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[Types of offences, strict versus fault based, due diligence defence]

Rethinking Loss-Shifting Civil Claims following the Company's Unlawful Conduct

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I. INTRODUCTION

When a company enters into a transaction or undertakes an action that turns out to be either illegal or otherwise exposes the company to substantial fines or other pecuniary sanctions, the question arises as to whether the company may then recover its fines, expenses and other losses from its directors and employees, in the absence of the relevant legislation specifically providing for, or denying a claim by, the company. [1] In these cases, the board may have made a specific decision to cause the company to enter into the unlawful conduct or may have failed to prevent the improper conduct from undertaken by its employees or officers acting on the company's behalf. This paper assumes that the directors or employees have not acted dishonestly or otherwise breach the no-conflict or no-profit rule. While the board is not likely to sue one of its own members, the action may be brought by a differently constituted board[2] or shareholders pursuant to the statutory derivative action.[3]

While there are few criminal prosecutions of companies, particularly for economic crimes, this is likely going to change with the introduction of the deferred prosecution agreements via the Crime and Courts Act 2013, and the proposed increase in fines for fraud, bribery and money laundering offences on companies will result in the issue becoming even more important.[4] Loss-shifting claims by the company against the directors or officers present several difficult policy issues. The company has the incentives to make the claim as it will

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1 For examples of a civil remedy being made statutorily available to a company against the director under the Companies Act 2006, see the following: (1) Section 463(2), a company can make a claim against directors for compensation for any loss it suffers as a result of any untrue or misleading statement in the directors' report; and (2) under sections 580(2) and 593(3), a company can make a claim against an allottee of shares in the situation in which it will have committed a criminal offence by allotting them to him.

2 For example, see Safeway.

3 For an example of a corporate action by a company against its former directors and employees, see *Safeway Stores v Twigger*.

4 See Sentencing Council, Fraud, bribery and money laundering: corporate offenders: Definitive Guideline; the Sentencing Council ("Sentencing Guidelines"). The Sentencing Council has adopted a similar methodology to that currently used by the UK Financial Conduct Authority which determines the starting figure from a percentage of the 'relevant revenue' derived from the alleged conduct. The financial risk to companies is increased by the multipliers which will be applied to this base figure in order to determine the final penalty. The Definitive Guidelines recommend a multiplier of as much as 400 per cent in the most egregious cases.

generally not be able to claim the fine/penalty from its own insurer,[5] and may wish to have recourse against its directors or employees for negligence or breach of duty of care, particularly if they are covered by directors' and officers' (D&O) insurance. However, in principle, it appears surprising if the impact of a criminal sanction could be negated by a civil claim. Yet, shareholders or creditors (where the company is insolvent) may not have participated in the wrongdoing at all and it appears harsh that the company is denied the claim from its directors.

While the most recent discussions of the point of illegality by the House of Lords in *Gray v Thames Trains*[6] and *Stone & Rolls* are largely inconclusive, the recent decisions of the Court of Appeal in *Safeway v Twigger*[7]*(Safeway)* and *Bilta (No. 2) v Nazir*[8] *(Bilta)* highlight the policy debates in this area. In *Safeway*, which concerns the infringement of the Chapter I prohibition of the Competition Act 1998, the Court of Appeal held that the claims by the company against its directors and employees for the fine/penalty and associated expenses were barred because they infringed the public policy maxim *ex turpi causa* that a person committed an illegal or unlawful act could not maintain an action for an indemnity against the liability which resulted from the act. Much of the reasoning of the Court of Appeal will apply to other kinds of corporate criminal or quasi-criminal wrongdoing. In *Bilta*, *Safeway* was distinguished on the grounds of [ ].

However, a number of questions remain. First, would public policy prohibition the recovery of fines/penalties against the director or employee in respect of a strict liability offence or an offence which carry strict liability but where the defendant has a defence of due diligence? *Safeway* was a case concerning fault-based quasi-criminal liability for the corporate wrongdoing, and the case left open the possibility of claims in respect of strict liability offences. Second, would the same prohibition barring claims apply to losses payable by the company as result of court-ordered compensation orders which form part of the settlement of the quasi-criminal prosecution or deferred prosecution agreement? These are not technically fines or penalties. Third, would the prohibition on recovery extend to losses suffered by the company in conjunction with the wrongdoing?

Part II deals with the scope of the public policy bar as set out in *Safeway* and the existing case law in respect of loss-shifting by the company in respect of recovery of fines/penalties and other losses. It argues that notwithstanding *Safeway v Twigger*, English case law draws a clear distinction between fines/penalties and other losses; the case law shows that the courts should be very slow to find the existence of a public policy bar in the latter.

Part III argues that contrary to academic arguments, the prohibition on the company's ability shifting losses arising from the *fines or penalties* can be justified conceptually not only on criminal law principles, but also on corporate law principles. While the prohibition in *Safeway* may be inconsistent with the policy of enforcing directors' duties, allowing such compensation claims by the companies for the penalties fines paid over to the regulator will also lead to other

5 FSA Handbook, GEN 6.1.5: "*No firm may enter into, arrange, claim on or make a payment under a contract of insurance that is intended to have, or has or would have, the effect of indemnifying any person against all or part of a financial penalty*"

6 [2009] UKHL33.

7 [2010] EWCA Civ 1472.

8 [2013] EWCA Civ 968; [2014] Ch 52.

issues, such as resulting in a windfall for the companies who may have benefitted from the criminal wrongdoing in other aspects, and loss-shifting may even disincentivise companies to take appropriate preventive measures to avoid the occurrence of corporate wrongdoing.

However, the public policy prohibition in respect of claims based on the company's fines/penalties does not apply with equal force with the company's civil claims. Using examples of possible civil claims arising from criminal prosecutions or quasi-criminal prosecutions of corporations will be drawn from the following key pieces of legislation: section 7 of Bribery Act 2000, Proceeds of Crimes Act, Financial Services and Markets Act 2000, and employment and workplace legislation. Part III argues that the prohibition should not bar the company from recovering from its errant directors other kinds of losses. It draws the distinction between fines/penalties and compensation, noting that the distinction may not be so clear in instances where compensation orders are part of the fines/penalties. Using examples under the Proceeds of Crimes Act, [ ].

Part IV compares the UK approach with the approaches in Australia and Singapore, as to the issues arising from loss-shifting in corporate wrongdoing actions. In the case of Australia, while Australia has a similar prohibition to UK in respect of barring recovery of fines/penalties, enforcement actions continue to be taken against directors for breach of their duty of care and skill in connection with corporate wrongdoing due to its active public enforcement regime by ASIC. In the case of Singapore, the issue of whether a company may bring an action against its former chief executive officer for bribes paid by the company to third parties (and which the CEO did not benefit personally) arose in *Ho v Scintronix*.

The comparison shows that while current arrangements may not be optimal, there are good reasons for not allowing loss-shifting by companies against their directors following from corporate criminal prosecutions. Part V concludes.

II. OVERVIEW AND RATIONALE OF THE *EX TURPI CAUSA* RULE

A. The decisions in *Safeway* and *Bilta*

In *Safeway*, the directors and employees of Safeway brought an application to strike out the claims from Safeway, which had sued them for an indemnity, for having caused it to be liable for substantial penalties potentially imposed for infringing Chapter I prohibition of the Competition Act 1998. The directors and employees had allegedly engaged in price-fixing with their counterparts in other supermarkets to increase the price of the dairy products, causing the company to breach the Competition Act 1998. Safeway entered into an early resolution agreement with the Office of Fair Trading ("OFT"), a form of settlement under which they admitted liability and agreed to pay a reduced penalty. The early resolution agreement between Safeway and OFT provided for Safeway to pay a fine of £16.5 million, to be reduced to £10.7 million, provided Safeway continued to co-operate with the investigations. Safeway sued the defendants, alleging that they had breached their employment contracts, fiduciary duties and/or were liable in tort of negligence.

At first instance, Flaux J held that the infringement of Chapter I prohibition was sufficiently morally reprehensible to engage the *ex turpi causa* rule. The rule may include not only criminal conduct but also quasi-criminal conduct, including anti-competitive acts in breach of the Chapter I prohibition in the Competition Act. Three reasons were given: first, the agreement made in breach of the prohibition was illegal and a party to the agreement cannot claim damages for losses caused by being a party to the illegal agreement.[9] Second, the infringement proceedings brought by OFT were regarded by case law as quasi-criminal in nature.[10] Third, the fine imposed by the OFT had characteristics of a criminal fine, whose purpose is to punish or deter, rather than compensation, and the penalty is paid into the consolidated fund.

However, Flaux J held that the wrongful acts that were committed by the defendants were attributed to Safeway by virtue of the general law of agency and the *ex turpi causa* was not a defence to the claim. On appeal, the finding of the seriousness of the infringement to engage the *ex turpi causa* rule was not challenged but the Court of Appeal reversed the decision, holding that the penalties incurred by Safeway were personal to the company, as opposed to merely vicarious, because section 36 of the Competition Act 1998 only imposed liability on the undertaking. As the liability was personal, it was contrary to public policy to allow the company's claims.

In reaching the decision, the Court of Appeal referred to *Gray v Thames Trains*, where Lord Hoffman explained that the *ex turpi causa* principles takes two forms. In the wider form, the rule prohibits the claimant from recovering compensation for loss which was suffered in consequence of its own criminal act. In its narrower form, the claimant cannot recover for damages which flows from the fine or other punishment imposed as a consequence of the unlawful act. The justification for both forms of the rule lies primarily on the ground of consistency, that is, it is inconsistent for a claimant to be personally liable to pay penalties but at the same time argues in a civil court that he is not answerable for that conduct.

According to the Court of Appeal, *Safeway* concerns both the wide and narrow forms of the rule, because the claims were for losses arising from the fine (being the sentence imposed as consequence of entering into the illegal agreement) and the costs associated with the OFT regulatory proceedings (which were the consequences of entering into the illegal agreement). Part II will deal with the narrow form of the rule, that is, for losses arising from the fine.[11] The consistency rationale barred the company's civil claims for the fines and the costs. In particular, Pill LJ held that the policy of the Competition Act 1998 was to attribute liability only to the undertaking (in this case, Safeway) and to place the impetus on the undertaking to take preventive measures. Allowing the company to claim from the directors (and hence, indirectly, D&O policy) would undermine the policy behind imposing personal (as opposed to vicarious liability) on the company.[12]

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9 E.g. Courage v Crehan (Case C-453/99) [2001] ECR I-6257.

10 R v Office of Fair Trading [2009] EWHC 1875 (Admin); [2009] UKCLR 895.

11 Part III will deal with the wide form of the rule.

12 See *Safeway* Stores *v Twigger*, para 44:
"The policy of the [Competition Act 1998] is to protect the public and to do so by imposing obligations on the undertaking specifically. The policy of the statute would be undermined if undertakings were able to

Safeway argued that it was a victim of fraud and was entitled to rely on the *Re Hampshire* principle,[13] which prevents the attribution of acts of the agent to principal where the agent commits fraud on the principal. The Court of Appeal rejected the argument, on the ground that invoking the *Re Hampshire* principle will offend the consistency principles.

Discuss Bilta.

B. RATIONALE FOR THE LIMITATION AS TO RECOVERY OF FINES/PENALTIES

Safeway has been criticized on a number of grounds.[14] Contrary to academic commentators, it is argued that the prohibition on recovery of fines/penalties can be defended on both criminal law and corporate law principles.

1. Criminal law: justifications based on consistency

In *Safeway*, the Court of Appeal highlighted the need for consistency in the result in criminal and civil law and it would be inconsistent with the policy of the Competition Act 1998, which imposes liability on the undertaking, to then recover the penalties from its directors and employees. The decision has been criticised on the ground that it is anomalous that the culpable directors or employees do not bear the consequences of criminal conduct which is carried out by corporation and it is ultimately the innocent shareholders or creditors who will be penalised;[15] it has also been similarly argued that actions against the directors and employees are not passing the liability, but suing them who have caused the liability in the first place.[16]

Two points may be made. First, loss-shifting is generally contrary to the orthodox view based on the deterrent policy of the statute imposing criminal liability, irrespective of whether the claimant is a corporation. In *R v Reliable Advertising and Addressing Agency*[17] and *Askey v Golden Wine Co*,[18] both cases cited in *Safeway*, it was held that the civil courts will not allow criminal penalties in civil actions. Both of these cases involve negligence on the part of the claimants; in *R v Reliable Advertising and Addressing Agency*, the defendants failed to take

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pass on the liability to their employees, or the employees' D & O insurers. Only if the undertaking itself bears the responsibilities, and meets the consequences of their non-observance, are the public protected. A deterrent effect is contemplated and the obligation to provide effective preventative measures is upon the undertaking itself."

13 [1896] 2 Ch 743.

14 See E Lim, "The Illegality Defence and Company Law" (2013) 13 JCLS 49; P Watts, "Illegality and agency law: authorising illegal action" (2011) JBL 213.

15 Eg see Lim, "A critique of corporate attribution: "directing mind and will" and corporate Objectives" (2013) JBL 333.

16 See P Watts, "Illegality and agency law: authorising illegal action" (2011) JBL 213, at 220.

17 [1915] 1 KB 652. Cf *Cointat v Myham & Sons* [1913] 2 KB 220 (the defendants sold the claimant butcher a pig which had tuberculous and the claimant was not aware of the state of meat. The inspector seized the meat and the claimant was convicted and fined; the claimant claimed the fine, and costs, for having bad meat in his premises and could recover from the defendant. This offence was one of strict liability.

18 [1948] 2 All ER 35.

sufficient precautions for their clients, certain money-lenders, to ensure that advertising circulars were not circulated to minors, which was a criminal offence. The money-lenders, who were fined, claimed unsuccessfully against the defendants the fine and costs involved. The court made it clear that the same reasoning would apply, even if liability is strict. Likewise, in *Askey v Golden Wine Co*, the claimants, sellers of spirits which was unfit for human consumption, failed to claim the value of its fines, costs and other damages, from its suppliers. Denning J held that that it was against public policy to allow the offender to recover the fines and costs as the criminal offence was imposed to make the claimants more careful in their dealings with the suppliers.[19]

Accordingly, where the board of the company has directed an act which is illegal (for example, directing the company to pay an illegal bribe), the company should not be able to claim its fine/penalties from the directors who have given such direction on policy grounds. If the legislation has imposed duties on the company to take reasonable due diligence in order to avoid falling foul of the prohibition on paying bribes, such as section 7 of the Bribery Act 2000, any attempt to remove the sting of liability or consequently, the duty to make the requisite investigation, and should be resisted.

Second, the theory that there is an innocent corporation (with innocent shareholders or creditors) and culpable directors is not the only theory of corporate criminal liability. Under the theory of aggregation,[20] the company is more than the sum of its parts; while a director may not be said to be negligent himself, two or more directors or employees can be shown collectively to have been negligent and whose conduct can be criticised. While a frequently cited example of corporate criminal liability being based on organizational ground is the Corporate Manslaughter and Corporate Homicide Act 2007, [21] the concept can be extended to other kinds of corporate wrongdoing that is dependent on fault or negligence, including the breach of the prohibition of Phase 1 of the Competition Act 1998. If the theory of aggregation is accepted, corporate criminal liability is imposed on the corporation if certain stakeholders of the corporation (including the directors and employees) commit offences in pursuit of the corporation’s goal.

The Sentencing Guidelines, imposed by the Sentencing Council on Fraud, Bribery and Money Laundering: Corporate Offenders, which impose the guidelines on fines for economic crimes committed by organisations, have held that one of the underlying principles of drafting the guidelines is that there must be real economic impact on the corporate offender, including on

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19 Denning J (at 380) held that the court must have regard “to the necessity for deterring him and others from doing the same thing again, to reform him, and, in cases such as the present, to make him and others more careful in their dealings”.

20 The theory of aggravation was discussed by Wells, *Corporations and Criminal Responsibility* (1993) 132-3.

21 See Law Commission, *Criminal Liability in Regulatory Contexts (Law Commission Consultation Paper No. 195 (2010)* at para 5.92. Under the Corporate Manslaughter and Corporate Homicide Act 2007, the company is not liable for corporate manslaughter if it causes a person’s death as a consequence of a gross breach of a relevant duty of care, being established if the conduct of the organization falls far below what can reasonably be expected in the circumstances, including the conduct of the workforce, its safety policies and practice of the company.

the shareholders.[22] In fact, in adjusting the level of fine, the impact of fine on the shareholders is expressly *not* regarded as a factor.[23] The premise must be on the basis that the shareholders take the risks and rewards of financing the company, which may have benefitted from the corporate wrongdoing.

2. Corporate law and economic justifications

Section 232(2) of the Companies Act 2006 sets out the general prohibition on the indemnification of directors against any liability attaching in connection with negligence, default, breach of duty or breach of trust in relation to the company, rendering such purported indemnification to be void. However, section 234 provides that indemnification in respect of third party claims is allowed, except in respect of criminal penalties, penalties imposed by regulatory bodies, costs incurred in defending criminal proceedings in which he is convicted and costs incurred by the director in defending civil proceedings brought by the company in which final judgement is given.

Thus, the company legislation recognises that was that a director cannot be indemnified by the company in respect of criminal penalties or quasi-criminal penalties as well as the costs in defending criminal proceedings.[24] This prohibition on indemnification is not dependent on whether the director is acting in good faith. The prohibition also does not depend on whether the director is convicted of an offence or quasi-offence that is fault-based. The basis must be that the allocation of penalties in criminal proceedings is in fact appropriate and that penalties imposed on a director should be borne by the director (with no possibility of recourse to the company). It would give rise to an anomalous situation where the company can hold the directors and employees liable for the fines/penalties incurred by the company but yet the directors cannot hold the companies responsible in respect of their own individual fines or penalties, notwithstanding the fact that they could have been acting what they perceive to be in the interests of the company.

Further, there may be good reasons to disallow shifting of losses by the company to its directors/employees and require the company to bear the fine/penalty. It has been argued by Professor Kraakman that unlike the situation where directors and employees have breached the no-conflict or no-profit rule, economic theory favours imposing criminal fines (or civil liability) on the enterprise alone and personal liability is only appropriate where enterprise liability fails. The reason is that the managers' actions which constitute the offences have been taken to benefit the enterprise. Large fines will reduce the enterprise earnings and therefore managerial rewards and shareholder pressure and reputational effect will have a bearing on corporate behaviour.[25] While the empirical evidence of such effect on UK companies is limited, if the enterprise is able

[22] Sentencing Council, *Fraud, Bribery and Money Laundering: Corporate Offenders: Definitive Guideline*, effective from 1 October 2014. See Consultation Paper, *Fraud, Bribery and Money Laundering: Corporate Offenders: Response to Consultation* (January 2014).

[23] See above, p 8.

[24] It appears that s 243 does not prohibit the indemnification of costs unsuccessfully defending the regulatory proceedings.

[25] See R Kraakman, "Corporate Liability Strategies and Costs of Legal Controls" (1983) 93 Yale LJ 857 at 866.

to shift the losses away from the enterprise, it certainly encourages moral hazard. After the risks are transferred, the enterprise has less incentives to maintain high levels of are to avoid the situation from arising in the first place

If the purpose of allowing the company to recover compensation in respect of fines or penalties incurred that are brought about by the conduct of the directors or the employees, there is another objection based on compensation principles. The recovery of the fine/penalty may give the company a windfall since the company would have benefitted from the criminal conduct or from the internal lack of oversight that allows the criminal conduct to occur. The examples of benefits may include direct benefit (such as obtaining a contract by reason of payment of a bribe or engaging in price-fixing) or avoidance of monitoring costs in ensuring that the circumstances do not arise. If the fine/penalty is not substantial and is less than the benefits that the company may have derived from the activity, then allowing the company to recover the fine will over-compensate the company. While it may be argued that the fines that are recoverable by the company would need to take into account the benefits received in respect of the illicit conduct, this means that the court will have to carry out the exercise of evaluating whether the benefits exceed the fines/penalties involved. Courts have declined to undertake such exercise. In *ASIC v Cassimati*,[26] the court held that it was against public policy if the directors are allowed to weigh the benefits of deliberately breaching a legislative provision versus the penalties that are involved.

C. Should the *ex turpi causa* rule prohibit recovery of fines/penalties in strict liability offences?

In *Safeway*, the Court of Appeal left open the question of whether the same result should be reached if the offence is one of strict liability. In an earlier decision of *Osman v J Ralph Moss Ltd*, the Court of Appeal held that the claimant, who had been told by the insurance agents that he was insured against motor vehicle accidents, when his insurance had lapsed, successfully recovered against his agents the fine. *Askey* was distinguished on the ground that the claimant was free of culpable negligence.

However, a subsequent case has confined *Osman* to its narrow facts, which applies only where there is absolutely no fault on the part of the claimant. In *R v Northumbrian Water, ex parte Newcastle*, [27] Collins J held that the health authority could not give an indemnity in respect of criminal charges under s 70 of the Water Industry Act 1991 (UK), which made it an offence to supply water that was unfit for human consumption; this was a strict liability offence but the defendant could avail himself of the defence of due diligence. *Osman* was confined only to the situation where "there is true liability and no conceivable fault (for want of a better word) on the part of the officer"; an offence under s 70 was not such a case because there was the defence of due diligence. Such offences will be rare, because legislation often imposes strict liability subject to a defence of due diligence. For example, section 7 of the Bribery Act provides that a commercial organisation will be liable to prosecution if a person associated with it bribes another person intending to obtain or retain business or an advantage in the conduct of business for that organisation. The commercial organisation will have a full defence if it can show that despite a

26 [2013] FCA 641.
27 [1999] Env LR 175 at 726.

particular case of bribery it nevertheless had adequate procedures in place to prevent persons associated with it from bribing.

Accordingly, it could be argued that the prohibition on bringing claims by the company against its director or employee should apply irrespective of whether the application of the fine/penalty depends on a finding of intention or negligence. Even where the offence is one of strict liability, the threat of the fine/penalty is to incentivise the taking of reasonable precautions to minimise the risk that the circumstances giving rise to liability will occur, and hence should be barred.[28] The only time where the prohibition does not apply is a case of an absolute offence without any defence of due diligence.

III. DISTINCTION BETWEEN CORPORATE FINES/PENALTIES AND OTHER LOSSES (WIDE VERSUS NARROW VERSIONS OF THE RULE)

Part III addresses the question as to whether recovery of losses which are not fines/penalties should similarly be prohibited on the consistency ground. Prior to *Safeway*, the consistency rationale for barring claims based on illegality was also used in an earlier House of Lords' decision in *Stone and Rolls v Moore Stephens*, a case which involved the wide form of the *ex turpi causa* rule. In that case, the liquidators of an insolvent company sued the auditors, who sought to rely on the defence of *ex turpi causa,* to prevent the company from recovering damages, in circumstances where the losses of the company was the result of the fraud of its sole director cum shareholder. The House of Lords held, by a majority of three to two, that the claim was barred by *ex turpi causa*. The basis of the majority decision was that it was a one-man firm and there were no innocent participants in the company, and that the fraud of the director-cum-shareholder would be attributed to the company. In these circumstances, the company in *Stone and Rolls* could not rely on the *Re Hampshire* principle,[29] which prevents the attribution of acts of the agent to principal where the agent commits fraud on the principal, to say it was not truly liable.

In *Stone and Rolls,* the auditors conceded that if the company had sued the director-cum-shareholder for breaching his duties to the company for misfeasance arising from wrongful trading, the claim would be barred by *ex turpi causa* on the ground that the directing mind and will would be attributable to the company.[30] The majority left open the question as to whether the claim by the company against the auditor or director would have been barred if the company had independent shareholders who were unaware of the fraud by the directing mind and will. Lords Walker and Browne (two of the judges in the majority) decided the case on the fact that the company as a one-man firm, whose sole directing mind and will was solely responsible for the fraud, and there were no innocent participants. Lord Phillips (the third judge in the majority)

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[28] See Herzfeld, "Still a troublesome area: legislative and common law restrictions on indemnity and insurance arrangements effected by companies on behalf of officers and employees" (2009) 27 C&SLJ 26.

[29] [1896] 2 Ch 743.

[30] Para 29. This concession may be open to question because the company is insolvent, the creditors of the company will be the ones who are prejudiced by the defence, rather than the sole shareholder of the company.

alluded to the question, which was also left unanswered, as to whether the same conclusion would be reached where the company tried to recover compensation from a director.[31]

In *Safeway*, the Court of Appeal took the approach that the costs associated with the OFT investigations were not recoverable by the company against the director. Referring to *Stone and Rolls*, it was held that the consistency argument barred such claims as well.

A. Case law on recovery against director for misfeasance consequent upon criminal conduct

The problem is that *Safeway* is hard to reconcile the earlier cases relating to the company's ability to recover against the director monies or property that were illegally transferred by the company to third parties, on the basis of misfeasance (but not amounting to breach of the no-conflict or no-profit rule). For example, in *Belmont Finance v Williams Furniture (No. 2)*,[32]G and his associates sold their shares in M to Belmont, a subsidiary of City, for £500,000, and G and his associates proceeded to purchase the shares in Belmont from City for £489,000. J was the directing mind of Belmont and City. Prior to executing the agreement for the sale and purchase of M shares, G had obtained counsel's opinion that the transaction did not contravene section 48 of the Companies Act 1948,[33] and the opinion was subsequently shown to the directors of Belmont and City (though the opinion was obtained by G did not make any reference to Belmont nor was it obtained on Belmont's behalf).

When Belmont went into liquidation, its liquidators sued City and the directors of Belmont, for the repayment of £489,000. Their case was that these shares in M were worth only £60,000, and that Belmont provided prohibited financial assistance to its purchasers for the acquisition of its shares, in contravention of the Companies Act 1948. The Court of Appeal found that the counsel's opinion was erroneous and while J and the other Belmont directors fell short of their duty of care, they were not dishonest. J believed that the transaction was in the interests of Belmont and that M shares were worth £500,000. However, as the Belmont directors was aware of the circumstances giving rise to the transaction, including the fact that the purpose of the transaction was for G and his associates to acquire Belmont at no cost to themselves, it is not a transaction in the ordinary course of business and M was not an asset that Belmont genuinely needed, J and the other Belmont directors had committed misfeasance and breach of trust by misapplying the £489,000.[34]

Additionally, two modern cases relating to the prohibition on financial assistance may also be instructive, even though the whitewash exception is abolished by the UK Companies Act 2006. *Cooks v Green*,[35] and *Re A Flap Envelop Limited*,[36] each involves a company which undertakes a whitewash waiver in connection with the use of its (the company's) assets to finance the sale of the shares of the company, which would otherwise be in breach of statutory

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31 Paras 59 to 61.

32 [1980] 1 All ER 393.

33 This was the predecessor to section 678 of the Companies Act 2006; the prohibition in Companies Act 1948 applied to private companies.

34 [1979] 1 Ch 250 at 271.

35 [2009] B.C.C. 204

36 [2004] 1 BCLC 64.

prohibition on financial assistance. In both cases, the directors failed to make the relevant inquiries, with the result that there were material errors in the statutory declaration that the company would be solvent after the financial assistance. The auditors did not also carry out the necessary checks when they issued the auditors' certificate in connection with the whitewash. The directors were held to be liable to the company in negligence for causing the company to provide illegal financial assistance.

Likewise, *Safeway* is also not consistent with the cases involving recovery by the company of assets or property unlawfully transferred by the director. Where the transfer of assets or property is unlawful, such transfer will be unauthorised since no board can authorise an unlawful transfer. In *Holland*, by way of *dicta*,[37] Lord Hope noted that there are two lines of case authority as to the nature of director's liability to the company in respect of misapplication of the company's assets.[38] In the first line of authority, the directors are strictly liable, subject to the possibility of statutory relief under section 1157 of the Companies Act 2006 if he has acted honestly and reasonably and the court decides that he ought fairly to be excused.[39] In the second line of authority, the director is only liable if he knew or ought to have known of the misapplication.[40] Even though it was unnecessary to express a concluded view on this issue, Lord Hope preferred the strict liability approach.[41] It is outside the scope of this article to discuss the merits of either approach, except to say that case clearly allows recovery for property transferred in breach of the capital maintenance rules.[42]

Likewise, in *Commissioners of Inland Revenue v Richmond, Re Loquitur*,[43] the directors of a company authorised the payment of certain dividends but failed to provide for tax on the sale of its business, with the consequence that the company did not actually have the profits to make such payment. The Commissioner of Inland Revenue, as creditors, sought an order for the directors to repay the unlawful dividend on the ground of misfeasance or breach of duty. The directors argued that they had sought the advice of several professional advisers, including the company's tax counsel, solicitors and accountants, and reasonably formed the view that they

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37 The Supreme Court held that the defendant, Holland, was not a *de facto* director of the companies involved and hence was not subject to fiduciary duties.

38 If the director is also a shareholder receiving the dividend, he will be liable to repay the dividend if knows or has reasonable grounds to believe that the dividend is unlawful under the Companies Act 2006: see Companies Act 2006, s 847. However the provision is silent on the liability of a director qua director.

39 Eg *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 Ch D 519. See *Re Kirkbys Coaches Ltd* [1991] BCC 130, Hoffmann J at 131; *Bairstow and Others v Queens Moat Houses plc* [2001] 2 BCLC 531; *Re In a Flap Envelope Co Ltd (in Liq)* [2003] BCC 487.

40 Eg *City Equitable Fire Insurance Co Ltd* [1925] Ch 407, per Romer LJ at 426.

41 See *Holland v HRMC* [2010] UKSC 51 at [46] "The trend of modern authority supports the view that a director who causes a misapplication of a company's assets is in principle strictly liable to make good the misapplication, subject to his right to make good, if he can, a claim to relief under section 727 CA 1985. The authorities that favour the contrary view really come to an end with *Dovey v Cory* [1901] AC 477, as the later judgment of Romer J in *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 can be read, at least in relation to dividends, as supporting strict liability. Furthermore, the whole point of introducing the right to claim relief under section 727 was to enable the court to mitigate the potentially harsh effect of being held strictly liable. That relief was introduced by section 32 of the Companies Act 1907, so it was not available when most of the cases in this line of authority were being decided." That was also the opinion of Lord Walker ([124]) and Lord Clarke ([146]).

42 See also *Selangor United Rubber Estates Ltd v Cradock (No. 3)* [1968] 1 WLR 1555 (on liability by the director to restore the misapplied assets of the company, which is akin to that of a trustee).

43 [2003] EWHC 999.

were entitled not to provide for tax because the company had, prior to the dividend payment, entered into a transaction pursuant to which they thought they could claim for rollover relief. Etherton J, relying on *Re Lands Allotment Company*,[44] held that directors were liable to make good the money misapplied in breach of trust. The directors' application under section 727 of the Companies Act 1985[45] failed because the actual advice contemplated certain assumptions relating to the transaction which the directors knew were not met and as experienced businessmen, they should, but did not, refer the transaction back to the relevant advisers for confirmatory advice.[46]

It is outside the scope of this article to determine whether the strict or fault-based liability approach should be preferred in the context of recovery of property improperly paid away. Whether or not liability depends on fault, the case law is clear that the company can recover the property that is unlawfully transferred and is not the subject of *ex turpi causa* rule.

B. Case law on recovery of third party losses consequent on criminal conduct

The cases have not allowed the wider form of the *ex turpi causa* rule to prohibit recovery of losses of company which are not fines or legal costs associated with the regulatory proceedings. While *Belmont Finance* and the subsequent cases of financial assistance may be justified on the ground that they relate to the capital maintenance rule and the rules exist to protect the company, the scope of the public policy bar in a corporate claim against a director were subsequently discussed in *Bilta v Nazir*, a case dealing with the wide version of the rule.[47] In that case, the Court of Appeal, in affirming the decision of the High Court, held that the defence of *ex turpi causa* is not available in a claim by the insolvent company against the *director* (as opposed to an auditor), whose duties included taking into account the interests of other persons, including the creditors, and not merely the company. *Stone and Rolls* was distinguished on this basis, and Pattern LJ suggested that *Stone and Rolls* should be confined to its facts. *Bilta v Nazir* was a company with two directors, one of whom owned all of the shares.

In *Brumder v Motornet*, it involved a breach of regulation 5 of Provision and Use of Work Equipment Regulations 1998. Notwithstanding that it is also a provision which imposes a penalty on the company only, the Court of Appeal held that *Safeway* was not applicable; there was no public policy reason to prevent the company from bringing an action against the director under section 174 of the Companies Act 2006 who had completely abdicated his responsibility of ensuring compliance with the health and safety regulation. Thus, the *ex turpi causa* rule would not apply to the claim by the company against the director in respect of losses incurred by the company as a result of being liable to the injured workman.

[Abbey]

C. Rationale for allowing loss shifting by the company to directors/employees for property transferred unlawfully

44 [1894] 1 Ch 616.
45 This is now found in section 1157 of the Companies Act 2006.
46 [2003] EWHC 999 at [239].
47 [2014] 1 Ch 52.

Where the company has its assets transferred unlawfully, the company is able to bring an action against the directors, on the basis of misfeasance. Further, the company is also able to recover from its directors for breach of their duty of care and skill when they commit the company to unlawful conduct. At first sight, the difference in outcome between *Safeway* and *Brumder* appears startling. Assuming that the directors or employees intentionally procure the company to enter into the anti-competitive agreements, they would escape liability whereas in *Brumder*, the negligent defendant would in theory be liable for breaching the duty of care in ensuring appropriate work and safety matters. However, Part II argues that the cases must be viewed in the light of the losses that are proposed to be claimed. There are clear public policy reasons against recovery of claims of fines/penalties but not other losses incurred by the company by reason of having to compensate third parties or by reason of its property being transferred improperly (irrespective of whether there was bad faith involved), even if it can be proved that these losses are consequent on criminal conduct.

If the company is held liable to pay damages to a third party, the third party may be at risk of not being adequately compensated if the company does not have sufficient funds to compensate them. Unlike the payment of fines/penalties where the recovery thereof may create moral hazards and lower the deterrence to the wrongdoing company, compensation of third parties does not affect deterrence. Hence, there is no reason why the company should not be able to recover from its errant directors or employees. Using Kraakman's model and applying in the UK context, one of the three reasons for allowing the liabilities of the enterprise to shift to the directors or managers is where the assets of the enterprise are insufficient. These are liabilities which they can shift through contract with the company (for example, indemnification for fines or liabilities) or through insurance, giving the third party victims of the tort or other wrong a fund against which they can claim.

In *Safeway*, the Court of Appeal has held that the difference between the wide and narrow versions of illegality lie in the issue of causation. In the latter case, causation may be difficult to prove. This may have been the case in respect of the other kinds of illegality. However, causation does not explain the cases of *Bilta v Nazir*, or *Brumder*.

D. Scope of prohibition

Once the scope of the prohibition is clarified, two remaining questions arise. First, how should costs and expenses of defending the criminal or regulatory proceedings be treated? Second, does the prohibition barring claims apply to losses payable by the company as result of court-ordered compensation orders which form part of the settlement of the quasi-criminal prosecution or deferred prosecution agreement?

1. Recovery of costs and expenses of defence proceedings

In *Safeway*, the costs and expenses of defence proceedings were treated as falling within the wide version of the *ex turpi causa* rule and were disallowed on the ground. As argued above, this part of the ruling is not consistent with the prior case law which has generally permitted recovery by the company for losses from a director arising from breach of duty of care and skill or misfeasance, notwithstanding they are consequent upon criminal conduct. The further question then arises is whether these costs and expenses should be recoverable.

It could be argued that recovering these costs and expenses are not inconsistent with the legislative purpose behind the imposition of the fine/penalty since the costs are incidental to, and are not, the main purpose of deterrence. At common law, [48]McGregor suggests that where there is *mens rea*, the fine as well as the costs of the unsuccessful defence cannot be recovered. Section 234 of the Companies Act 2006 does not permit indemnification of costs in defending criminal proceedings when the outcome is unsuccessful. Thus it is suggested that the outcome of the proceedings should be important and that these costs and expenses are not recoverable from the directors.

2. Recovery of court-ordered compensation orders

In principle, once it is accepted the basis of the consistency rationale for prohibiting the recovery of fines/penal rests on consistency, there should not be any bar to the recovery of such compensation orders, subject to the normal issues of causation.

IV. Inconsistency with Enforcement of Directors' Duties

A. Australia

Section 180 of the Corporations Act 2001 sets out the statutory duty of the director to exercise due care and diligence.[49] Breach of section 180 can lead to a civil penalty order,[50] a disqualification order[51] or a compensation order.[52]

Healey, *MacDonald* and *Fortescue* are recent decisions in which the Australian courts had to consider the application of section 180 in compliance failures. ASIC has taken "the stepping stone" approach to director's duty of care and diligence, by first bringing an action against the company for civil penalties in respect of wrongdoing, and upon such finding, bringing follow-on actions against the directors for breach of the statutory duty of care. In these three cases, the Australian courts have imposed a more stringent standard of care required of directors in compliance decisions relating to financial reporting and corporate disclosures, by: (1) requiring that the board should be the final gatekeeper in these decisions,[53] (2) limiting the ability of directors to delegate to or rely on external advisers, officers and fellow directors, and (3) disapplying the defence of business judgment.

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48 McGregor, McGregor on Damages (17th edition, Sweet & Maxwell, London, 2003) at [17-050].
49 Breach of section 180 can lead to civil sanctions.
50 Corporations Act, s 1317E.
51 Corporations Act, s 206C.
52 Corporations Act, s 1317H.
53 In *Healey*, the board was described as the "final filter", [2011] FCA 717 at [582].

(a) Final gatekeeper

In *ASIC*, Middleton J held that there was a strict obligation on directors to ensure that the provisions in Corporations Act dealing with corporate accounts were considered and applied in the proper manner. [54] In that case, there were material errors found in the accounts: the 2007 annual reports of Centro Properties Group ('CNP') and Centro Retail Group ('CER') failed to disclose significant matters. In the case of CNP, the report failed to disclose some $1.5 billion of short-term liabilities by classifying them as non-current liabilities, and failed to disclose guarantees of short-term liabilities of an associated company of about US$1.75 billion that had been given after the balance sheet. In the case of CER, the 2007 annual reports failed to disclose some $500 million of short-term liabilities that had been classified as non-current. ASIC brought enforcement proceedings against the chief executive officer, the chief financial officer and the non-executive directors (including the chairman). Middleton J refused to distinguish between the roles of the executive and non-executive director and held that there was a "core, irreducible requirement of directors to be involved in the management of the company and to take all reasonable steps to be in a position to guide and monitor".[55]

In *ASIC v MacDonald*, ASIC brought enforcement proceedings against the directors of a company formerly known as James Hardie Industries Ltd, a publicly listed company which was historically a manufacturer of asbestos products. ASIC alleged that the board of directors (including the executive director and the non-executive directors) breached their duty of care when they allowed James Hardie to issue a public announcement regarding a proposed restructure of the company which involved the separation of the asbestos liabilities of James Hardie from its other operations and the asbestos liabilities were to be managed by a foundation. The announcement stated that the foundation would be fully funded to meet the expected liabilities, which turned out to be wholly inaccurate. The funding of the trust was determined using inadequate actuarial reports and the trust was massively under-funded, leaving victims of asbestos liabilities potentially without any remedies.

The case against the directors in James Hardie was that not that the disclosure was misleading or that they were involved in misleading conduct; rather it was that they breached of section 180 of the Corporations Act 2001 by approving the misleading announcement of James Hardie, which was also convicted under sections 1041E and 1041H of the Corporations Act. At first instance before Gzell J, the director and all of the non-executive directors were held to have breached their duties under section 180. On appeal, the decision was reversed on, among other grounds, that ASIC did not prove that the offending announcement was approved by the board before its issuance. This finding was reversed on appeal to the High Court, and the decision of the first instance judge was upheld. Section 189 was raised but was dismissed as there was no evidence of reliance placed by the director. What is significant is that while there is no specific reference in the Corporations Act that specifically imposes a duty on the director to assume

[54] The director's obligation, under s 344 of the Corporations Act 2001 is to "take all reasonable steps" to comply, or secure compliance, with Pt 2M.3 (which deals with financial reports, directors' reports, audit, reporting to members and lodgement with ASIC). They are under the same duty with respect to the financial records which the entity must keep under Pt 2M.2. If they fail to take all reasonable steps to comply or secure compliance, they contravene the Corporations Act.

[55] At [16]-[17].

responsibility for the disclosure announcement, Gzell J found that such a non-delegable duty exists equally for executive and non-executive directors, and matters of approval of such significant announcements were not operational matters.

(b) The disapplication of the business judgment rule

Australia has a statutory business judgment rule,[56] derived from the concept of the business judgment rule under US corporations law.[57] While there are restrictions on the application of section 180(2),[58] the courts in *MacDonald* and *Fortescue* have held that disclosure issues are not "business judgments". In *Healey*, the provision was not even discussed, presumably on the ground that the decision on compliance with financial accounts is not "business judgment". These two cases are consistent with the Australian courts' general refusal to allow the directors to undertake a cost-benefit exercise in determining whether the costs of compliance exceed the detriment.

In *ASIC v Maxwell*,[59] Brereton J held that it may be breach of a duty for a director to embark on or authorise a course of conduct which attracts the risk of the exposure of the company to civil penalties or other liabilities under the Corporations Act, at least if the risk is clear and the countervailing potential benefits insignificant.[60] In a subsequent case of *ASIC v Cassimati*,[61] the court played down the reference to the cost-benefit exercise, holding that it was against public policy if the directors are allowed to weigh the benefits of deliberately breaching a legislative provision versus the penalties that are involved.

(c) Limits on reliance on professional advisers

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56 Section 180(2) of Australian Corporations Act contains the statutory business judgment rule that provides protection for directors in the case of decisions that appeared sound at the time they were made but turned out to be bad. For section 180(2) to apply, the director must: (a) make the judgment in good faith for a proper purpose; (b) does not have a material personal interest in the subject matter of the judgment; (c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and (d) rationally believe that the judgment is in the best interests of the corporation.

57 See American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (1992) [4.01(c)]. For example, in Delaware law jurisprudence, decisions of the board are subject to the business judgment rule, that is, the directors are presumed to have exercised their decision with sound business judgment. Under the business judgment rule, the court will presume director independence, disinterestedness on the part of the directors, good faith and due care. The burden is on the plaintiff to overturn these presumptions by showing breach of duties of loyalty and care. The court will not review the substantive merits of the decisions made by directors.

58 The conditions that the director must satisfy are: (a) make the judgment in good faith for a proper purpose; (b) does not have a material personal interest in the subject matter of the judgment; (c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and (d) rationally believe that the judgment is in the best interests of the corporation

59 (2006) 59 ACSR 373.

60 *ASIC v Maxwell* (2006) 59 ACSR 373 at [104]. See also *ASIC v Adler* (2002) 41 ACSR 72 where the relevant companies were found to have breached the provisions on related party transactions in Chapter 2E of the corporations Act and the financial assistance provision in section 260A, and Santow J went on to consider whether the individual directors had failed to discharge their statutory duty of care. See also ASIC v Citrofresh International Ltd (No 2) [2010] FCA 27.

61 [2013] FCA 641.

In this regard, section 189 of the Australian Corporations Act 2002 provides that it is a defence to an action under section 180 where directors have relied on professional advice in good faith and after making an independent assessment of the information or advice. In *Healey*, according to Middleton J, while directors are entitled to rely on Chief Executive Officer, chief financial officer, the independent auditor, the board audit and risk management committees, reliance ceases to be reasonable when a director is or should be aware of circumstances which would cause a reasonable person to question what he was being told. On the facts, the errors as to classification of the debt were so plainly obvious had the directors, who are or should be aware of accounting standards. Section 189 was not cited in the judgment. Middleton J rejected the view of Rodgers J in *Daniels v Anderson*[62] that reliance on others is only unreasonable if the circumstances are so plain, manifest and simple of appreciation that no one with any degree of prudence would rely on:

> "174 In this proceeding, the directors' responsibilities and duties were outside the realm of operational responsibility… This is not a case concerning the need to verify information or scrutinise data of a type outside each director's own knowledge. The salient feature here is that each director armed with the information available to him was expected to focus on matters brought before him and to seriously consider such matters and take appropriate action. This task demands critical and detailed attention, and not just 'going through the motions' or sole reliance on others, no matter how competent or trustworthy they may appear to be.
> 175 Directors cannot substitute reliance upon the advice of management for their own attention and examination of an important matter that falls specifically within the Board's responsibilities as with the reporting obligations. The Act places upon the Board and each director the specific task of approving the financial statements. Consequently, each member of the board was charged with the responsibility of attending to and focusing on these accounts and, under these circumstances, could not delegate or 'abdicate' that responsibility to others."

Accordingly, it is clear that even in the absence of red flags or evidence of wrongdoing, there cannot be unquestioning reliance on management or external auditors by the directors.

In *MacDonald*, the defence of the chief executive officer based on reliance on the external solicitors who were present at the boardroom when the decision was made to approve the misleading announcement failed. The solicitors acted reasonably in the circumstances by raising the issue of the reliability of the actuarial reports with the chief executive officer prior to the board meeting who assured them that the trust was fully funded. They were not required to advise on the issue in relation to the whether the funding was adequate. As such, there was no reliance on advice of the external solicitors as to the accuracy of the announcement.

In light of *ASIC v Healey* and *ASIC v Hellicar*, the question is whether an English court will adopt the Australian position in imposing higher standards on directors, particularly in the areas of corporate reporting and corporate disclosure matters.

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62 In any event, the Court of Appeal in Daniels v Anderson disagreed with Rodgers J on this issue, stating that this statement did not accurately state the extent of the duty of directors in modern company law.

It is noted, however, that the enforcement actions are brought by ASIC as the securities regulator.

B. Singapore

[To include]

V. CONCLUSION

It might have been expected that in assessing whether directors have breached their duty of care, skill and diligence in respect of corporate compliance failures, such assessment would treated in the same way as other commercial decisions of the company. However, this is not in fact the case. This article argues that the