CAREFUL DIRECTORS FOR NATION BUILDING: A COMPARATIVE STUDY BASED ON SRI LANKAN COMPANY LAW*

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ABSTRACT

The law relating to duties of company directors historically categorised them as fiduciary duties. As such the duties consisted of inter alia the duty of care which is one of the important duties for the effective function of companies. The duty of care is often connected with skill and diligence but not always. Since the concept of duty of care is rooted from the laws of trust it has the fiduciary flavour which is considered sacred. English courts had opportunities to consider the nature and the extent of directors duty of care and one of such was in the case of Re City Equitable Fire Insurance Company Ltd. The courts interpreted, imposed a subjective test and narrowed down the directors' duty of care in this case. The subjectivity would have been acceptable at that time, but not so when complexities evolved. The later development towards differentiation between executive and non-executive directors and between the role of directors in a small private company and a large quoted company deviated from the application of old style gentleman approach and the subjective standard of ability. Case law added to this and there are extreme cases that imposed personal liability for not exercising reasonable diligence. It is clearly seen in the restatement of fiduciary duties by way of s.174 of the Companies Act 2006 of the United Kingdom that the legislature tends to accept modernization. The use of the term 'must' in the said provision emphasises the yardstick that of a reasonable person. However, the law of Sri Lanka surprisingly not recognises an objective standard. Although the Companies Act 2007 of Sri Lanka introduced a provision specifically on directors duty of care in exercising powers or performing duties, it is measured by what is reasonably expected of a person of 'his' knowledge and experience. Recent corporate collapses in Sri Lanka caused many hardships to stakeholders including frustrated creditors committing suicide. This culminated in questioning whether directors are in practice carefully exercising required duties. This paper attempts to analyse comparatively the extent of duty of care in the Sri Lankan context with a view to suggest reforms.

Key words: Directors, Duty of care

1. Introduction

Business development is a thirst of every region and nation. In a post-war context, development is very vital for Sri Lanka which is striving hard to rebuild. Development or nation building is not possible by government alone. Public participation by way of active involvement in income generating activities is essential to help economic growth. This can be better done by companies which shape the world. Companies (or the popular term private sector) are known as the engine of economic growth in any nation. It is crystal clear from the available data that private sector contributes tremendously to the financial stability of countries. Though the term private sector includes limited liability companies, partnerships, sole proprietorships and associations; the involvement of the latter three, in terms of financial contribution, is very minimal. Limited liability companies (companies), while being active mostly, have turned out to be risky in recent times. The collapse of many companies in the US, the UK, Australia and also in Sri Lanka not only affected the economy but also troubled the stakeholders.[2] The question emanates from the collapses is, "what or who the cause for the collapse is?" In every single instance, the answer is the same and that is, "improper management by the company directors".[3]

The management of companies is, by law, left in the hands of the board of directors. S.184 of Companies Act 2007 of Sri Lanka (hereinafter will be referred as CA 2007 (SL)) is evident for this. The term 'directors' cannot be interpreted in a narrow sense to include only those who are designated as directors. Instead, a control test is used to give a wide meaning to embrace whoever controls the company or gives instructions.[4] The office of directors is inevitable in the lives of companies which are

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[2] For example Enron of US went bankrupt leaving $23 billion in liabilities and $11 billion loss to shareholders. Likewise WorldCom of US collapsed in 2002 with $11 billion loss. Collapse of Satyam of India caused net loss of IRs.233 crore and the Golden Key of Sri Lanka created debt amounting to more than SLRs.23 billion.

[3] In Sri Lanka, it was the collapse of Pramuka Bank and few finance companies few years ago that aggitated the public. The collapse of Goldenkey Credit Card Pvt Ltd, Touchwood Investments PLC, Central Investment and Finance PLC, Ceylinco Finance and Guarantee Property Developers Pvt Ltd are the current incidents which the authorities are taking steps to resolve.

[4] Common law cast upon the duties on directors who are properly appointed and on those who are not appointed as well. This latter category was referred as *de facto* directors. S.529 CA 2007 (SL) defines the term director to

artificial persons. It is for this reason the appointment of directors is made mandatory in companies statutes. The position of 'director' in companies encapsulates within it the activity of directing transactions of the companies. Directing activities take account of acting individually and collectively as a board on behalf of the juristic person of companies at all times. It ranges from minor day-to-day activities to major transactions affecting companies' wealth, business present and future.
Law imposes many duties on directors directly by way of specific statutory provisions and by way of rules that are formulated by regulatory authorities such as Securities and Exchange Commission. This includes statutory duties, duties under the listing rules and the rules popularly known as corporate governance. In addition, there are authorities by way of decided cases which came to be known as common law duties or fiduciary duties. Duty of care is one of the important fiduciary duties that has its roots from the law of trust and the law of tort.

Duty of care means the standard of care, the skill and devotion to the company’s affairs that the directors are expected to demonstrate. Standard that is expected may differ depending on the size and type of companies. Generally, duty of care is a common expectation that can be applied to any situation whether it is signing a contract, purchasing equipments, exercising borrowing powers, approving a design, changing business activities or any other decision making. Hence, when a company suffers losses which were the result of a reckless, negligent performance or careless decision making, the directors are, no doubt, accountable.

2. Origin and Development of Fiduciary Concept

Under the law of trust, a trustee is under an equitable obligation to hold the trust property for the benefit of beneficiaries. Equity regards the trustee as having a special kind of over-reaching obligation to the beneficiaries, (further to his explicit obligations under the trust) a fiduciary obligation characteristics of which are very different from any contractual obligation under the common law. Fiduciary obligations are obligations owed to another person and such fiduciary must act with loyalty and in good faith in dealings which affect that person. Such fiduciary obligation to act with loyalty and in good faith means more than that the fiduciary must act honestly and fairly.[5]

Lord Millett pronounced clearly in Bristol *and West Building Society v Mothew*[6]that,

'A fiduciary is someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence'.

The question of 'to whom the directors owe a duty' was answered in the case of *Percival v. Wright*[7] and a restatement is found under s.170 of CA 2006 (UK) to the effect that they owe the duty to the company.[8] A director is considered as a fiduciary to his company. His directions to the company relating to company's business and affairs affect the company. This is the very reason the directors are expected to act only in the best interest of companies and not in any careless manner.

Fiduciary duties of directors vary and include acting in good faith in the best interest of the company, exercising proper skill and care in the performance of duties, not to make secret profit, not to conflict self interest with duties towards the company etc. Out of these, the second mentioned duty, the duty of care has its roots not only in the law of trust, but in the law of tort as well. As discussed, the duty of loyalty or being honest is based on fiduciary principles developed by the courts of equity. Duties of care and skill are based on the principles of the law of negligence under the tort law.[9]

3. Duty of Care of Directors under the common law

The oldest case relating to directors duties is said to be *Charitable Corporation v. Sutton.*[10] The company in this case was a chartered corporation which suffered a substantial loss due to lack of supervision on the activities of a warehouse keeper in his duties of making loans to poor people on securing pledges. Although it was found that only five out of fifty in the committee of the company were actively involved in the affairs of the company, all fifty were held liable. The court ruled that the forty five were grossly negligent in being inactive and thereby allowing the other five to cause losses to the company. It was further held that the committee men were agents of those who employed them and therefore liable for commission or omission of mal-feasance. The court went on to explain that when the committeemen act within authority, but unfortunately resulted in bad consequences, they should not be liable for breach since they cannot predict. On the other hand, the members of the committee who leave everything to be managed by others should be held responsible. In *Re Leeds Banking Company*[11] the directors

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include a person occupying the position of director by whatever the name called, a person in accordance with whose instructions a director or board is required or accustomed to act. This is similar to the definition under s.1261 of Companies Act 2006 of UK. The second part of the definition is for 'shadow director' which term is freely used under the UK statute while not in the Sri Lankan counterpart.

[5] See: Penner J E, The Law of Trust, 2nd Edi, 2002, p.20

[6] [1996] EWCA Civ 533, [1998] Ch 1

[7] [1902] 2 Ch. 421This has been distinguished in a narrow sense in later cases to the effect that the directors owe duties to shareholders as well in certain instances.

[8] S.170 - Scope and nature of general duties
(1) The general duties specified in sections 171 to 177 are owed by a director of a company to the company.

[9] Davies Paul L, Gower and Davies' Principles of Modern Company Law, 8th Edi, 2008, p.488

[10] [1742] 2 Atk.400

[11] [1866] Ch App 561

delegated authority of allotting shares vested on them to the managers of the company. It was held that the directors have no power to delegate and if they do so, it will be *ultravires.* Later in *Joint Stock Discount Company v. Brown* [12] two directors who were not present in all the meetings in which the decision under dispute was taken, were held liable for negligence. The cases of *Land Credit of Ireland v. Lord Fermoy*[13]and *Overend & Gurney Co. v. Gibb* [14] are examples that the directors were relieved from liability. In the first case it was the position that they shouldn't be held liable for being defrauded and in the second case it was because the directors acted in good faith. At the same time *Overend & Gurney Co. v. Gibb* formulated the requirement of 'ordinary prudent man' in ascertaining the negligence of the director concerned.

Subsequently, the pronouncement in Re *Forest of Dean Coal Mining Co*[15]was remarkable and two folded. While the case emphasised that fraudulent persons should be brought before justice, it opined that capable and honest directors should not be deferred from acting as directors.

The aspect of directors' qualifications was an important factor in the case of *Re Denham & Co.*[16] Court illustrated directors as 'country gentlemen and not as skilled accountants'. In this case the chairman and a book-keeper deceived a director for the purpose of passing a resolution against the common law rule of not to pay dividends out of capital. It was revealed that certain directors did not possess business experience. One director had attended only one meeting in four years and admitted that his limited knowledge in accounts did not permit him to detect fraud in accounts. Court however ruled that he could rely on the figures produced by the company book-keeper especially when there are no grounds to suspect that the information may be wrong. The case *Re Cardiff Savings Bank*[17] went little further and held that a director who attended only one meeting in 38 years was not liable for negligence.

Re National Bank of Wales Ltd[18] is another case on similar lines. In this case the banking company faced financial constraints and was amalgamated with another company. The true state of affairs resulting in loss of stated capital and other huge debts were detected only after the amalgamation. But the bank had been paying dividends to show that they were flourishing. The chairman and the manager were prosecuted and were convicted. The question with regard to duty of care was more crucial in this case with regard to the defendant director who attended matters whenever possible and did not have any suspicion on anything being wrong. It was held that men who hold responsible position must be able to be trusted, unless there is a reason to distrust them and businesses cannot be carried on with principles of distrust. Therefore, holding a director liable for negligence, which was in fact "trust" placed on others, was seen as laying too heavy burden on honest businessman. The defendant director was acquitted in this case.

A strong judgement on directors breach of duties after *Charitable Corporation v. Sutton* was in *Ashhurst v. Mason.* [19]Authors however opine that the court was reluctant to interfere in the management of the company by imposing its judgement on the expected behaviour of directors, unless the defendant director had manifested gross neglect. [20]

A similar pattern was observable in the 20th century case of *Davey v. Cory* [21] to the effect that businessman can proceed with their duties only with the element of trust placed on the others in companies. Lord Macnaughten said in this case that,

"I do not think it desirable for any tribunal to do that which Parliament has abstained from doing - that is, to formulate precise rules for the guidance or embarrassment of business men in the conduct of business affairs." [22]

In *Re Brazilian Rubber Plantations and Estates Ltd*, [23]the company had 5 directors. One of them absolutely did not have any business experience; the 2nd one was 75 years old and was deaf; the 3rd one agreed to be a director because a friend of his was a director; and the other 2 were only able businessmen. The directors caused a contract to be entered between the company and a certain syndicate for the purchase of a rubber plantation in Brazil. A prospectus containing false statements relating to the extent of the plantation, the type of trees, etc was issued. The information contained therein was given to the directors by a person who had an original option to purchase that property and this person had never been to Brazil. This person had sold the option over

[12] [1869] LR 8 Eq 381
[13] [1870] 5 Ch App 763
[14] [1872] LR 5 (HL) 480
[15] [1878-79] L.R 10 Ch D 450
[16] [1884] 25 Ch D 752
[17] [1892] 2 Ch 100 (Known as Marquis of Bute's case) In this case the defendant director, Marquis was the President of the bank and the appointment was by way of inheritance when he was six months old infant. The bank rules provided that the bank shall be managed by the president, trustees and the manager. Non adherence with the rules and many irregularities including fraud was not known to Marquis who hardly involved with the official activities. The action was by the liquidators to hold him liable.
[18] [1899] 2 Ch. 626
[19] [1875] LR 20 Eq 225
[20] See: Arsalidou Demetra, The Impact of Modern Influences on the Traditional Duties of Care, Skill and Diligence of Company Directors, 2001, p.18
[21] [1901] AC 477
[22] ibid at 488. Also see: *Lucas v. Fitzgerald* [1903] 20 TLR 16 Relying on a verbal statement of the managing director that the company was prospering was held not negligence. *Re Denham & Co.*[1883] 25 Ch.D 752. Director receiving money innocently was held not liable.
[23] [1911] 1 Ch 425

the rubber plantation for £ 15,000 to a vendor who sold it back to the company for £150,000. The directors caused the company to purchase without making inquiries. It was held that the conduct did not amount to gross negligence. Neville L.J. pronounced that,

> “It has been laid down that so long as they act honestly, directors cannot be made responsible in damages unless they are guilty of gross negligence."

A director’s duty is therefore required of him to act with such care as is reasonably expected from him having regard to his knowledge and experience. It seems that the court adopted only a subjective standard. The court opined that the director is not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance.[24] It was further held that the directors are not bound to take any definite part in the conduct of the company’s business in so far as he undertakes it he must use reasonable care. Such reasonable care must be measured in the care an ordinary man might be expected to take in the same circumstances of his own behalf.[25]

The case that gained much publicity after *Brazilian Rubber Plantations and Estates Ltd* was *Re City Equitable Fire Insurance Co. Ltd*[26] mainly because of the rules formulated by Romer J relating to directors duties. In this case an insurance company was brought to a winding-up stage due to fraud by the managing director. I was revealed that the other directors were not part of the fraud. Still the liquidator sought to make the other directors too liable for negligence by way of unwise authorization of payment of dividend out of capital and bad investment. Romer J held that although some of the directors did breach their duty of care, they were not liable to reimburse, because an exclusion clause for negligence was valid. Even in absence of exclusion clauses, in his view, ‘for a director acting honestly himself to be held legally liable for negligence, in trusting the officers under him not to conceal from him what they ought to report to him appears to us to be laying too heavy a burden on honest businessmen.’ Though he felt ‘some difficulty’ with the distinction, negligence would need to be ‘gross’ to visit liability.[27] The following rules were set out by Romer J in this case:

1. A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. For example, a director of a life insurance company does not guarantee that he has the skill of an actuary or of a physician. In the words of Lindley M.R.: "If directors act within their powers, if they act with such care as is reasonably to be expected from them, having regard to their knowledge and experience, and if they act honestly for the benefit of the company they represent, they discharge both their equitable as well as their legal duty to the company." This point may be concluded by stating that the directors are not liable for mere errors of judgment. *Lagunas Nitrate Co. v. Lagunas Syndicate* [28] may be an example.

2. A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so. *Re Cardiff Savings Bank* case stated above may be an example.

3. In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. The following words containing similar meaning in the case of in *Re National Bank of Wales Ltd*,[29] may be relevant at this juncture.

> "Was it his duty to test the accuracy or completeness of what he was told by the general manager and the managing director? This is a question on which opinions may differ, but we are not prepared to say that he failed in his legal duty. Business cannot be carried on upon principles of distrust. Men in responsible positions must be trusted by those above them, as well as by those below them, until there is reason to distrust them. We agree that care and prudence do not involve distrust; but for a director acting honestly himself to be held legally liable for negligence, in trusting the officers under him not to conceal from him what they ought to report to him, appears to us to be laying too heavy a burden on honest business men."

This case went to the House of Lords, and is reported there under the name of *Dovey v Cory* referred above Lord Davey's following observations are pertinent:

> "I think the respondent was bound to give his attention to and exercise his judgment as a man of business on the matters which were brought before the board at the meetings which he attended, and it is not proved that

[24] at p.437
[25] See: Lord Millett, Directors’ duties in the context of complex international finance, 2005, THE DILIGENT DIRECTOR, available at https://insol.org/Cayman%20Islands/Papers/Tab%205%20Directors%20duties.pdf
[26] [1925] 1 Ch 407
[27] at pp.428-430
[28] [1899] 2 Ch. 392 In this case, it was held that if a director discharged his responsibility with particular care, used his powers properly within the company constitution and if he utilizes his experience and knowledge to the maximum while acting as director, it will be considered that he has discharged both his duties to company, equitable and lega, well.
[29] [1899] 2 Ch. 629 at 673

> he did not do so. But I think he was entitled to rely upon the judgment, information and advice, of the chairman and general manager, as to whose integrity, skill and competence he had no reason for suspicion. I agree with what was said by Sir George Jessel in *Hallmark's Case*, [(1878) 9 Ch. D. 329] and by Chitty J. in *Re Denham & Co*. [1984] L.R 25 Ch.D 75, that directors are not bound to examine entries in the company's books. It was the duty of the general manager and (possibly) of the chairman to go carefully through the returns from the branches, and to bring before the board any matter requiring their consideration; but the respondent was not, in my opinion, guilty of negligence in not examining them for himself, notwithstanding that they were laid on the table of the board for reference."

Pavlides v. Jensen[30] although cited as an illustration for shareholder remedies often, is also a case that touched on directors duties. In this case the directors sold a property of the company at a price much lower than the market value. An action was brought by a minority shareholder alleging breach of duty resulted in loss to the company. It was held that the negligence by the directors in relation to the value of company property did not amount to fraud and when the general meeting decides not to sue, no action will avail.

Duties of directors were given prominence in *Dorchester Finance v. Stebbing.*[31]Out of 3 directors in a company in this case, two were chartered accountants and the other had considerable amount of accounting knowledge. 2 *were* non-executive directors and one of the chartered accountants was the executive director. The 2 non-executive directors seldom visit the company and left the company affairs to be carried out by the executive director. The 2 often signed blank cheques. The executive director used the cheques to make unrecoverable loans. No board meetings were held. Court held that the 2 non-executive and inactive directors were in breach of duty by failing to oversee the third.

Cases decided until the later part of twentieth century did not firmly establish directors duties. It was seen that the courts have been lenient in this regard. Nevertheless, the cases held on the enactment of Insolvency Act 1986 (IA 1986 (UK)) of the United Kingdom took a different turn. In *Norman v. Theodore Goddard*[32] Q was a chartered surveyor and was a director of the company which had investment by way of principal asset of a trust. Theodore Goddard (TG), a firm of solicitors was the trustee of the said trust and one of the partners of TG was administering the trust. The said partner advised Q to pass a substantial sum of the company's money to another offshore company for tax purposes. In fact, the said partner was controlling the offshore company and thereby he was able to defraud considerable amount of money. Relying on the advice of the said partner for tax matters was held not negligent on the part of Q since there was nothing to make him suspect that an 'outwardly respectable' partner. However, Hoffman J pronounced that,

' The question is whether in all the circumstances he took reasonable care. The extent of the duty of care owed by a director has been discussed in a number of cases but I need mention only two principles which seem to me to emerge clearly from the authorities. First, a director performing active duties on behalf of the company need not exhibit a greater degree of skill than may reasonably be expected from a person undertaking those duties. A director who undertakes the management of the company's properties is expected to have reasonable skill in property management, but not in offshore tax avoidance. It may be that in considering what a director ought reasonably to have known or inferred, one should also take into account the knowledge, skill and experience which he actually had in addition to that which a person carrying out his functions should be expected to have.'

Hoffman J accepted without hearing argument of the counsel of TG that the test of directors duty of care was accurately stated in s 214(4) of the I A 1986 (UK):[33]

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[30] [1956] Ch 565
[31] [1989]BCLC 498
[32] [1991] BCLC 1028
[33] Section 214 of Insolvency Act 1986 refers to 'wrongful trading'. But the section was applied in *Norman v. Theodore Goddard* case for an incident during the life of the company. S.214 reads as follows (irrelevant parts are deleted and appropriate words are in bold):
S. 214 Wrongful trading.
(1) Subject to subsection (3) below, if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.
(2) This subsection applies in relation to a person if—
(a)the company has gone into insolvent liquidation,
(b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and
(c) that person was a director of the company at that time;
but the court shall not make a declaration under this section in any case where the time mentioned in paragraph (b) above was before 28th April 1986.
(3) The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2)(b) was first satisfied in relation to him that person took every step with a view to minimising the

'... the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both – (*a*) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (*b*) the general knowledge, skill and experience that that director has.'

Norman v. Theodore Goddard and the Australian case of *Daniel v. Anderson*[34] are examples of objective test applied by court with regard to duty of care and this approach to be welcome in the opinion of the writer.

Another remarkable judgement was in *Re D'Jan of London Ltd.*[35] In this case an insurance proposal was erroneously completed by an agent of the company. The director, trusting that it was in order, signed it. It did not disclose that he was previously the director of a company that went into insolvency. The policy was void when the company's warehouse was burnt down and the error resulted in the insurance company repudiating liability for fire. It was held that the director had not shown the appropriate standard of skill or reasonable diligence and therefore breached his duties to the company. Hoffman J sitting as additional judge added that the duty of care owed by a director was correctly stated in s.214 of IA 1986. It can be said that an "objective plus subjective" standard was first introduced in the wrongful trading provision of the IA 1986 (UK).

In addition, cases under the Company Director Disqualification Act 1986, for example, *Re Barings plc (No 5,)*[36] indicate that directors will also be liable for failing to adequately supervise employees or for not having an effective risk management system in place. In this case, the London directors ignored a warning report about the currency exchange business in Singapore where a fraudulent trader caused heavy losses and it brought the whole bank into insolvency. The directors were disqualified for failing to have an internal control.

4. Duty of care under the statute of the United Kingdom

Most recent enactment of the Companies Act 2006 (CA 2006 - UK) has clear provisions. The all-important duty of care is found in section 174.[37] Directors must display the care, skill and competence that is reasonable for somebody carrying out the functions of the office, and if a director has any special qualifications, even a higher standard will be expected. Davies comments that common law position was endorsed by both Law Commission and the Company Law Review and now finds expression in s.174.[38] However, under s.1157 under the power of the court in granting relief in certain cases, courts may, if directors are negligent but found to be honest and ought to be excused, relieve directors from paying compensation. Thus the law has thereby maintained a balance between the parties.

A rule known to be business judgement rule has a close connection with the duty of care of directors. Business judgement rule operates as a safe harbour rule or as a presumption of no liability if certain basic requirements are fulfilled. The conditions are the absence of self interest, being reasonably informed and making a rational business judgment. The main rule is still the duty of care. Directors and officers argue that they are first covered by the Business Judgment Rule and even if they lose on this they can still fight on the grounds that the duty of care has been complied with or that the conduct of which the plaintiff complains did not cause damage to the Corporation. [39]

Lastly, it is to be noted that in the recent case of *Foster Bryant Surveying Ltd. v Bryant* [40] Rix LJ cited with approval certain principles. In this case Mr Foster and Mr Bryant were directors of Foster Bryant Surveying Ltd (FBS Ltd), a surveying company and most of their work came from a company called Alliance. Mrs Bryant also worked for FBS Ltd and suddenly Mr Foster

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potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.

(4) For the purposes of subsections (2) and (3), **the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both—**

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

(b)the general knowledge, skill and experience that that director has.

(5) The reference in subsection (4) to the functions carried out in relation to a company by a director of the company includes any functions which he does not carry out but which have been entrusted to him.

[34] [*1995*] 13 ACLC 614.

[35] [1994] 1 BCLC 561

[36] [2000] 1 WLR 634; [1999] 1 AER1017

[37] S.174 - Duty to exercise reasonable care, skill and diligence

(1) A director of a company must exercise reasonable care, skill and diligence.

(2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with—

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and

(b) the general knowledge, skill and experience that the director has.

[38] Davies Paul L, Gower and Davies' Principles of Modern Company Law, 8th Edi, 2008, p.490

[39] See: http://www.companydirectors.com.au/Director-Resource-Centre/Policy-on-director-issues/Policy-Submissions/1997/Duty-of-Care-and-the-Business-Judgement-Rule

[40] [2007] EWCA Civ 200; [2007] IRLR 425; [2007] 2 BCLC 239

announced that she was going to be made redundant. This made Mr Bryant unhappy and subsequently he resigned. Alliance wanted both of them to continue their work. Mr Foster argued that Mr Bryant's services should be contracted out through their company FBS Ltd only and not separately. However, Mr Bryant set up a new company with the support of Alliance. This was all done a few days before the resignation had actually taken effect. FBS Ltd sued Mr Bryant alleging that he had breached his fiduciary duty during the period between resigning and his resignation taking contractual effect; for breach of his fiduciary duty of loyalty; and for the diversion of corporate opportunities to himself. It was held that there was no breach of fiduciary duty. Canadian case of *Canadian Aero Service Ltd v O'Malley*[41]was cited with approval. Rix LJ felt that judgement was right in seeing the strict equitable rule, nevertheless merit based. He also referred to three further cases[42] and drew the conclusion that although the general equitable principle which places an embargo on conflicts of duty is beyond doubt, the extent of a director's duty may depend upon the particular circumstances of the case. He further stressed that there should be some relevant connection or link between the resignation and the obtaining of the business. It can be done by demonstrating lack of good faith which is evident from planning an exploitation while still a director, and that the resignation was an integral part of the dishonest plan. A causal connection between the resignation and the subsequent diversion of the opportunity to the director's new enterprise was found when it was a breach of duty. Rix LJ however recognised the difficulty of accurately summarising the circumstances in which retiring directors may or may not be held to have breached their fiduciary duties since that was based on the circumstance of each issue. It was clear, however, that the defendant's resignation in this case was innocent of any disloyalty or conflict of interest.

The following principles relating to fiduciary duty (though especially on diversion of corporate opportunities) were adopted and approved in *Foster Bryant Surveying Ltd v Bryant*[43]. These are applicable to establishing liability for breach of duty and closely connected to directors duties in a company generally:

1. A director, while acting as such, has a fiduciary relationship with his company. That is he has an obligation to deal towards it with loyalty, good faith and avoidance of the conflict of duty and self-interest.

2. A requirement to avoid a conflict of duty and self-interest means that a director is precluded from obtaining for himself, either secretly or without the informed approval of the company, any property or business advantage either belonging to the company or for which it has been negotiating, especially where the director or officer is a participant in the negotiations.

3. A director's power to resign from office is not a fiduciary power, He is entitled to resign even if his resignation might have a disastrous effect on the business or reputation of the company.

4. A fiduciary relationship does not continue after the determination of the relationship which gives rise to it. After the relationship is determined the director is in general not under the continuing obligations which are the feature of the fiduciary relationship.

5. Acts done by the directors while the contract of employment subsists but which are preparatory to competition after it terminates are not necessarily in themselves a breach of the implied term as to loyalty and fidelity.

6. Directors, no less than employees, acquire a general fund of skill, knowledge and expertise in the course of their work, which is plainly in the public interest that they should be free to exploit it in a new position. After ceasing the relationship by resignation or otherwise a director is in general (and subject of course to any terms of the contract of employment) not prohibited from using his general fund of skill and knowledge, the 'stock in trade' of the knowledge he has acquired while a director, even including such things as business contacts and personal connections made as a result of his directorship.

7. A director is however precluded from acting in breach of the requirement at 2 above, even after his resignation where the resignation may fairly be said to have been prompted or influenced by a wish to acquire for himself any maturing business opportunities sought by the company and where it was his position with the company rather than a fresh initiative that led him to the opportunity which he later acquired.

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[41] [1974] S.C.R. 592 Canaero was a company whose main business was topographical mapping and geophysical exploration. O'Malley and Zarzycki were senior officers of Canaero, and, together with Wells, were directors of the company. After the acquisition of Canaero's parent by another company, Wells resigned from his position as director. Consequently O'Malley and Zarzycki too resigned from their positions. Prior to their resignation, the three decided to form a business venture in the same fields as Canaero and it was so incorporated. The new company was soon chosen to receive a contract to perform a topographical survey and related mapping for the Government of Guyana, and the agreement was executed. The proposal upon which the contract was granted was based on preparatory work that had been performed by O'Malley and Zarzycki for Canaero prior to their resignations. Canaero filed a claim against the three (together with Terra) on the basis that the defendants had improperly taken the fruits of a corporate opportunity in which Canaero had a prior and continuing interest. The Court held that anyone in a supervisory or controlling role of a company has a fiduciary duty towards the company which includes the duties of loyalty, good faith and avoidance of a conflict of duty and self-interest. But these duties, except in so far as they depend on statutory provisions expressly limited to directors, are not so restricted but apply equally to any officials of the company who are authorized to act on its behalf, and in particular to those acting in a managerial capacity.

[42] cases *Island Export Finance v Umunna* [1986] B.C.L.C. 460, *Balston Ltd v Headlines Filters Ltd* [1990] F.S.R. 385 *and Framlington Group Plc v Anderson* [1995] 1 BCLC 475.

[43] [2007] Bus LR 1565

8. In considering whether an act of a director breaches the preceding principle the factors to take into account will include the factor of position or office held, the nature of the corporate opportunity, its ripeness, its specificness and the director's relation to it, the amount of knowledge possessed, the circumstances in which it was obtained and whether it was special or indeed even private, the factor of time in the continuation of the fiduciary duty where the alleged breach occurs after termination of the relationship with the company and the circumstances under which the breach was terminated, that is whether by retirement or resignation or discharge.

9. The underlying basis of the liability of a director who exploits after his resignation a maturing business opportunity of the company is that the opportunity is to be treated as if it were the property of the company in relation to which the director had fiduciary duties. By seeking the exploit the opportunity after resignation he is appropriating to himself that property. He is just as accountable as a trustee who retires without properly accounting for trust property.

10. It follows that a director will not be in breach of the principle set out as point 7 above where either the company's hope of obtaining the contract was not a 'maturing business opportunity' and it was not pursuing further business orders nor where the director's resignation was not itself prompted or influenced by a wish to acquire the business for himself.

11. As regards breach of confidence, although while the contract of employment subsists a director or other employee may not use confidential information to the detriment of his employer, after it ceases the director/employee may compete and may use know-how acquired in the course of his employment (as distinct from trade secrets - although the distinction is sometimes difficult to apply in practice).[44]

5. Duty of care under the law of Malaysia

The Companies Act 1965 of Malaysia (as amended) provides that a director of a company shall exercise reasonable care, skill and diligence with the knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities; and any additional knowledge, skill and experience which the director in fact has.45 The words underlined give a clear indication that the expectation is objective. However, the same provision in its subsection (b) raises a question as to whether it involves any subjectivity. The answer to that question may be that the knowledge and experience which the director in fact has must be considered in addition to the knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities. It means where a director has additional knowledge, skill and experience such as professional qualification or experience, that director will be assessed against a reasonable person who has similar additional knowledge, skill and experience. Therefore, the actual knowledge and experience of a director is to be considered in addition to the minimum standard, that is a reasonable diretor.

6. Duty of Care of Directors under the law of Sri Lanka

Prior to may 2007 the duties of directors were easily devisable into two, namely the statutory duties (that are mere regulatory in nature) and fiduciary duties as pronounced by judges of the courts of England. The new Companies Act No. 07of 2007 (CA 2007 SL) codified most of the fiduciary duties of directors to make it clear to all stakeholders and to provide for easy enforcement mechanism. Section 189 of CA 2007 provides that a person exercising powers or performing duties as a Director of a company shall exercise the degree of skill and care that may be reasonably be expected of a person of his knowledge and experience. Although the Statute introduced this concept of duty of care of directors very recently, common law interpreted and accepted the same more than a century ago. However, the exact degree of care expected or the standard of care envisaged in a given situation had been questions at issue right through and the exponents were unable to come to a conclusion as to whether it should be a subjective standard or an objective standard.

The remarkable requirement of satisfying solvency test was introduced in the statute of Sri Lanka by following New Zealand pattern. In this regard, the statute provides for specific duties, and imposes liabilities on directors if duties are breached. Duties relating to the submission of audited accounts[46] are paramount duties since the shareholders and the investors rely on those to make their future decisions which include election of directors or whether to remain in the same company. Submission of audited accounts is also a requirement under the listing rules of the stock exchange.[47] Duty of directors on serious loss of capital[48] is a

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[44] Source: http://books.google.lk/books?id=RX2cAQAAQBAJ&pg=PA565&lpg=PA565&dq=%221.+A+director,+while+acting+as+such,+has+a+fiduciary+relationship+with+his+company

[45] **Section 132. As to the duty and liability of officers.**

(1) A director of a company shall at all times exercise his powers for a proper purpose and in good faith in the best interest of the company.
(1A) A director of a company shall exercise reasonable care, skill and diligence with—
(a) the knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities; and
(b) any additional knowledge, skill and experience which the director in fact has.

[46] S.150-153 *CA 2007 SL*

[47] 7.4 and 7.5 Listing Rules of Colombo Stock Exchange

precautionary measure to prevent insolvent liquidation. Duty of directors on insolvency[49] is another novel provision which imposes personal liability on directors for their breach of duty relating to steps that should be taken on coming to know that the company is unable to settle its debts as they fall due. In the last two instances the law expects directors to consider the option of winding-up to avoid insolvent liquidation and thereby saving the creditors from a miserable dilemma. If the directors exercise proper duty of care in all the above circumstances, the chances of sudden collapse will be atypical. Therefore, wherever there is sudden financial crisis, the suspicion is whether the directors performed their duties with proper duty of care that is expected of them.

Apart from the statutory provisions, there are corporate governance codes in place in every modern state, including Sri Lanka. However, the problems result from negligent performance and reckless decision making seem to have not improved. It is an open secret that directors of companies that go for insolvent liquidation do not become paupers. On the contrary, they are well off with their other businesses unless the law imposes criminal sanction on them. Hence, it is obvious that mismanagement of directors caused insolvency. Had the directors performed required duty of care in the proper way, the company would not have gone for insolvent liquidation. Mismanagement has a serious repercussion on more than one issue. Shareholders will be disappointed without their dividends and return of capital as well. Creditors will be unpaid and may face lot of complications. Employees will lose their jobs or there may be unpaid wages and other related compensation. The good name of the capital market may be tarnished and the economy of the country will be affected by a series of unwarranted collapses.

It becomes necessary therefore, to have clearly defined duties to take care in respect of the performance of duties of directors. The terminology used in the statute of Sri Lanka sounds subjective which should be scrutinized. If the standard of care expected is that of knowledge and experience of the particular director in question, such errant Director may simply escape liability by proving his lack of knowledge or inexperience in financial matters. This is because the law does not require any educational qualification to hold positions as directors. Therefore, the law should be more stringent without allowing loopholes to escape.

Sri Lankan courts did not have the opportunity to interpret the phrase 'duty of care' when it comes to the duties of company directors. Even if such a situation arises, one cannot apply a blindfolded subjective standard by directly interpreting s.189. At the same time we cannot chose a pure objective test that the UK statute expects. The issue should be analysed taking into account the duty of care that is practically possible, taking into consideration the vast responsibilities the managers and directors shoulder. A balance between the responsibilities undertaken and the possible safeguard measures to prevent abuse of powers and insolvent liquidation should be maintained. Otherwise no intelligent prudent person will be willing to accept the position of director in companies.

7. Conclusion

On a comparative analysis of the legal framework relating to directors' duty of care in Sri Lanka, and UK it is clear that the legislature has adequately provided for what is necessary for effective and lasting good governance of companies. Exponents consider Corporate Governance as a simple mechanism for monitoring since the company financial reports should have a statement of compliance of corporate governance. However, the writer finds it inadequate. The enormous responsibilities shouldered by directors have to be considered while enforcing the duty of care to provide possible safeguards for sustainability of good governance which is free from abuse. A subjective test may not be suitable for Sri Lanka since practical incidents indicate that law evasion is more than law abiding. Still for all we have to be mindful that over regulation will de-motivate the business community. Therefore, the author envisage suggesting reforms to the existing statutory provisions and regulations, that are practicable in Sri Lanka, for encouraging businessmen and others including intellectuals to take part in business activities while adhering to good governance practices.

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[48] S.220 *CA 2007 SL*
[49] S.219 *CA 2007 SL*