injunctions should play a major role in the future and it will be necessary for enforcers to have the means to enter the civil courts on a level playing field with the business community. This requires trading standards officers to be granted rights of audience and trained adequately or funding be provided for them to have legal representation. On such organisational matters is the effectiveness of the new law likely to rest just as much as its legal form and interpretation. A review is promised in three years and it will be important to see how this landmark change in consumer protection law has affected the ability to protect consumers in practice.

Geraint Howells[*]

Insurance
Editor: John R. Birds

Cayman Islands; Insured persons; Misrepresentation; Non-disclosure; Pre-existing condition; Private medical insurance

Non-disclosure and misrepresentation—insurance law in the Cayman Islands: David Robert Zeller v British Caymanian Insurance Co Ltd

Introduction

The decision of the Judicial Committee of the Privy Council in *Zeller v BCIC Ltd* was handed down on January 16, 2008.[1] The Privy Council found in favour of the appellant, an insured whose health insurance contract had been cancelled by the respondent insurer on the grounds of non-disclosure and misrepresentation.

While the decisions of the Privy Council and the dissenting judge in the Cayman Islands Court of Appeal are in line with "modern consumer insurance law"[2] in the United Kingdom and elsewhere, because of differences in the statutory control,

[*] Professor of Commercial Law, University of Manchester, and Barrister, Gough Square Chambers. Versions of this article have been presented at conferences organised by Dublin Centre for European Law and Istanbul Comparative Law Centre and SLS conference, as well as most importantly at Manchester University at a seminar to mark the retirement of Richard Bragg.

[1] *Zeller v BCIC Ltd* [2008] UKPC 4; [2008] Lloyds Rep. I.R. 545.

[2] See *Birds' Modern Insurance Law*, 7th edn (London: Sweet & Maxwell, 2007), p.16.

regulation and nature of the health insurance market in the Cayman Islands, the practical effect there may be less marked.

The second part below examines the facts of the case and the context of the litigation. The third part briefly considers the pre-existing legal position in the Cayman Islands and the English authorities which are of persuasive precedent in the Cayman Islands. The fourth part analyses why the majority of the Privy Council came to disagree with two of the three judges of the Court of Appeal and the trial judge. Finally, the last part discusses the impact and significance of the decision for the health insurance business in Cayman and perhaps other similar small jurisdictions.[3]

The case

The litigation in *Zeller* arose when the respondent insurer repudiated a claim and cancelled the appellant's health insurance policy. The history preceding the litigation is that in 2001, the appellant, Mr Zeller, moved to the Cayman Islands from the United States to take up employment there. As required by the Health Insurance Law[4] he sought health insurance cover, and at the invitation of his prospective employer he completed an application for health insurance issued by the respondent insurer. The application form was comprised of a number of questions related to the health and medical circumstances of the appellant (the Health Questionnaire). Of significance to the subsequent events and litigation, the appellant had not indicated that during a series of routine physical examinations from 1997 to 2001 his physician had indicated that he had elevated cholesterol and had noted, on one occasion in 1998, a heart murmur. In subsequent examinations prior to the application for health insurance, no murmur was detected and no medical diagnosis or treatment for the high cholesterol was prescribed; instead, recommendations to improve and maintain a healthy lifestyle were made by the physician.

As presented in the court judgments, the Health Questionnaire was divided into three sections. Section A, was prefaced by a direction:

> "Check each item Yes or No... To the best of your knowledge and belief, has any person named in this application had, within the last seven years, or does such person now have, any of the following?"

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[3] In the Caribbean alone a number of countries have legal systems based upon the English common law: Antigua and Barbuda; Bahamas; Barbados; Belize; Dominica; Grenada; Jamaica; Saint Kitts and Nevis; Saint Vincent and the Grenadines; Trinidad and Tobago; Anguilla; Bermuda; British Virgin Islands; Cayman Islands; Turks and Caicos; and Montserrat.

[4] 2005 Revision. This law mandates private health insurance cover for all employees. This is necessary as there is no state healthcare provision and is made feasible by the fact that the rate of unemployment is low: 3.8% in 2007 (a rise from 2.6% in 2006) (Cayman Chamber of Commerce Labour Force Survey 2007). Those without access to insurance owing to unemployment or other reasons may seek cover from the state insurer the Cayman Islands National Insurance Company, which was established for this purpose.

There followed a list of specified medical conditions (a) to (o), mostly described in technical language,[5] each with a box beside it in which to signify "Yes" or "No". Relevant to the case were items "(d) Goiter, thyroid trouble, diabetes", against which Mr Zeller signified Yes and wrote in "Thyroid", and for (k) "heart trouble, abnormal blood pressure (hypertension or hypotension), anaemia, rheumatic fever", Mr Zeller signified No.

Section B asked:

> "In addition to the conditions listed in Section A, to the best of your knowledge and belief, within the past five years, has any person named in this application. . .
>
> (a) Had a physical examination?
> (b) Excluding physical examinations, consulted a physician, health care provider, or other individual or facility for medical or surgical treatment, advice, or screening for any condition not listed in Section A?
> (c) Had any departure from good health not previously mentioned in any of the above questions for which treatment or advice may or may not have been sought?"

Mr Zeller answer Yes to (a) and No to both (b) and (c).

Finally, section C requested:

> "If you have checked 'Yes' to any part of Section A or Section B, please provide complete information on this Section and provide medical report. . ."

There followed a box with several columns. Under "Diagnosis and Treatment" the appellant entered "Thyroid (hypo)". He then gave the dates of treatment as from 1980 to the present. In the last column under "Physician's Name and Address or Hospital's Name and Address" he mistakenly entered the prescription for the medication prescribed for his thyroid condition.

Applicants were instructed to read carefully, sign and date the next section, which provided:

> "IT IS UNDERSTOOD AND AGREED THAT:
>
> (a) The coverage will become effective the first of the month following approval of the application by British Caymanian Insurance Co. Ltd. (hereafter 'Insurer') which reserves the right to reject or accept any enrollment application. Coverage provided by Insurer is not effective until receipt and approval of the application by Insurer. The coverage will become effective the first of the month following approval of the application by Insurer.
> (b) The statements and answers made herein are complete and correct to the best of my knowledge and belief. Should any statements or answers

[5] Examples were (a) "Cancer, tumor or other growth" and (f) "Substance abuse (drugs or alcohol dependency, abuse or addiction)".

contained in this application be untrue (if such statements are fraudulent or material to the acceptance of this application) then the contract(s) may be cancelled by the Insurer and their obligation shall consist only of the return of any subscription charges actually paid, less the amount of any benefits paid under the contract;

(c) The employee shall repay to the Insurer the amount of any payment made in error to the employee on behalf of the employee or any covered family member as the result of a claim.

(d) Upon presentation of the original or a photocopy of this signed questionnaire I authorize any medical, professional, hospital, clinic, other medical or medically related facility, governmental agency or other person or firm to provide the Insurer information including copies of records concerning advice, care or treatment provided to me and/or my dependents including without limitation, information related to mental illness or use of drugs or alcohol.

IMPORTANT: PLEASE VERIFY THAT ALL THE INFORMATION ON THIS APPLICATION IS PROVIDED. ALL INCOMPLETE APPLICATIONS WILL BE RETURNED TO THE APPLICANT FOR MORE INFORMATION, THIS WILL CAUSE A DELAY IN THE PROCESS OF ENROLLMENT."

The form concluded:

> "I hereby authorize my employer to deduct from my earnings, at such intervals as agreed upon, such amount needed to cover my contribution toward the premium charges for the coverage applied for. And I certify that all data furnished on the front and back of this form is true to the best of my knowledge" [*sic*].

The application was subsequently accepted as submitted and health insurance cover commenced and continued until 2003. During 2003, the appellant's physician in Cayman detected a large heart murmur and subsequently expensive heart surgery was required. The respondent insurer then sought to repudiate liability and cancel the policy on the basis of the appellant's non-disclosure and misrepresentation.

At first instance the Grand Court ruled in favour of the respondent, stating that the appellant was in breach of his duty to disclose material facts.[6] Of significance to the later appeals, it was held that it was not necessary for the insurer to ask a specific question for the information sought to be material and the appellant's belief that his heart and cholesterol conditions were not material was irrelevant. In addition, the Grand Court found the health insurance questionnaire to have been unambiguous.

In the Cayman Court of Appeal it was ruled by a majority of 2:1 that the insurance policy was avoidable for non-disclosure, confirming that as a contract

[6] *Zeller* [2004–05] C.I.L.R. 283.

uberrimae fidei the appellant was under a duty to disclose all that a reasonable man would have considered material, being disclosure of all that he ought to have realised was material and not what he did in fact realise was so. Two of the three judges concluded that the health questionnaire, completed by the insured when applying for insurance, clearly required the insured to disclose medical history not specifically asked about in the earlier questions, which may have been relevant to the insurer accepting the applicant as an insured.

The Privy Council allowed the appeal of Mr Zeller, essentially following the reasoning of the dissenting judgment of the Court of Appeal, that being that Zeller was found to have answered the insurer's questions completely and correctly to the best of his knowledge and belief. Consequently, the cancellation of insurance cover was ruled to be invalid.

Existing law

The position with respect to non-disclosure and misrepresentation in English law is fully developed although currently subject to a review by the Law Commission.[7] In the Cayman Islands English authorities are of persuasive precedent, and prior to the *Zeller* case, there was just one Cayman authority concerning non-disclosure in insurance law. *McLaughlin v American Home Assurance Co*[8] was a case primarily concerning proof of arson and a fraudulent insurance claim. The Cayman Court of Appeal confirmed obiter dicta that the test of materiality as laid down in the English authority *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd*[9] was applicable, although on the facts it was ruled that a previous fire at the premises that had caused damage, but for which an insurance claim had not been made, was not material since it would not have induced the making of the contract on the relevant terms.

A notable feature of the treatment of insurance contracts in the Cayman Islands and many other small Commonwealth jurisdictions is that there has been less statutory reform. For example there is no equivalent to the Misrepresentation Act 1967, comparatively less market conduct regulation of insurers, no insurance ombudsman or other dispute resolution mechanism, no effective self regulation[10] and no statutory control over policy terms.[11]

It is important to highlight these different statutory, regulatory and social contexts existing in England and the Cayman Islands before presenting an evaluation of the decisions. It is a moot point whether, when commenting upon the state of

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[7] "Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured", Consultation Paper 182 (2007).

[8] *McLaughlin v American Home Assurance Co* [1994–95] C.I.L.R. N-18 and [1996] C.I.L.R. N-6.

[9] *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] A.C. 501 HL.

[10] As in the UK, for example, the Statements of Practice issued by the Association of British Insurers, now replaced by the FSA's rules in the Insurance Conduct of Business (ICOB) sourcebook.

[11] As in the European Union, for example, Member States have implemented Directive 1993/13 on unfair terms in consumer contracts [1993] OJ L95/29.

law in Commonwealth jurisdictions with an English common law legal system, account should be taken of the lack of statutory reform and other extrajudicial developments to thereby distinguish English common law authorities. Put simply, in the event of statutory reform in the United Kingdom, for example the Misrepresentation Act, does the fact that no equivalent legislation has been adopted in a jurisdiction indicate that the legal development was unnecessary or undesirable? Or is the lack of reform explained by the other factors? In addition, the social context may differ; a prime example in this case is that in Cayman private health insurance is mandatory and there is no state health provision. Therefore there are more severe consequences for persons without cover.

Case analysis

The trial judge in *Zeller* had found both conditions, namely the heart murmur and the elevated cholesterol, when taken together with the thyroid condition that was disclosed, to have been material to the risk.[12] The judge rejected the argument on behalf of the appellant that he believed that his condition did not require any great medical attention, stating that, "[t]he authorities are clear. In order to exonerate the [appellant] there must be some reasonable grounds for the belief".[13] This stands in contrast to the English insurance law position whereby in the case of insurance contracts, because of s.20(5) of the Marine Insurance Act 1906,[14] there is no representation that there are reasonable grounds for any belief stated.[15] However, an equivalent to the Marine Insurance Act 1906 was not enacted in the Cayman Islands, and thus s.20(5) was not binding upon the trial judge.

The Court of Appeal of the Cayman Islands rejected, by majority, Zeller's appeal against the first instance decision. The reasoning of the majority ruling that was delivered by Forte J.A. rested upon the following:

Section B was designed to catch conditions not listed in Section A and having answered B(a) affirmatively, the appellant should have provided details.

Then, applying a test of reasonableness, the applicant had failed in his duty of disclosure as stated in *Joel v Law Union and Crown Insurance Co*[16]:

> "The disclosure must be of all you ought to have realized to be material, not of that only which you did in fact realize to be so."[17]

The majority of the court dismissed the significance of the wording in the health questionnaire requiring answers, "to the best of your knowledge and belief",

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[12] It was accepted that the respondent insurer would have declined cover to the appellant had the information been provided (*Zeller* [2004–05] C.I.L.R. 283 at [40]–[41]).

[13] *Zeller* [2004–05] C.I.L.R. 283 at [40]–[41].

[14] "A representation as to a matter of expectation or belief is true if it be made in good faith."

[15] *Economides v Commercial Union Assurance Plc* [1997] 3 All E.R. 636 CA (Civ Div).

[16] *Joel v Law Union and Crown Insurance Co* [1908] 2 K.B. 863 CA.

[17] *Joel* [1908] 2 K.B. 863 CA, per Fletcher-Moulton L.J. at 883–884. Note that the dissenting judge distinguished this case as inapplicable to modern consumer insurance cases, but the Privy Council applied the authority, quoting Fletcher Moulton L.J.:

finding that this was only used to address the fact that the forms were used to effect group policies whereby one party not being fully apprised of the health condition of all and other applicants. The majority presumed that a person is able to state factually his own health conditions and therefore the statement was inapplicable where answered on one's own behalf.

Finally, the court further dismissed the relevancy of the appellant's belief that his "heart murmur" and high cholesterol were not conditions of the type requiring inclusion in the questionnaire, as it was concluded that he was simply guilty of not declaring the details of his visits for physical examinations. This was factual rather than based upon opinion or belief and resulted in his application being incomplete, contrary to his declaration that, "[s]tatements and answers herein are complete and correct to the best of his knowledge and belief".

Thus the Court of Appeal's reasoning differed from that of the trial judge, thereby avoiding the authority that statements of belief do not have to be reasonably held, by treating the statement of completion to be the best of one's knowledge and belief, as a fact, that being the complete and correct completion of the application form, rather than the more subjective assessment of one's health and an evaluation of conditions as medical or otherwise.

Interestingly, Taylor J.A., the dissenting judge in the Court of Appeal, highlighted that the earlier heart murmur and raised cholesterol were not proven to have been underlying conditions of the poor health and necessary surgery of Mr Zeller in 2003.[18] He appeared to take account of the mandatory nature of health insurance in Cayman and of the resultant consequences and expectations of an insured. It was noted that Zeller had cover in the United States without qualification and accepted that he would not have moved to Cayman had he known of the restrictions on cover to be imposed by the insurer. His legal analysis comprised two aspects—first, an application of what is referred to as "modern consumer insurance law" and secondly a legal construction of the contract.

Modern consumer insurance law The authority for a consumer approach to insurance law emanates from a number of cases decided predominantly in Australia and more recently in the United Kingdom. This modern authority qualifies the rule that applicants have an obligation of disclosure going beyond the scope of an insurer's questions. In *Economides v Commercial Union Assurance Plc*[19] the majority of the court held that the test for misrepresentation was one of honesty for consumer insurance, thereby rejecting the notion that the insured must have reasonable grounds for the belief held. According to Taylor J.A. such "modern"

> "Thus the applicant is expected to exercise his judgment on what appears to him to be worth disclosing. He does not lose his cover if he fails to disclose a complaint which he thought to be trivial but which turns out later to be a symptom of some much more serious underlying condition."

The Privy Council concluded that upon the evidence presented, the appellant did have reasonable grounds for his belief as to his health as stated and the answers provided.

[18] This was not addressed by the other two judges.

[19] *Economides* [1997] 3 All E.R. 636 CA (Civ Div).

English authorities are of persuasive authority in Cayman. Furthermore, given that no statutory codification has yet occurred in the United Kingdom, the case authorities should carry influence without being distinguished owing to different social policies regarding consumers. He therefore distinguished *Joel*[20] as inapplicable to modern-day cases of "consumer insurance". He also made approving reference to a measure of self regulation in the UK insurance market in the form of the Statement of General Insurance Practice whereby insurers agreed to restrict their reliance on remedies for non-disclosure to cases where fraud has occurred.

Construction of the contract Taylor J.A. concluded that Section B of the health questionnaire was "somewhat puzzling",[21] and proceeded to conclude, first, that Section B(a) and (c) were construed as taking priority over (b). Thus it did not appear that Zeller was required to answer Yes to B(b) since that question was to be taken as only concerned with consultations not associated with physical examinations in B(a).

Secondly, as Section C called for a statement of diagnosis and treatment this suggested that Section B was only concerned with cases where there was some medically diagnosed illness, sickness or ailment. Thus, since elevated cholesterol and heart murmur are merely factors increasing the risk of development of a disease but not amounting to a disease, sickness, ailment or illness, in the mind of an ordinary applicant, the conditions were not caught. If the insurer wanted to know of such conditions that involved not diagnosed illness or sickness but merely an increased risk of such in the future, such information should have been sought by general questions which the insurer chose not to ask. The insurer had thus waived the requirement to disclose the findings of the physical examinations.

Finally, the application form and declaration did not provide for any obligation of disclosure beyond the completion of the form completely and correctly to the best of his knowledge and belief.[22]

The appeal to the Privy Council focused solely on non-disclosure, wherein the respondent relied upon *Brownlie v Campbell*,[23] *Bates v Hewitt* (1867)[24] and *Zurich General Accident and Liability Insurance Co Ltd v Morrison*[25] to argue that the duty of disclosure required all facts material to the risk to be disclosed and that was irrespective of whether the applicant reasonably or otherwise believed it to be so.

The Privy Council found that the statements made by the appellant were true to the best of his knowledge and belief and thus the insurer was not entitled to cancel the policy. The real question was whether the appellant honestly believed he

[20] *Joel* [1908] 2 K.B. 863 CA.

[21] Although it was seemingly unnecessary to formally construe the policy against the insurer on the basis of contra proferentem.

[22] Unlike the other judges, Taylor J.A. found that the questionnaire sought answers with respect to each person covered, and applications on behalf of dependents but not stranger colleagues.

[23] *Brownlie v Campbell* (1879–80) L.R. 5 App. Cas. 925 HL.

[24] *Bates v Hewitt* (1866–67) L.R. 2 Q.B. 595 QB.

[25] *Zurich General Accident and Liability Insurance Co Ltd v Morrison* [1942] 2 K.B. 53 KBD.

was answering questions truthfully. It was found that no one in Zeller's position would regard himself as suffering or having suffered from heart trouble, finding that "his heart had given him no trouble at all".

Therefore Section A was correctly and completely answered. As was Section B, in that the answer to B(a) was correct and therefore did not require an affirmative answer to B(b).

The state of health of the applicant was significant with regard to question B(c) whereby the court stated that the answer was correctly answered as "No" as the appellant genuinely did not know and honestly did not believe that the findings of his physical examinations amounted to a departure from good health. Indicative factors presented and accepted in the evidence were that, thyroidism and minor ailments apart, the appellant honestly believed he was and had been in excellent health. This was supported by the following accepted evidence: he had never taken any medication for either the heart murmur or the raised cholesterol level, nor been treated in any other way; there was no suggestion he had ever been off work for either condition; his doctor had given him a clean bill of health on his departure to Cayman; and his active lifestyle. Therefore question (c) did not call for an affirmative answer.

The only fault of Zeller related to Section C which called for an elaboration of any affirmative answer given in sections A and B and so, in this case, of Mr Zeller's thyroid condition and physical examination. His answers here were defective because although he provided details regarding the thyroid condition[26] no information was provided about the physical exams. The Privy Council ruled that the insurer had waived disclosure here however on the grounds that the insurer could have asked for a report and for disclosure of Mr Zeller's physician's name and address had it wanted it, Mr Zeller did not actually have a medical report to provide,[27] and the insurer was content to exclude cover for Mr Zeller's thyroid condition without further inquiry. The design of the application form and the insurer's review and actions upon receipt were seemingly important here. The Privy Council did not go as far as Taylor to rule that Section C did not encompass the findings of the physical examinations, owing to the conclusion that there was no medical condition, but instead found the insurer to have waived disclosure because the answer provided to the thyroid condition was obviously incomplete and yet no further inquiry came, which suggested that no reliance was being placed on the answers presented therein. The effect of the decisions is the same, however, and could easily be circumvented by redrafting the application forms.

Conclusion

Zeller stands for the proposition that insurers must carefully design application forms and questionnaires used to support underwriting but must also take seriously their role in the jurisdictions that place heavy reliance upon insurance products.

[26] In fact, he omitted to give his physician's name and address.

[27] His physician's notes, although later obtained, were not considered to constitute a medical report.

The decision itself is certainly welcome for the insured population in Cayman, but it will possibly have little effect in practice since the decision was founded essentially upon the construction of the health questionnaire in the application form. Without the enactment of provisions of the Marine Insurance Act 1906, or other statutory control in the Cayman Islands, insurers are free to amend their proposal forms in order to circumvent the decision. In particular, they may be designed to provide that all conditions, not just existing actual diagnosed illnesses, must be declared. The information to be disclosed could go beyond answers to questions asked and even beyond those facts that the applicant reasonably believed to be conditions about which the information was sought or material to the insurer, and thus many applicants could find themselves without cover and facing considerable medical costs. With respect to English law, the Privy Council has provided a persuasive authority, in the *Zeller* case, which may be regarded as confirming the authority of *Economides* in a situation where a proposal form, as is now common practice, limits the answering of questions to the best of the knowledge and belief of the proposer.

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Shipping Law
Editor: Paul Todd

Insurance; Registered owners; Salvage; Wrecks

The International Convention on the Removal of Wrecks 2007—a flawed instrument?

Introduction

The incidence of a wreck, whether caused by negligence, perils of the seas or some other cause, has always constituted the nightmare scenario for the seafarer. However, it is likely to constitute the prospect of a bonanza for the wrecker from land; in some more recent times, it has been the incubus for environmentalists. It is surprising that a wreck removal convention saw the light of day as late as 2007 when the Nairobi International Convention on the Removal of Wrecks (WRC 2007) was adopted after a very long period of gestation; indeed a review of national laws on wreck removal was carried out by IMCO's[1] Legal Committee in 1974/1975.

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[1] The International Maritime Consultative Committee, the precursor to the International Maritime Organisation (IMO).

The WRC 2007 is an unusual addition to the well-established liability quintet of conventions, namely the International Convention on Civil Liability for Oil Pollution Damage 1992,[2] the International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage 1992,[3] the International Convention on Liability and Compensation for Damage in Connection with the Carriage of Hazardous and Noxious Substances by Sea 1996,[4] the International Convention on Civil Liability for Bunker Oil Pollution Damage 2001[5] and the Protocol of 2003 to the International Convention of the Establishment of an International Fund for Compensation for Oil Pollution Damage 1992.[6] The objective of the Convention is to allow a state party to take proportionate and reasonable measures in accordance with the Convention in relation to the removal of a wreck posing a hazard in the Convention area, normally up to the limit of that state's exclusive economic zone, but not necessarily including internal or territorial waters, as will be discussed further below. The Convention provides an interesting definition of hazard to take into account the expected environmental impact; art.1(5) defines "hazard" as meaning:

> "... any condition or threat that (a) poses a danger or impediment to navigation; or (b) may reasonably be expected to result in major harmful consequences to the marine environment, or damage to the coastline or related interests of one or more States".

Besides the typical liability provisions modelled on CLC 1992 and Ch.II of the HNS 1996, the WRC 2007 imposes a number of obligations upon state parties, particularly arts 5, 6, 7, 8 and 9. It also imposes non-liability obligations upon the registered owner; for example, in art.9(2), in terms of which the "registered owner shall remove a wreck determined to constitute a hazard".

It is the view of the author, as will be elaborated in this article, that the international community has not been enterprising enough in the adoption of this instrument, as it is based largely on a model of conventions initiated in the 1960s, and which have very little to do with wreck removal.

The definition of "wreck"

An acceptable definition of "wreck" may be very hard to come by. The British Merchant Shipping Act 1995 in s.255 defines "wreck" as including "jetsam, flotsam, lagan and derelict found in or on the shores of the sea or any tidal waters".[7] This provision is the same as that contained in s.510 of the Merchant

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[2] CLC 1992 (consolidated text).

[3] Fund Convention 1992 (consolidated text).

[4] HNS 1996.

[5] Bunker Oil Pollution Damage Convention 2001.

[6] Supplementary IOPC Fund Protocol 2003.

[7] These terms were elaborately defined in the case *Cargo ex Schiller* (1877) 2 P.D. 145 CA at 148:

Shipping Act 1894. Earlier definitions were more restrictive; for example, Brice[8] refers to the *Termes de la Ley*[9] where it is stated:

> "'Wrecke' or 'varech' … is where a ship is perished on the sea, and no man escapeth alive out of the same, and the ship or the part of the ship so perished, or the goods of the ship came to the land of any lord, the lord shall have that as a wrecke of the sea. But if a man, or a dog or a cat, escape alive, so that the party to whom the goods belong, come within a year and a day, and prove the goods to be his, he shall have them againe…"

In *R. v Forty-Nine Casks of Brandy*,[10] the judge refers to *Blackstone's Commentaries'* statement that:

> "… [W]reck, or shipwrecks, legally 'wreccum maris', wreck of the sea, in legal understanding, is applied to such goods as after shipwreck, are by the sea cast upon the land".

A wider and more recent definition is the one provided by Dromgoole and Gaskell:

> "… wreck in a … wide sense, so as to encompass all property cast ashore or remaining at sea after a marine casualty, including the hull of the vessel, together with its fixtures and fittings and the contents of the vessel, including cargo and personal possession of passengers and crew".[11]

The WRC 2007, in para.4 of art.1, provides an even wider definition to include even a vessel in the reasonable expectation of becoming a wreck in the traditional sense:

> "'Wreck', following a maritime casualty, means:
>
> (a) a sunken or stranded ship; or
> (b) any part of a sunken or stranded ship, including any object that is or has been on board such a ship; or
> (c) any object that is lost at sea from a ship and that is stranded, sunken or adrift at sea; or

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"Flotsam, is where a ship is sunk or otherwise perished, and the goods float on the sea. Jetsam, is when the ship is in danger of being sunk, and to lighten the ship the goods are cast into the sea, and afterwards, notwithstanding, the ship perish. Lagan (*vel potius* ligan) is when the goods which are so cast into the sea, and afterwards the ship perishes, and such goods cast are so heavy that they sink to the bottom, and the mariners, to the intent to have them again, tie them to a buoy or cork, or such other thing that will not sink, so that they may find them again."

8 Brice, *Maritime Law of Salvage* (London: Sweet & Maxwell, 1999), para.4.35.

9 Said to originate around 1527.

10 *R. v Forty-Nine Casks of Brandy* (1836) 3 Hag. Adm. 257 Ct of Admiralty at 277 .

11 Dromgoole and Gaskell, "Interests in Wreck" in Palmer and McKendrick (eds), *Interests in Goods* (LLP, 1998), pp.141–204 at p.142.

(d) a ship that is about, or may reasonably be expected, to sink or to strand, where effective measures to assist the ship or property in danger are not already being taken."

Definition of ship

The WRC 2007 contains, in para.2 of art.1, a wide and almost all-inclusive definition of "ship", i.e. meaning:

> "... a seagoing vessel of any type whatsoever and includes hydrofoil boats, air-cushion vehicles, submersibles, floating craft and floating platforms, except when such platforms are on location engaged in the exploration, exploitation or production of seabed mineral resources".

First, the vessel must be sea-going, thereby ruling out a vessel which is exclusively river-going, as well as a vessel, without motive power of its own, utilised for the storage of oil. However, it would seem that the latter point is debatable, because in relation to "dumb" vessels, the situation is not completely clear, as evidenced by old cases relating to old merchant shipping legislation defining a "vessel" and including the requirement of "used in navigation": in *The St Machar*,[12] a collision case, it was held that a vessel, launched and water-borne, but incapable of self-propulsion is a vessel; in *The Mudlark*[13] it was held that a sea-going steel hopper barge was a "vessel" for the purpose of s.742 of the Merchant Shipping Act 1894; in *The Harlow*[14] it was held that barges fitted with rudders and not propelled by oars were "ships" for the purpose of s.742 of the MSA 1894; more recently in relation to the Merchant Shipping Act 1894, it has been held that a jet-ski used for fun was not a seagoing ship.[15] The WRC 2007 definition would include a seaplane but not a flying boat; it would include a submarine and a yacht but not a distressed aircraft. It would also probably include a jet-ski which is used for navigational purposes. During the drafting of the Convention a proposal had been made to include fixed platforms within this definition; this was eventually not included, one of the reasons given being that fixed platforms are not part of the Protection and Indemnity Club insurance system.[16]

The definition of "maritime casualty"

Paragraph 3 of art.1 of the WRC 2007 provides that "maritime casualty" means a collision of ships, stranding or other incident of navigation, or other occurrence on board a ship or external to it, resulting in material damage or imminent threat

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[12] *St Machar, The* (1939) 65 Ll. L. Rep. 119 IH.
[13] *Mudlark, The* [1911] P. 116 PDAD.
[14] *The Harlow* 15 Asp M.L.C. 498.
[15] *Steedman v Scofield* [1992] 2 Lloyd's Rep.163 QBD (Admlty).
[16] IMO documentation: LEG 91/3, February 16, 2006, Annex 3, p.1.

of material damage to a ship or its cargo. Quite surprisingly, in the definition of "casualty", no reference is made to environmental or third party damage or threat thereof; however, arts 7, 8 and 9 refer to "hazard" and that in turn is defined as:

> "... any condition or threat that: (a) poses a danger or impediment to navigation; or (b) may reasonably be expected to result in major harmful consequences to the *marine environment*, or damage to the coastline or related interests of one or more States".[17]

If there were only danger of damage to bunkers, particularly if owned by someone other than the registered shipowner, the question would arise whether the bunkers are part of the ship, and in this respect art.1(3) of the WRC 2007 does not provide any guidance.

Strict liability

The costs of locating, marking and removing the wrecks is imposed by way of strict liability on the registered owner in terms of art.10 of the WRC 2007, in the same way as strict liability for oil pollution damage is imposed on the shipowner in terms of CLC 1969. Previous convention wording is used in the WRC 2007 in art.1(8) to define the registered owner as:

> "... the person or persons registered as the owner of the ship or, in the absence of registration, the person or persons owning the ship at the time of the maritime casualty".

Moreover, it is further provided in the same paragraph that in the case of a ship owned by a state and operated by a company which in that state is registered as the operator of the ship, "'registered owner' shall mean such company". Similar wording is contained in art.1(4) of the Bunker Oil Pollution Convention 2001. Most of the defences provided in the CLC 1992 and the Bunker Oil Pollution Damage Convention 2001 are granted in the WRC 2007 to the owner; the registered owner can prove that the casualty that caused the wreck:

"... (a) resulted from an act of war, hostilities, civil war, insurrection, or a natural phenomenon of an exceptional, inevitable and irresistible character;
(b) was wholly caused by an act or omission done with intent to cause damage by a third party; or

> was wholly caused by the negligence or other wrongful act of any Government or other authority responsible for the maintenance of lights or other navigational aids in the exercise of that function".[18]

In contrast to the earlier conventions there is no primary defence of contributory negligence in the WRC 2007, and therefore the registered owner will not, at least

[17] See para.5 of art.1 of the WRC 2007 [emphasis added].
[18] WRC 2007 art.10 para.1.

initially, raise the defence of negligence of a state or state authority in the provision of a place of refuge. It may well be that art.10(4), in providing that "nothing ... shall prejudice any right of recourse against third parties", does not go far enough as to provide a cause of action against the state negligently providing a place of refuge.

A defence of state immunity in relation to warships, naval auxiliary or other ships operated on government non-commercial service, unless a state decides otherwise, is provided in art.4(2).[19] The term "ships operated on non-commercial service" is bound to raise difficulties when applied to a civilian ship engaged in an activity jointly with the armed forces. Such a problem arose in the different context of the Protection of Military Remains Act 1986,[20] which provides that a vessel was to be considered as having been in military service if "it was in service with, or being used for the purposes of, any of the armed forces of the United Kingdom". The facts as described by the Court of Appeal in *The Storaa*[21] were that the vessel with that name was sailing in military convoy, it was armed, and she was being used for the transportation of cargo for the Ministry of War Transport. She was under the control of the Royal Navy to a significant extent and had been involved in attempts to fight off enemy torpedo boats. It was held by the Court of Appeal in judicial review proceedings that the secretary of state had been wrong to decide that the vessel had not been sunk while "in military service".

Although, as in the earlier conventions, the defences available to the registered owner are substantially curtailed, the diplomatic conference did not go as far as to remove the natural phenomenon exception; however, the occasion for the use of that defence is unlikely to arise in practice as the natural phenomenon must have "an exceptional, inevitable and irresistible character".[22] In this day and age and taking into account the substantial advances in meteorology, it is difficult for a case to arise where the three requirements mentioned will be found all to exist; the wording used in the WRC 2007 makes it virtually impossible for a court to give effect to the exception where the damage has been caused by a storm whose approximate location and extent have been predicted.

Definition of "registered owner" and related issues

Following in the footsteps of CLC 1969, art.1(8) of the WRC 2007, as mentioned earlier, defines "registered owner" as:

> "... the person or persons registered as the owner of the ship or, in the absence of registration, the person or persons owning the ship at the time of the maritime casualty".

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[19] See further WRC 2007 art.4 paras 3 and 4.

[20] 1986 c.35. See also text above at fn.46.

[21] *R. (on the application of Fogg) v Secretary of State for Defence*; sub nom. *The Storaa* [2006] EWCA Civ 1270; [2006] 2 Lloyd's Rep. 576.

[22] WRC 2007 art.10(1).

The same paragraph goes on to say that:

> "... [I]n the case of a ship owned by a State and operated by a company which in that State is registered as the operator of the ship, 'registered owner' shall mean such company."

In terms of art.10 of the Convention, civil liability for costs of locating, marking and removing the wreck is imposed on the registered owner as defined in the Convention. One may note that in this respect the WRC follows the precedent of the CLC 1969 and its amendments in that the "operator" of the vessel is not allocated with civil liability as is the case in the Bunker Oil Pollution Damage Convention 2001. On the contrary, the latter Convention defines the responsible "shipowner" as meaning "the owner, including the registered owner, bareboat charterer, manager and operator of the ship". There is likely to be little doubt that the term that is susceptible to the most expansive interpretation is "operator" to the effect that it could include mortgagees in possession and salvors.[23] The latter would have been likely the parties most involved in the wreck removal, and their inclusion as potential defendants would have acted as a disincentive. It may be recalled that the final inclusion of "operators" as potential defendants in the final draft of the Bunker Oil Pollution Damage Convention was the cause of substantial debate at the Diplomatic Conference to that Convention in 2001 which was resolved on the basis of a non-binding resolution, extolling the virtues of a salvors' exemption, attached to the final convention.[24]

When it comes to matters other than civil liability, the position of operators changes in that in terms of the WRC 2007 the operator of a ship is singled out as the object, together with the master, of the obligation, to be enforced by the flag state, to report to the flag state the eventuality resulting in a wreck.[25] "Operator" is in turn interpreted in art.1(9) as meaning "the owner of the ship or any other organisation or a person such as the manager or bareboat charterer who has assumed the responsibility for operation of the ship from the owner and who, on assuming such responsibility, has agreed to take over all duties and responsibilities established under the International Safety Management Code, as amended".

Whereas salvors and others are excluded from art.10 liability as this liability is channelled onto the registered shipowner, the WRC 2007 does not exclude them from the possibility of civil liability outside the ambit of legislation implementing the said Convention. In this respect the WRC 2007 does not follow the CLC 1992 and HNS 1996 regimes which exclude the possibility of salvors and some others from civil liability "under this Convention or otherwise".[26]

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[23] G. Gauci and J. Pace, "The International Convention on Civil Liability for Bunker Oil Pollution Damage 2001" [2003] J.I.C.L. 104, 107.

[24] Gauci and Pace, "The International Convention on Civil Liability for Bunker Oil Pollution Damage 2001" [2003] J.I.C.L. 104, 108–109.

[25] WRC 2007 art.5.

[26] See CLC 1992 art.III(4); HNS Convention 1996 art.7(5).

The identity of the claimant

One of the objectives of the WRC 2007 as specified in art.2 thereof is that:

> "A State Party may take measures in accordance with this Convention in relation to the removal of a wreck which poses a hazard in a Convention area".

The "affected state" is required in arts 7 and 8 thereof to take measures to locate, and mark the wreck, and, if the owner does not remove the wreck within a specified time as specified in art.9, that state:

> "... may remove the wreck by the most practical and expeditious means available, consistent with considerations of safety and protection of the marine environment".[27]

Costs of locating, marking and removing the wreck under arts 7, 8 and 9 are then allocated in terms of art.10 of the Convention to the registered owner under a regime of strict liability. Such costs, if incurred by a person or party other than the affected state would not appear to fall within the ambit of applicability of the Convention. The Convention does not therefore grant a right of action accessible as widely as the preceding pollution liability conventions; of course a state may unilaterally grant such a right when giving effect to the convention in national law.

Geographical application of the WRC 2007

As in CLC 1992 and other conventions modelled on it, art.1(1) of the WRC 2007 defines "convention area" as meaning:

> "... the exclusive economic zone of a State Party, established in accordance with international law or, if a State Party has not established such a zone, an area beyond and adjacent to the territorial sea of that State determined by that State in accordance with international law and extending not more than 200 nautical miles from the baselines from which the breadth of the territorial sea is measured".[28]

The Convention, unless it is made applicable to internal waters and the territorial sea in terms of art.3 thereof, would not be applicable in those waters. A state might well have its own indigenous legislation to deal with a wreck in the territorial waters. For instance, in English law, s.56 of the Harbours, Docks and Piers Clauses Act 1847,[29] which constitutes in effect model legislation for use within the English jurisdiction, provides:

> "The harbour master may remove any wreck or other obstruction to the harbour, dock, or pier, or the approaches to the same, and also any floating

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[27] WRC 2007 art.9 para.7.
[28] See the United Nations Convention on the Law of the Sea 1982 art.57.
[29] 10 & 11 Vict. c.27.

timber which impedes the navigation thereof, and the expense of removing any such wreck, obstruction, or floating timber shall be repaid by the owner of the same; and the harbour-master may detain such wreck or floating timber for securing the expenses, and on non-payment of such expenses, on demand, may sell such wreck or floating timber, and out of the proceeds of such sale pay such expenses, rending the overplus, if any, to the owner on demand."

Similar complementary provisions are contained in s.252 of the British Merchant Shipping Act 1995, which in its first two paragraphs provides:

"(1) Where any vessel is sunk, stranded or abandoned in, or in or near any approach to, any harbour or tidal water under the control of a harbour authority or conservancy authority in such a manner as, in the opinion of the authority, to be, or to be likely to become, an obstruction or danger to navigation or to lifeboats engaged in lifeboat service in that harbour or water or approach thereto, that authority may exercise any of the following powers.

(2) those powers are—

(a) to take possession of, and raise, remove or destroy the whole or any part of the vessel and any other property to which the power extends;

(b) to light or buoy the vessel or part of the vessel and any such other property until it is raised, removed or destroyed; and

(c) subject to subsections (5) and (6) below, to sell, in such manner as the authority think fit, the vessel or part of the vessel so raised or removed and any other property recovered in the exercise of the powers conferred by paragraph (a) or (b) above;

(d) to reimburse themselves, out of the proceeds of the sale, for the expenses incurred by them in relation to the sale."[30]

Without the application of the extension in art.3 of the WRC 2007, or equivalent national legislation, the ordinary application of that Convention might leave a gap in coverage between the so-called "approaches" and the exclusive economic zone area. If the applicability of the WRC 2007 is restricted to the exclusive economic zone outside territorial and internal waters, it is unlikely to be of much relevance in a large number of cases where a wreck constitutes immediate hazard to a coastal state. On this point one will have to wait and examine what the practice of national legal implementation will bring about.

The WRC 2007 is specifically rendered inapplicable in relation to measures taken under the Intervention Convention as amended or its 1973 Protocols.[31]

[30] See, further, s.253 of the Merchant Shipping Act 1995 in relation to "powers of lighthouse authorities in relation to wreck".

[31] WRC 2007 art.4 para.1. The full title of the Intervention Conventions is: International Convention relating to Intervention on the High Seas in Cases of Oil Pollution Casualties 1969; Protocol relating to Intervention on the High Seas in Cases of Pollution by Substances other than Oil 1973.

The WRC 2007 operates in the exclusive economic zone whereas the Intervention Conventions relate to interventions on the high seas; furthermore the WRC 2007 is not restricted to instances where there is a threat of pollution. Despite the apparent different ambit of application, there is a potential for overlap in that the high seas in 1969 encompassed the area now covered by the exclusive economic zone.

Can the shipowner be liable in respect of wrecked cargo?

As has already been noted, the WRC allocates liability for locating, marking and removing the wreck to the registered shipowner. It may well end up being the case, in terms of the Convention and particularly art.1(4) referred to above, that the shipowner is held liable for the removal of cargo only, e.g. one container which has been washed overboard. In such cases, it would appear that, on the basis of general principles, the costs would not constitute a general average expense, and therefore it would be advisable for the shipowner to include an indemnity clause in the relevant contract of carriage. This approach may be a safer alternative to one based exclusively on relying on the shipowner's implied indemnity.[32]

Removal of wreck or salvage?

A difficulty may arise as to whether the removal of a wreck by way of salvage in terms similar to those of an LOF 2000[33] contract and entered into by a salvor and a state can constitute an expense for which the registered shipowner is liable in terms of the WRC 2007. It can be envisaged that a defendant shipowner would argue that since an LOF contract can provide for an award exceeding expenses and a reasonable profit, the costs of locating, marking and specifically removing the wreck should not include such elements of profit. A similar argument has been used by the IOPC Fund[34] when claims in respect of a salvage award as a preventative measure under the Fund Convention were rejected on the basis that they went beyond "costs and a reasonable element of profit".[35] The point has already been made by the author that in relation to the Fund Convention, the IOPC Funds attitude cannot be justified where an LOF contract is one that has been reasonably entered into.[36] The same point can be made here that when the LOF award or part of it constitutes the bona fide cost of locating, marking and removing the wreck, the "registered owner" as defined in the WRC 2007 should be liable for such costs. A further difficulty arises in relation to the "special compensation" and

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[32] See *Athanasia Comninos and Georges Chr Lemos, The* [1990] 1 Lloyd's Rep. 277 QBD (Comm).

[33] Lloyd's open form of salvage agreement 2000.

[34] International Oil Pollution Compensation Fund, set up under the Fund Convention 1971.

[35] *IOPC Funds 1996 Claims Manual*, p.23; see also *IOPC Fund 1992 Claims Manual*, April 2005 edn, p.23.

[36] G. Gauci, *Oil Pollution at Sea—Civil Liability and Compensation for Damage* (Wiley, 1997), p.38.

the "enhancement" in terms of the LOF 2000 and the International Convention on Salvage 1989, i.e. as to whether any of these elements are recoverable under the WRC 2007; it may well be arguable that *de lege ferenda* salvage law should accept the concept of liability salvage, in the sense that "potential liability" will be considered maritime property in the same way as ship and cargo; the person whose liability is avoided by the salvage services will be liable for that part of the salvage award which reflects his potential liability. But even if this were to happen and services are provided to a contracting state in terms of a contract on an appropriately amended LOF, resulting in the location, marking and removal in relation to cargo which threatens the environment, vis-à-vis that state the registered shipowner remains liable in terms of art.10. In terms of art.10(4), however, the registered shipowner would be entitled to use rights of recourse against third parties.

Another difficulty under this subheading relates as to whether the removal of a historic (or archaeological) wreck can constitute a salvage operation in terms of the English law of salvage. A difficulty arises as a result of the likelihood that a historic wreck is, according to some not in any danger, and the latter is a requirement of traditional and modern English salvage. Brice[37] refers to the contrary view of a Canadian court in *H.M. v Mar-Dive*[38] relating to the case of a historic wreck; the requirement of danger would be missing. In relation to the "underwater cultural heritage", Brice[39] cites a Report of the ILA[40] Cultural Heritage Law Committee:

> "It should be noted that the law of salvage relates solely to the recovery of items endangered by the sea... For underwater cultural heritage the danger has passed; either a vessel has sunk or an object has been lost overboard. Indeed the heritage may be in greater danger from salvage operations than from being allowed to remain where it is... The major problem is that salvage is motivated by economic considerations; the salvor is often seeking items as fast as possible rather than undertaking the painful excavation and treatment of all aspects of the site that is necessary to preserve its historic value."

Furthermore, where the historic wreck poses an element of hazard, it is obviously the case that the Nairobi Convention was not intended to be applicable to historic wrecks. This view is borne out by art.13, which, following earlier liability conventions, stipulates a short prescriptive period of limitation:

> "Rights to recover costs under this Convention shall be extinguished unless an action is brought hereunder within three years from the date when the hazard has been determined in accordance with this Convention. However, in no case shall an action be brought after six years from the date of the maritime casualty that resulted in the wreck. Where the maritime casualty consists of a series of occurrences, the six-year period shall run from the date of the first occurrence."

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37 Brice, *Maritime Law of Salvage* (1999), para.4.66.
38 *H.M. v Mar-Dive* [1997] A.M.C. 1000.
39 Brice, *Maritime Law of Salvage* (1999), para.4.9.
40 The International Law Association.

The last sentence in the above, together with the definition of "maritime casualty" in art.1(3) of the Convention, rules out applicability in the case of a wreck which can reasonably be characterised as having a historic nature. Indeed, it can well be argued that both the International Convention on Salvage 1989 and the WRC 2007 operate within the realm of commercial as distinct from archaeological law; this distinction has been made by Barr J., in the High Court of the Republic of Ireland, in the case of *La Lavia*[41]:

> "... [I]t is possible to provide a general guide-line. It seems to me that when so much time has elapsed since the original loss of a vessel that the question of ownership, and attendant acolytes such as indemnification, lose their practical significance and merge into history, then the wreck should be regarded as having passed from the commercial realm of maritime salvage into the domain of archaeological law... The common factor is the sea and both are distinct aspects of salvage law which, in my view dovetail comfortably."

Furthermore, since the *La Lavia* decisions, art.4 of the ground-breaking Convention on the Protection of the Underwater Cultural Heritage 2001 provides a total minimum of 100 years in water for the application of the definition of "underwater cultural heritage".[42] On this point, and for the sake of completeness, one must also refer to the general but very limited provisions of arts 149[43] and 303 of the Law of the Sea Convention, and in particular para.1 of art.303 which provides that, "states have the duty to protect objects of an archaeological and historical nature found at sea and shall co-operate for this purpose".[44] In this respect, it has been authoritatively stated that:

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[41] July 26, 1994.

[42] art.1(1)(a) of the Convention on the Protection of the Underwater Cultural Heritage 2001 defines "underwater cultural heritage" as meaning:

> "all traces of human existence having a cultural, historical or archaeological character which have been partially or totally under water, periodically or continuously, for at least 100 years such as: (i) sites, structures, buildings, artefacts and human remains, together with their archaelogical and natural context; (ii) vessels, aircraft, other vehicles or any part thereof, their cargo or other contents, together with their archaeological and natural context; and (iii) objects of prehistoric character."

[43] Article 149 provides:

> "All objects of an archaeological and historic nature found in the Area shall be preserved or disposed of for the benefit of mankind as a whole, particular regard being paid to the preferential rights of the State or country of origin, or the State of cultural origin, or the State of historical and archaeological origin."

[44] For further discussion on this matter see T. Scovazzi, "The Convention on the Protection of the Underwater Cultural Heritage" in T. Scovazzi (ed.), *La Protezione del Patrimonio Culturale Sottomarino nel Mare, Mediterraneo* (Giuffrè, 2004). See also the European Convention on the Protection of the Archaeological Heritage 1992.

> "... [T]he Convention on the Protection of the Underwater Cultural Heritage may be seen as a reasonable defence against the results of the counterproductive regime of UNCLOS."[45]

Other legislation applicable in terms of national English law in relation to wrecks includes the Protection of Wrecks Act 1973; the Protection of Military Remains Act 1986[46] and the Merchant Shipping and Security Act 1997.[47] The relevant provisions in these statutes would apply where the wreck needs protection rather than when a wreck constitutes a hazard.

Limitation of liability

The WRC follows in the footsteps of the Bunker Oil Pollution Damage Convention 2001 in not providing a freestanding regime of limitation of liability; this brings about the possible disadvantage that a wreck removal claim may compete with other claims on one constituted limitation fund. The WRC 2007, by wording similar to that contained in the Bunker Oil Pollution Damage Convention 2001, provides in art.10(2), that the right of the registered owner to limit liability under any national or international regime remains unaffected; the example of the Convention on Limitation of Liability for Maritime Claims 1976 (as amended) is referred to in the same provision, as is the case with the text of the Bunker Oil Pollution Damage Convention 2001. It may be noted that art.2 of the London Limitation Convention 1976 provides for limitation in relation to the:

> "... raising, removal, destruction or the rendering harmless of a ship which is sunk, wrecked, stranded or abandoned, including anything that is or has been on board such a ship".[48]

The United Kingdom has made a reservation in relation to this subheading and consequently such claims do not, generally, benefit from limitation of liability where English law applies.[49] However, a problem is bound to arise because art.2(1)(e) of the Limitation Convention provides for limitation in respect of the removal, destruction or the rendering harmless of the cargo of the ship, and this provision does apply in English law. There is therefore a problem as to whether English law provides for limitation in relation to the removal of cargo from a wreck. Whatever the outcome, it is undoubtedly the case that one of the latest

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[45] Scovazzi, "The Convention on the Protection of the Underwater Cultural Heritage" in *La Protezione del Patrimonio Culturale Sottomarino nel Mare, Mediterraneo* (2004), p.33.

[46] 1986 c.35, described in its preamble as:

> "... an Act to secure the protection from unauthorised interference of the remains of military aircraft and vessels that have crashed, sunk or been stranded and of associated human remains, and for connected purposes."

[47] 1997. Ch.28 s.24 of the Act deals with the "implementation of international agreements relating to protection of wrecks".

[48] London Limitation Convention 1976 art.2(1)(d).

[49] See para.3 of Sch.7 Pt II, and s.185 of the Merchant Shipping Act 1995.

maritime conventions in the 21st century continues to perpetuate an imbalance created centuries ago.[50] It is the view of this author that there does not continue to exist any justification for the virtually unbreakable right of the shipowner to limitation of liability[51] and, furthermore, that the reservation of the Government of the United Kingdom in relation to wreck removal in the Limitation Convention of 1976 should continue to apply when the new Convention comes into force, which is likely to be the case as art.10(2) of the Wreck Removal Convention is worded in permissive terms. Furthermore, in contrast to the Bunker Oil Pollution Compensation Convention 2001, no resolution extolling the virtues of the Limitation Convention 1976 as amended was adopted at the end of the Diplomatic Conference of 2001; this non-committal approach by the Diplomatic Conference in the case of the WRC 2007 may be viewed as consistent with the view that support for limitation of liability in maritime law is at best lukewarm.[52] A key difference between the pollution liability conventions and the wreck removal convention is that, whereas the quantum of pollution liabilities can be immense and very unpredictable, the costs of marking, locating and removing of wrecks are unlikely to be so; this is probably the main reason why there is a strong argument that limitation of liability should have no place at all in a convention on maritime wreck removal.

Compulsory insurance

In language based on the earlier pollution liability conventions, art.12(1) of the WRC 2007 imposes a requirement of insurance on the registered owner of ships of 300 gross tonnes or more:

> "The registered owner of a ship of 300 gross tonnage and above and flying the flag of a State Party shall be required to maintain insurance or other financial security, such as a guarantee of a bank or similar institution, to cover

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[50] See, generally, G. Gauci, "Limitation of Liability in Maritime Law: an anachronism?" (1995) 19(1) *Marine Policy* 65; G. Gauci, "Limitation of Liability: Some Reflections on an out-of-date privilege" in *Annuaire de Droit Maritime et Oceanique*, Vol.XXIII (2005), pp.47–61.

[51] It may be noted that an amended proposal for a Directive on the civil liability and financial guarantees of the owners (COM(2007) 674 final, October 24, 2007) makes provision for the following:

> "For ships flying the flag of a State party to the 1996 Convention, it should not be possible to apply limitation of liability under the 1996 convention to victims not party to the maritime transport operation, if the owner of the ship responsible for the damage has failed to act in a professional manner and should have been aware of the harmful effects of his act or omission. For ships not flying the flag of a State party to the 1996 Convention, it should not be possible to apply limitation of liability under the 1996 convention to victims not party to the maritime transport operation, if the owner of the ship responsible for the damage has committed gross negligence."

[52] In respect of limitation of liability in maritime law generally, see Gauci, "Limitation of Liability in Maritime Law" (1995) 19(1) *Marine Policy* 65.

> liability under this Convention in an amount equal to the limits of liability under the applicable national or international limitation regime, but in all cases not exceeding an amount calculated in accordance with article 6(1)(b) of the Convention on Limitation of Liability for Maritime Claims, 1976, as amended."

Article 12, in para.10, further provides for a right of direct action against the insurer. The insurer can utilise the defences available to the shipowner and can in any event utilise the right to limit liability; bankruptcy and the winding-up of the shipowner as a defence for the underwriter are not available, and this would in all probability block the effects of the notorious English case of *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti)*[53] as long as the national law implementing the Convention is appropriately worded. In this context, compulsory insurance, even though in all cases (including the instance in English law where wreck removal is not subject to limitation as discussed above), subject to a limit, is an acceptance of the stark reality that an unenforceable judgment against a shipowner is likely to be valueless to the victorious claimant.

The requirement of insurance in terms of art.12 of the WRC 2007 is enforced as with the previous liability conventions by a system of flag-state control and port-state control.[54] Protection and Indemnity Clubs generally and as a matter of course provide coverage in respect of wreck removal; obviously if and when the WRC 2007 comes into force the wording of the applicable insurance rule may well need to be amended in order to comply with the requirements of the convention.[55]

The requirement of insurance is more likely to constitute an inducement to a coastal state which happens to be in a quandary as to whether to allow a place of refuge to a ship in distress. The regime of refuge for ships in distress does not, as the law now stands generally give a "watertight" entitlement in terms of the customary law of the sea and, in practice a states may waver as to whether to grant it or not; indeed para.3.12 of the IMO Guidelines on Places of Refuge for Ships in Need of Assistance 2003 contains nothing more than an exhortation:

> "3.12 When permission to access a place of refuge is requested, there is no obligation for the coastal State to grant it, but the coastal State should weigh all the factors and risks in a balanced manner and give access wherever reasonably possible."

When granting a place of refuge, obviously a state or port authority will be concerned about guarantees and about the fact that the vessel will prima facie be entitled to limit liability in respect of any damage caused. It is interesting to note

[53] *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti)* [1990] 2 Lloyd's Rep. 191 HL.

[54] WRC 2007 art.12 paras 7 and 11.

[55] See for example the London Steam-Ship Owners' Mutual Insurance Association Limited Rules 2008–2009 r.9.18.

that these two issues were items on the agenda for a meeting organised by the International Association of Ports and Harbours in April 2008.[56]

The application of the Wreck Removal and Oil Pollution Regimes—can there be an overlap problem?

As is well known, CLC 1992, the Fund Convention 1992 and the Supplementary Fund Protocol 2003 provide for compensation for oil pollution damage usually from a tanker. The liability is strict and compensation is limited ultimately to an overall 750 million special drawing rights.[57] There is no definition of "wreck" in these aforementioned international instruments. However, the applicability of the Convention is dependent on the definition of the phrase "ship", which is defined as "any sea-going vessel and seaborne craft of any type whatsoever constructed or adapted for the carriage of oil in bulk as cargo...".[58] A ship which is a sunken wreck can be characterised neither as sea-going nor as seaborne. The possible outcome is that, in applying a strict interpretation of the oil pollution conventions, the extraction of oil from sunken vessels as a preventive measure will not be covered under the oil pollution conventions; the same can be said in the case of a wreck discharging or leaking oil.

However, the practice at the IOPC Funds (which administer the International Oil Pollution Compensation Funds) seems to be to allow recovery for pollution damage from wrecks and particularly the expenses of the extraction of oil from wrecked tankers, as long as this is reasonable. This was the case for instance in relation to the tanker *Dolly* in Martinique waters in 1999.[59] This application of the definition of "ship" is probably being applied correctly because an oil spill is frequently and in a large number of instances emanating from a wreck—e.g. *The Braer*[60] and *The Erika*,[61] and any other interpretation would stultify the purpose of the law; moreover the definition of "incident" in the Pollution Conventions lends support to this view; "incident" is defined in the Conventions as:

> "... meaning any occurrence, or series of occurrences having the same origin, which causes pollution damage or creates a grave and imminent threat of causing such damage".[62]

Indeed the incident causing the spill is very likely originally to be a maritime incident which occurred at the time when the "wreck" had been a seagoing ship. This view would not apply in the case of anything resembling a historic wreck as the claimant would find a time-bar obstacle in art.VIII of CLC 1992 (an article used

[56] S. Speares, "IAPH to seek guarantees for ports of refuge liability", *Lloyd's List*, February 6, 2008, p.7.

[57] Supplementary Fund Protocol 2003 art.4(1).

[58] See CLC 1992 art.1(1).

[59] November 1999. See IOPC Funds Annual Report, 2001, pp.107–108.

[60] United Kingdom, 1993.

[61] France, 1999.

[62] See CLC 1992 art.1(8).

as a model in the text of the WRC 2007) which provides that the absolute limit of the time-bar will never exceed six years from the date of the first occurrence giving rise to the incident. Moreover, it may well be that, in the case of an incident from a historic wreck, the first of the occurrences has taken place before the coming into force of the Convention in the relevant legal system, and this would raise the defence that the conventions were inexistent at the time of the "incident".[63]

More recently, the *Prestige* spill raised the issue of extraction of oil from a sunken wreck, and the Executive Committee of the 1992 IOPC Fund treated the claim in this respect as inadmissible[64]; the French and Spanish delegations later submitted a note to the Assembly where certain proposals were made in relation to admissibility.[65] This note was further refined in a draft text (for inclusion in the 1992 Fund Claims Manual); the draft text in its main operative part provides that:

> "Claims for the cost of measures to remove any remaining persistent oil from a sunken ship are also subject to the overall criterion of reasonableness from an objective point of view."

Reasonableness is to be determined "on a case by case basis", taking into account four general lists of criteria: one group refers to factors relating to the condition and situation of the ship, the second relates to the likelihood, nature and extent of possible damage; the third relates to the feasibility of the operation, and fourthly the:

> ". . . cost of the operations, especially in relation to the likely pollution damage which would have resulted from the release of the remaining oil from the ship".[66]

The text was adopted by the Assembly of the IOPC Fund 1992 in June 2007.

The removal of oil from a non-historic wreck might also fall to be covered under our WRC 2007; art.9(2) thereof provides that the registered owner shall remove a wreck determined to constitute a hazard; if this is not done in the stipulated time, the state may itself, as discussed earlier, undertake the removal of the wreck (art.9(7)). It also provides in art.10 that the registered owner "shall be liable for the costs of locating, marking and removing the wreck . . . unless . . .". The removal of cargo from a wrecked vessel prima facie *does* fall under the provisions of the WRC 2007 as the definition of wreck in art.1 thereof includes "any part of a sunken or stranded ship, including any object that is or has been on board such a ship". In relation to the removal expenses however, the six-year overall time-bar period, modelled obviously on CLC 1969 rather than on the more victim-friendly HNS Convention 1996,[67] may again block recovery in the case of a not-so-recent wreck.

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[63] See also Fund Convention 1992 art.6.

[64] However, the Executive Committee decided that the sealing of the oil leak from the wreck was admissible in principle. M. Jacobsson, "Compensation for costs of removal of oil from sunken tankers" (2007) 6(4) *Shipping & Transport International* 10.

[65] IMO Documentation: 92FUND/A.11/24/1 (September 29, 2006).

[66] IOPC Fund documentation: 92FUND/A/ES.12/8, 31 May 2007, Annex.

[67] The HNS 1996 provides an overall prescriptive period of 10 years rather than six in relations to claims under Ch.2, i.e. against the shipowner.

The WRC 2007 provides in art.11 that there will be no liability inter alia for wreck removal under the Convention if, and to the extent that, liability would be in conflict with CLC 1992, HNS 1996, the Bunker Oil Pollution Damage Convention 2001, and the Convention on Third Party Liability in the Field of Nuclear Energy 1960 as amended, on the Vienna Convention on Civil Liability for Nuclear Damage 1963.

It is probably interesting to note that the WRC 2007 does not mention a possible overlap with the Fund Convention 1992, and there are instances where the Fund Convention 1992 applies to the exclusion of CLC 1992, e.g. where the pollution damage results from a natural phenomenon of an exceptional inevitable and irresistible character.[68] In these instances in relation to oil pollution, all remedies under the WRC 2007 in relation to the oil extraction would be blocked because the owner can raise the defence in art.10(1)(a) that the maritime casualty that caused the wreck resulted from "a natural phenomenon of an exceptional, inevitable and irresistible character". In these instances, a remedy would be available exclusively under the Fund Convention 1992. The position would be similar if the cargo was a hazardous substance in which case the remedy would lie in Pt 3 of HNS 1996. In these cases, the remedy for recovery in relation to the extraction of sunken cargo and/or bunker would have to be sought within those Conventions and not within the WRC 2007. It is clear that in the case of a loss caused by a phenomenon of an exceptional, inevitable and irresistible character, a remedy would be available under the Fund 1992 or HNS 1996 regimes, but not under the Bunkers Convention 2001. Moreover, in the relationship between wreck remover and salvor, salvage law would apply.[69]

Can there be a wreck without an owner?

Wrecks have an obvious attraction for wreckers, treasure hunters, the media and the public in general. One need only refer to the recent pictures in the media of persons involved in the extensive appropriation of flotsam wrecked after the incident involving the *MSC Napoli* in the southwest coast of England. The mere fact that the appropriation relates to flotsam does not in English law[70] give ownership to the finder. Indeed s.241 of the British Merchant Shipping Act

[68] See CLC 1992 art.III(2) and Fund Convention 1992 art.4(2).

[69] WRC 2007 art.11 para.2.

[70] As to the position under US law, see T. Schoenbaum, *Admiralty and Maritime Law*, 3rd edn (2001), para.14-7, where the distinctions between the law of salvage and the law of finds are discussed, in relation to US law, and it seems important to note that the law of finds, in contrast to salvage law, focuses on determining title to property, title to which may have been lost. The law of finds has been described very well as follows:

> "The elements required for application of the law of finds are also well-established. First, the law of finds applies only when property has been abandoned. Competing searchers are entitled to enter the area where the abandoned property is located and to seek to reduce it to their possession as long as they act without infringing on the rights of other searchers. Second, rights are 'transferred' to the first person who reduces

1995,[71] sourced obviously from s.523 of the 1894 British Merchant Shipping Act,[72] provides that:

> "Her Majesty and Her Royal Successors are entitled to all unclaimed wreck in the United Kingdom and in United Kingdom waters except in places where Her Majesty or Her Royal predecessors has granted the right to any other person."[73]

It is the obligation of the finder of such wreck to notify the office of the Receiver of Wrecks as specified in s.236 of the British Merchant Shipping Act 1995. Furthermore it was decided in *Pierce v Bemis (The Lusitania)*[74] that the right of the Crown did not extend to an extra-territorial wreck, in respect of which the rule of the then applicable s.523 of the Merchant Shipping Act 1894 did not confer any *droit* on the Crown. Moreover s.239 of the Merchant Shipping Act 1995 provides that the owner of any wreck in the possession of the Receiver who establishes his claim to the wreck to the satisfaction of the receiver within one year from the time when the wreck came into the receiver's possession shall, on paying the salvage, fees and expenses due, be entitled to have the wreck delivered or the proceeds of the sale paid to him. It must be noted that s.241 provides an entitlement to the Crown which it is free to accept or decline, and it is undoubtedly well arguable that a wrecked item does not become a *res nullius* even where abandoned *sine spe recuperandi* and where the Crown does not exercise its entitlement mentioned above.

Like other liability conventions, the WRC 2007 imposes liability on a registered owner who is defined as meaning:

> "... the person or persons registered as the owner of the ship or, in the absence of registration, the person or persons owning the ship at the time of the maritime casualty".[75]

A difficulty might arise as to what the "time of the maritime casualty means", as it might well be arguable that the ownership of the vessel has been abandoned prior to the casualty and therefore there can be no allocation of responsibility within

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> the property to possession" (C. Furrer Newton, "The Titanic and the Law of the Sea Convention" (1986) 10 *Hastings International and Comparative Law Review* 159, 167).

The matter may be further complicated by the assertion of governmental interests; see in this respect, Schoenbaum, *Admiralty and Maritime Law* (2001), para.14-7 at p.854 et seq.

[71] See further s.243 of the 1995 British Merchant Shipping Act in relation to the disposal of unclaimed wreck.

[72] On this subject, F.R. Sanford refers to an early agreement concerning "the seignorial right to vessels and goods shipwrecked on the coast of Brittany": *Origins of the Early English Maritime and Commercial* (Oxford: Professional Books Ltd, 1930, repr. 1989), p.68.

[73] The procedure in this respect includes the payment of salvage by the receiver to the salvors (para.5 of s.243 of the British Merchant Shipping Act 1995).

[74] *Pierce v Bemis (The Lusitania)* [1986] 1 Lloyd's Rep. 132 QBD (Admlty).

[75] WRC 2007 art.1 para.8.

the Convention. Some English judgments seem to suggest that abandonment by an owner of his insured vessel can divest him of ownership; for instance, in *Arrow Shipping Co Ltd v Tyne Improvement Commissioners (The Crystal)*,[76] the House of Lords decided that at the time the wreck removal expenses were incurred in that case, the owners had abandoned this vessel as derelict and had given the requisite notice of abandonment to the underwriters. It was held that the defendants were not liable for the wreck removal expenses because they were not the vessel's owners at the material time. However, in the later Court of Appeal decision in *Ocean Steam Navigation v Evans*[77] Greer L.J. casts doubt on this approach when he states that:

> "... [I]t does not follow that, because notice of abandonment is given to an insurer, therefore the vessel, which may have some value, is abandoned to all the world or that it has no owner at all, and becomes what lawyers prefer to describe, using the Latin language, a *res nullius*."[78]

Whereas the Convention does not adopt the watertight language of the US Oil Pollution Act of 1990[79] by allocating responsibility also to the person operating or owning the vessel immediately prior to the abandonment, it is likely that any interpretation of the Nairobi Convention will be a purposive one not stultifying one of the obvious purposes of the Convention; on that basis we can say that that a purposive interpretation of "registered owner" should include the person registered as owner prior to a unilateral abandonment of registration and ownership.

Dispute settlement

Unlike the pollution liability regimes, the WRC 2007 in art.15 provides, in the case of a dispute between two states regarding the interpretation or application of the Convention, for a system of dispute resolution based on art.287 of the United Nations Convention on the Law of the Sea 1982. It is noteworthy that insofar as other disputes are concerned, the WRC 2007 does not contain provisions relating to jurisdiction, and recognition and enforcement of judgments; such provisions caused a substantial impasse in the diplomatic conference leading to the Bunker Oil Pollution Damage Convention 2001.[80]

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[76] *Arrow Shipping Co Ltd v Tyne Improvement Commissioners (The Crystal)* [1894] A.C. 508 HL.

[77] *Ocean Steam Navigation v Evans* [1934] XL Com Cas. 108.

[78] See, further, G. Gauci, "The Abandonment of an Oil Tanker: Compensation and Insurance Implications" [1995] J.B.L. 105.

[79] Public Law 101-380 (H.R. 1465).

[80] See Gauci and Pace, "The International Convention on Civil Liability for Bunker Oil Pollution Damage 2001" [2003] J.I.C.L. 104, 125.

A missed opportunity?

After reviewing the WRC 2007, it may be reasonable to note that much more could have been done to regulate wreck removal liability at an international level. The convention as adopted is a very conservative example of international maritime legislation. Instead of seizing the opportunity to create a model for the future reform of earlier conventions, the WRC 2007 uses a liability model which deals with a different aspect of maritime law and in most parts harks back to the late 1960s; in particular it allows the privilege of limitation of liability, it channels primary civil liability on one party only, it does not fully clarify the overlap between the wreck removal and oil pollution civil liability regimes, it is too liberal with the provision of defences, and it is likely to be too geographically restricted. On the whole, the said Convention, as it stands, may be viewed as a missed opportunity.

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BOOK REVIEWS

THE LAW OF RESCISSION. By Dominic O'Sullivan, Steven Elliott and Rafal Zakrzewski [Oxford University Press, 2007, ISBN: 978-0-199-25011-0, lxxiii + 699pp. Hardback. £125.00]

This book deals with a very difficult area of the law which has confounded scholars, practitioners and students alike for decades, perhaps even centuries. Cases on rescission are chaotically everywhere. In tackling the subject head-on and attempting to bring order out of chaos, this work is timely, much needed and admirably ambitious. It may be described as a mammoth work of art.

In terms of scope, the rescission covered in this book relates to the undoing of contracts and gifts by virtue of defect of formation and other invalidating events. It is not about the rescission caused by termination for breach or substantial variation of an existing agreement.[1]

The book is divided into seven parts. Part I identifies the problems surrounding the law of rescission, the terminological confusion that has built up over the years, and the effect of rescission proper. Also invaluable in this part is Ch.3 on historical foundations which put the current understanding of the law in perspective.

Part II discusses the grounds for rescission, such as misrepresentation, non-disclosure, duress, undue influence and mistake. Part III covers the mode of rescission. It seeks to maintain a clear demarcation between rescission at law and rescission in equity. It advances the proposition that while rescission at law is a self-help remedy, rescission in equity always needs a court order except in the case of fraud.

Parts IV to VI deal with the various bars to rescission. Part IV (nearly 170 pages) is devoted to *restitutio in integrum* in respect of the provision of property, money and services. Proprietary remedies and personal claims such as compensation are also covered. Part V considers the impact of intervention by third parties and the implications of rescission for third parties, in particular bona fide purchasers. Part VI looks at other bars to rescission, e.g. affirmation, delay, estoppel, contractual exclusion and statutory intervention under the Misrepresentation Act 1967.

The final Part VII is on the rescission of gifts and transactions effected by deed.

As the law of rescission remains relatively untouched by statutes, it is particularly helpful that there are copious citations of Commonwealth authorities throughout. Comparative analysis on such a complex subject is most desirable. The citation of English authorities is also comprehensive. Subsequent to the publication of the book, there have been a number of interesting cases which should be included in the next edition, e.g. *Quest 4 Finance Ltd v Maxfield*[2] and *Peart Stevenson Associates Ltd v Holland*[3] on the non-reliance clauses; *London Allied Holdings*

[1] L.C. Ho, "Novation, variation and rescission—a question of intention?" (2008) 1 *Corporate Rescue and Insolvency* 95.

[2] *Quest 4 Finance Ltd v Maxfield* [2007] EWHC 2313 (QB).

[3] *Peart Stevenson Associates Ltd v Holland* [2008] EWHC 1868 (QB).

Ltd v Lee[4] on the proprietary consequences of rescission. There is little doubt that this book will appear in law reports very soon.

A book review of this sort is meant to persuade readers to use the book, and not meant to engage in a substantial debate. Nevertheless, this reviewer notes that the book does not attempt to ground the right of rescission in any theory, e.g. unjust enrichment and wrongs. That rescission exists at law and in equity is taken as a given. This is a bit surprising since the book originated in a D.Phil. thesis supervised by the late Professor Birks. This reviewer also spotted a minor mistake in the book. It is said: "[t]he representee has an action ... under section 2(1) of the Misrepresentation Act 1967 if the misrepresentation is innocent" (p.82, citing *Atlantic Lines & Navigation Co Inc v Hallam (The Lucy)*[5]). But an innocent misrepresentation (i.e. non-fraudulent and non-negligent) would not lead to a claim under s.2(1) of the Misrepresentation Act 1967. In fact *The Lucy* is about s.2(2) of the 1967 Act.

There is no other contemporary book on rescission which is as easily readable, comprehensive and scholarly as the one under review. It is a good read and, more importantly, an excellent reference work. Some might complain that the book is not tightly bound by any theoretical thread, but this is probably inevitable. Successive generations of scholars have had huge difficulty locating the precise theoretical rationale of rescission. At any rate, no one can doubt that every reader will find materials of great interest within its pages. As such, the authors are to be warmly congratulated and the book is to be greeted with open arms.

Look Chan Ho[*]

PROSPECTUS FOR THE PUBLIC OFFERING OF SECURITIES IN EUROPE: EUROPEAN AND NATIONAL LEGISLATION IN THE MEMBER STATES OF THE EUROPEAN ECONOMIC AREA. By Dirk Van Gerven (ed.) [Law Practitioner Series, Vol.1, Cambridge University Press, 2008, ISBN 978-0-521-88070-1, x +503pp. Hardback. £85.00]

In the aftermath of the fall of the socialist economy in the 1980s, the capitalist economy appears to be almost the single economic philosophy dominating the world over the past two decades. A central concern of this philosophy is thought to be securities markets. They operate as intermediaries between the issuers of securities and their investors. In the age of globalisation, both issuers and investors tend to fly to the market that looks most rewarding for them. The internationalisation of securities markets provides them with this opportunity to shop around to maximise their benefits. This book is devoted to the facilitation of internationalisation of securities markets in Europe.

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[4] *London Allied Holdings Ltd v Lee* [2007] EWHC 2061 (Ch).

[5] *Atlantic Lines & Navigation Co Inc v Hallam Ltd (The Lucy)* [1983] 1 Lloyd's Rep. 188 QBD (Comm).

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This is an edited book written by several professionals having expertise in corporate law in general, and in their respective national securities regulation laws in particular. Their scholarship and practical experience are clearly evident in their works. This book embodies the description of current laws of 15 European countries governing prospectuses and offshore listing of securities within the Member States of the European Union and European Economic Area. The contents and themes of the book are aptly edited by Dirk Van Gerven, who has vast experience in dealing with securities laws and litigation as demonstrated by his extensive publications in the area of securities law.

The Council of the European Union adopted the Prospectus Directive on November 3, 2003, reflecting the desires of the European Commission regarding the regulatory improvement for securities markets. It also prescribed a transition period ending July 1, 2005 by which time all members were required to bring about necessary reforms in their laws in line with the Directive, and they have done so accordingly. This was an effort towards achieving effective integration of securities markets among the EU Member States through the unification of regulatory rules and establishment of a single competent authority in each state to approve prospectuses.

The main objectives of the Prospectus Directive are:

- the harmonisation of the rules relevant to prospectuses and offshore listing;
- the designation of a single competent authority to approve prospectuses; and
- the introduction of a European passport facilitating the same prospectus being issued throughout the European Union and the European Economic Area without further approval in each Member State.

The objectives of the EC initiatives are to improve and unify the prospectus regulatory regimes; consequently, this book deals with the requirements of both offerings of primary securities to the public and requests for admission of securities to trading on a regulated market in the European Union. In doing so, the book demonstrates the legislative reflections of Member States on the EU guidelines and the uniformity of rules between nations, and highlights the compliance requirement and consequences of non-compliance with the guidelines. The liability of persons involved in the public offering process including both the entities and individuals, criminal sanctions for violations of legal requirements and the regulatory and enforcement regimes are clearly outlined in the book.

As mentioned earlier, this book does not cover the discussion of laws of all Member States simply because it is volume one of a set of two volumes. This volume has been broken up into four distinct parts. Part I contains the legal framework and community rules set out in the EC Prospectus Directive and the EC Prospectus Regulation, while Part II embodies the rules and reports implementing the Prospectus Directives in 14 EU Member States. They include: Belgium, the Czech Republic, Denmark, Estonia, Greece, Hungary, Latvia, Lithuania, Luxembourg, the Netherlands, Poland, Portugal, Slovakia and the United Kingdom. Part III describes national reports for EEA members, which is Norway, and Part IV presents three annexes, being the EC Prospectus Directive, the EC Prospectus

Regulation and a list of current national legislation implementing the Prospectus Directive. It may be noted that the second part is silent about the Prospectus Regulation perhaps because its application in the Member States is direct requiring no further state adoption. It is understood that volume two will cover the implementing rules of the remaining Member States.

As noted by the editor, this book aims at incorporating a "comprehensive analysis" of the European legal framework for securities regulation across the European Union and the European Economic Area in order to facilitate corporate securities finance being raised from the public. Although intended to be a piece of critical and comprehensive analysis of the laws of the selected jurisdictions, the book remains largely descriptive in that it basically collates the relevant national laws as reformed along the lines of the EU guidelines. Thus its aim might not have been achieved entirely. However, the contents of the current laws of the Member States are portrayed in a simple and lucid manner, which demonstrates the skills and efficiency of the authors in rendering the complex legal ideas into simple expressions of legal requirements. The authors and editors deserve praise for the precision, simplicity and clarity of their presentation throughout the book.

Although the book does not provide a critical analysis of the current law of the Member States, its objective is to present a consolidated volume of the EU guidelines and the response of the Member States thereto; by compiling the reformed and uniform rules of 15 nations, this objective has obviously been achieved. This is so because it will serve as a useful publication for the purposes of fundraising and investment decision-making by the issuers of securities in the EU and EEA countries, their investors, financial advisers and intermediaries and all other stakeholders. However, this publication could have been improved further by the inclusion of critical analysis of diverse national liability and enforcement regimes for these EU Directives as devised by different Member States and by identifying the similarities and dissimilarities and their impacts on investor protection. Such a comparison and contrast could provide a convenient guideline to both issuers and investors as to their respective rights and obligations associated with investment in securities.

Despite some shortcomings as mentioned above, the reviewer has no hesitation in saying that this is an informative piece of work where experienced and efficient authors have successfully presented the complicated ideas and provisions of inherently complex securities law in a way that helps students, academics, amateurs and professionals in securities markets understand the laws of selected EU and EEA countries.

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