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Business Judgment and Director Accountability: A Study of Case-law Over Time

Abstract: It is often assumed that judges are reluctant to review directors' business judgments, which contributes to a lack of director accountability, particularly in large companies. This claim has never been systematically interrogated. This paper therefore analyses English and Welsh cases to ascertain whether judges do review and impose liability for directors' judgments, whether this has altered from the mid-nineteenth century until the present, or varies by cause of action, and what types of company or claimant are involved. It finds that challenges to business judgment have been successful over the whole time period, with a marked increase in legal liability since 2007. This cannot be linked to changes in substantive law, but probably a greater willingness by claimants in insolvent companies to mount challenges to business judgment. Nevertheless liability levels remain low, and largely confined to private companies.

Key words: *Business Judgment; Directors' Duties; Accountability; Corporate Governance; Private Enforcement; Public Enforcement.*

A. Introduction

It is rare for directors to be sued by their companies or shareholders, or subjected to regulatory sanctions for business decisions that cause harm. One key reason could be the view set out in the case law and literature that directors' business judgments are immune from judicial review.[1]

The extent to which directors should be accountable for business judgments is contentious. However although several jurisdictions, including the United States and Australia,

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[1] See for example, *Carlen v Drury* (1812) 1 V & B 154,158; *Re Elgindata* [1991] BCLC 959, 993-4; *Howard Smtih v Ampol Petroleum* [1974] AC 821, 832.

have a 'business judgment rule', a rule of law that protects directors' decisions from judicial scrutiny in most cases, no such formal rule exists in England and Wales, and the extent to which the courts defer to directors' judgments, and when, has never been systematically examined.

This is a significant gap in knowledge that raises important social, legal and practical issues. Following the Global Financial Crisis (GFC) and corporate collapses such as that of Carillion plc, there have been increased calls in the media, by policy-makers, and by politicians for greater director accountability before courts or regulators,[2] for decisions that may be misjudgements rather than misconduct.[3] Accountability is seen as necessary to legitimise the grear power exercised by the directors of public and large private companies, and to promote good governance behaviour[4] and market trust.[5] If business judgments are protected from review this could be a significant factor in the present lack of litigation against these directors, particularly in listed public companies.[6] This is because structural safeguards render it unlikely that these directors will breach fiduciary duties. However, as the financial crisis demonstrates, such safeguards do not eliminate the risk of poor business decisions but these might be immune from judicial review as business judgments. Even a mistaken belief that the courts will not review business judgments will deter potential claimants.

Accountability is also important in small private owner-managed companies, and litigation is seen as a mechanism to promote such accountability. Most litigation against

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[2] See for example, Parliamentary Commission on Banking Standards, *Changing Banking For Good*, HC 175-I (2013) 8; Department for Business Innovation and Skills, *Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business Discussion Paper* (July 2015) para 41; S Sadan, 'Carillion's Collapse exposes deep corporate governance failings' *Financial Times* 14 February 2018.

[3] K Burgess, 'Carillion's board: misguided or incompetent? The directors ticked all the good governance boxes, yet the contractor still collapsed' *Financial Times* 17 January 2018.

[4] J Roberts, T McNulty and P Stiles, 'Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom' (2005) 16 *British Journal of Management* S5-S26.

[5] J Loughrey, 'Smoke and Mirrors? Disqualification, Accountability and Market Trust' (2015) 9 *Law and Financial Markets Review* 50.

[6] J Armour, 'Enforcement Strategies in UK Corporate Governance' in J Armour and J Payne (eds.), *Rationality in Company Law: Essays in Honour of Dan Prentice* (Hart Publishing, 2009), 85. However see M Moore, 'Redressing Risk Oversight Failure in UK and US Listed Companies: Lessons from the RBS and Citigroup Litigation' (2017) 18 *European Business Organization Law Review* 733.

directors occurs in these companies, but it is not known whether this involves reviewing business judgment, rather than challenging misconduct. [7] Failing to review business judgment could reduce the utility of litigation to promote accountability. Conversely review could be problematic: it has been argued that holding directors liable for poor decisions could have adverse economic impacts by deterring entrepreneurial risk taking and discouraging able people from becoming directors.[8]

However despite the importance of the issue, little is known about how courts deal with cases that raise matters of business judgment. This paper investigates this lacuna by analysing English and Welsh case-law to identify how the courts have responded to challenges to directors' business judgment over time. In order to do this we created a dataset of 130 cases, coded across 25 categories. Although the earliest case in the study dates from 1742, directors' judgments began to be considered by courts in a sustained fashion about 150 years ago, when company law was developing, and the Companies Act 1862 was regarded as a ground-breaking piece of legislation. Directors 'actions were being placed under the spotlight and duties that they were to fulfil were being developed by the courts through case law.

The study considers whether judges do review directors' judgments and whether, and how, as the law developed, levels of challenges to, and liability for directors' business judgment altered. It specifically considers: whether the overall numbers of cases involving consideration of directors' business judgment changed over time or varied by cause of action, company or claimant type; whether there have been changes over time in levels of liability in

[7] R Tomasic and F Akinbami, 'Shareholder ACtivism and Litigation Against UK Banks: The Limits of Company Law and the Desperate Resort to Human Rights Claims?' in J Loughrey (ed), *Directors Duties and Shareholder Litigation in the Wake of the Fnancial Crisis* (Edward Elgar, 2011),158-162.

[8] V Finch, 'Company Directors: Who Cares about Skill and Care?' (1992) 55 MLR 179; A Hicks, 'Directors' Liability for Management Errors' (1994) 110 LQR 390; S Worthington, 'The Duty to Monitor: A Modern View of the Director's Duty of Care' in F Patfield (ed), *Perspectives on Company Law: 2* (Kluwer Law International, 1997); C Riley, 'The Company Director's Duty of Care and Skill: the Case for an Onerous but Subjective Standard' (1999) 62 MLR 697, 709.

different categories of case involving challenges to business judgment; and what factors might influence these findings.

There is little empirical work in the corporate law field generally or in relation to business judgment specifically, yet an empirical approach has 'the ability to reveal counterintuitive patterns and to test our basic assumptions about the world.'[9] Our empirical data suggests that, contrary to orthodoxy, courts do review business judgments and that legal challenges to, and rates of liability for, business judgment have increased since 2007. This cannot be linked to changes in substantive law. The increase in numbers of legal challenges may be due to a greater willingness by liquidators, administrators and the Insolvency Service to pursue litigation, and an increase in the number of cases captured in on-line databases. However these factors cannot explain increased rates of liability.

The paper is structured as follows: it first examines the meaning and importance of director accountability and how judicial review of directors' business judgment constitutes an accountability mechanism. The following sections describe our methodology. The last sections set out our findings, and the analysis of those findings, before the paper concludes.

B. Business Judgment and Director Accountability

For many years, and particularly since the GFC, the concept of accountability has been used increasingly in government reports, discussion papers and the academic literature on corporate governance. Together with transparency it has been described as 'the most important elements of good corporate governance.'[10] The Cadbury Report said many years

[9] A Dignam and P Oh, 'Disregarding the Salomon Principle: An Empirical Analysis, 1885-2014' (2019) 39 OJLS 16, 19.

[10] The definition appears at: <http://webarchive.nationalarchives.gov.uk/20090902193559/berr.gov.uk/whatwedo/businesslaw/corp-governance/page15267.html > accessed 28 February 2018.

ago, that '(t)he issue for corporate governance is how to strengthen the accountability of boards of directors to shareholders.'[11] More reently a key government policy response to the GFC was to make companies more accountable to shareholders and the public.[12]

The need for accountability is often linked to agency problems arising from the dispersion of 'ownership' and control in Anglo-American public companies. Agency problems are created by the fact that in these companies the power to run the company is placed in the hands of the board of directors rather than the shareholders, who are loosely referred to as the owners of a company, which creates the risk that directors will shirk or pursue their own interests rather than those of shareholders'.

Agency problems also arise in private companies: opportunistic behaviour by majority shareholders can result in the oppression of minority shareholders. [13] These can be particularly acute in small owner-managed companies, as shareholders typically fail to formalise many of their understandings about how the company should be run, or fail to envisage the circumstances that later arise.[14] Agency problems between shareholders and unsecured creditors are also particularly acute in such companies as these are more likely to continue to trade when insolvent and to take excessive risks with creditors' money than larger firms.[15] In addition the Government has acknowledged that 'the conduct and governance of large (private) companies…has a sizeable impact on the interests of employees, suppliers,

[11] Report of the Committee on the Financial Aspects of Corporate Governance under the chairmanship of Sir Adrian Cadbury (Gee Publishing,1992), [6.1].

[12] Department for Business Innovation and Skills and HM Treasury, *Making Companies More Accountable to Shareholders and the Public* (updated 9 December 2013) <https://www.gov.uk/government/policies/making-companies-more-ACcountable-to-shareholders-and-the-public > accessed 12 October 2018.

[13] R Kraakman, J Armour, P Davies, L Enriques, H Hansmann and G Hertig, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press, 3rd ed, 2017), 30.

[14] R Goddard, 'Enforcing the Hypothetical Bargain: Sections 459-461 of the Companies ACt 1985' (1999) *Company Lawyer* 66, 69; see also O Hart, 'Corporate Governance: Some Theory and Implications' (1995) 105 *The Economic Journal* 678, 680.

[15] R Mokal, 'An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain' (2000) 59 *CLJ* 335, 353–354.

customers and others'[16] which creates a need for accountability in relation to directors of these companies.[17]

Many explanations for accountability also emphasise its link with power.[18] In many fields accountability is something that is required as an exchange for the grant of authority.[19] The essential rationale for board accountability is said by many to enable boards to have legitimacy in relation to the exercise of the power they have.[20] By addressing the use and abuse of authority and power, accountability is designed to protect certain people or groups, which in the context of Anglo-American corporate law and governance, comprises the shareholders. [21]

Accountability has also been linked to restoring and protecting market trust by deterring undesirable market conduct, and by reassuring market participants that steps will be taken against those who act in an untrustworthy fashion.[22] A lack of accountability can create a perception that trust destroying behaviour can be engaged in with impunity, and thus deter participation in the market.[23] This can be an issue with companies of all kinds. In terms of public companies, the manner in which the banks were run prior to the GFC and the fact that no one appeared to be held accountable, was acknowledged as damaging public trust.[24]

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16 Department for Business, Energy & Industrial Strategy *Corporate Governance Reform: The Government's Response to the Green Paper Consultation* (August 2017), 40.
17 Ibid, 43.
18 A Licht, 'Accountability and Corporate Governance' (September 2002) 1 <http://ssrn.com/abstrACt=328401> accessed 31 August 2018.
19 A Sinclair, 'The Chameleon of ACcountability: Forms and Discourses' (1995) 20 *Accounting, Organizations and Society* 219, 221.
20 M Moore, *Corporate Governance in the Shadow of the State* (Hart Publishing, 2013), 35*;* A Keay, 'Exploring the Rationale for Board Accountability in Corporate Governance' (2014) 29 *Australian Journal of Corporate Law* 115.
21 A Licht, 'Accountability and Corporate Governance' (September 2002) 17 <http://ssrn.com/abstrACt=328401> accessed 31 August 2018.
22 Department for Business Innovation and Skills, *Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business Discussion Paper* (July 2015) 53; *Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business Government Response* (April 2015) 4, 13.
23 J Loughrey, 'Smoke and Mirrors? Disqualification, Accountability and Market Trust' (2015) 9 *Law and Financial Markets Review* 50, 52.
24 V Cable, 'Trust: Why it Matters' Reform Conference on Responsible Capitalism (15th July 2013) <https://www.gov.uk/government/speeches/reform-conference-on-responsible-capitalism > accessed, 31August 2018.

Meanwhile in 2013 the Government's overarching policy of 'Making Companies More Accountable to Shareholders and the Public' addressed a loss of trust by shareholders and the public in the way that companies in general were run, and contained measures aimed at owner-managers of smaller private companies whose activities caused harm to creditors.[25] More recently the Government's Green Paper on Corporate Governance set out proposals aimed at ensuring that public companies and large private companies 'earn and keep the trust and confidence of their customers, employees and the wider public' by promoting better corporate governance by strengthening accountability.[26]

C. Litigation as an Accountability Process

While accountability is seen as important, it is a notoriously difficult concept to define. One study that focuses on its meaning in corporate governance argues that accountability describes a process involving several stages.[27] First a person or entity -in this case, the board and individual directors- must be called to account, that is, obliged to recount or report their conduct to a third party (in this case, the shareholders). The next stage requires that directors must explain and justify their decisions, actions and omissions. This stage is key to the idea that accountability includes the notion of being answerable. The third stage is that shareholders can

25 Department for Business Innovation and Skills and HM Treasury, *Making Companies More Accountable to Shareholders and the Public* (updated 9 December 2013) <https://www.gov.uk/government/policies/making-companies-more-ACcountable-to-shareholders-and-the-public > accessed 12 October 2018.

26 Department for Business, Energy and Industrial Strategy, *Corporate Governance Reform Green Paper* (November 2016), 7. See also Department for Business, Energy & Industrial Strategy *Corporate Governance Reform: The Government's Response to the Green Paper Consultation* (August 2017), 7, 37.

27 A Keay and J Loughrey, 'The Framework for Board Accountability in Corporate Governance' (2015) 35 *Legal Studies* 252.

ask questions and debate the directors' conduct before passing judgment. Finally, there must be the possibility of consequences, positive or negative, being visited upon the directors.[28]

Adopting this definition, it can be seen that there are various mechanisms by which directors can be held to account: shareholders can hold boards to account at the general meeting for example. Litigation is just another, ex post, accountability mechanism but unlike other mechanisms that are accepted as desirable, the extent to which directors should be held accountable through judicial processes for decisions that have poor outcomes is controversial. For example the Carillion Report was concerned that directors should not be subject to an 'unreasonable degree of legal exposure' in relation to the decisions they take, and commented that it should not be 'left to the courts to clear up the corporate mess'.[29] Much of the debate centres around the extent to which directors should be accountable for breaching their duty of care when business judgments have adverse impacts,[30] though challenges to directors' business judgments can arise in a wider range of litigation scenarios. Arguments against such liability include that it would over-deter risk-taking and discourage people from taking up directorial roles,[31] that courts lack the ability to assess business judgments and do not adopt the same approach to risk taking as directors, and that hindsight bias will affect judicial decision-making.[32]

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28 R Mulgan 'Accountability': An Ever Expanding Concept?' (2000) 78 *Public Admininistration* 555; M Bovens, T Schillemans and P T'Hart 'Does Public Accountability Work? An Assessment Tool' (2008) 86 *Public Admininistration* 225.

29 House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, *Carillion* (16 May 2018) HC-769, 70

30 M Eisenberg, 'The Divergence of Standards of Conduct from Standards of Review in Corporate Law' (1993) 62 *Fordham Law Review* 437, 445-446; C Riley, 'The Company Director's Duty of Care and Skill: the Case for an Onerous but Subjective Standard' (1999) 62 MLR 697, 712.

31 Eisenberg, ibid*;* Riley, ibid*,* 712 ; B Cheffins and B Black, 'Outside Director Liability Across Countries' (2006) 84 *Texas Law Review* 1385, 1389.

32 H Arkles and C A Schipani, 'Medical Malpractice v. The Business Judgment Rule: Differences in Hindsight Bias,' (1994) 73 *Oregon Law Review* 587, 595-600 .

Nevertheless calls for director accountability that succeeded the GFC and corporate crises seem to demand precisely this type of accountability.[33] It is beyond the scope of this article to explore in detail why, but one possibility is that when people have been harmed by decisions, adequate accountability entails the possibility of rectification or retribution through a judicial process.[34] Another is that this form of accountability is considered necessary to deter the conduct that has caused harm.[35] Yet as canvassed previously, because little is known about how challenges to directors' business judgment fare in the courts, it is unclear to what extent litigation does, and could, operate as an accountability mechanism in relation to such conduct. It is to this that the remainder of the paper turns.

D. Research Methods

1. Case selection rationale

In order to assess how the courts approach business judgment we conducted a database search using Lexis and Westlaw for cases involving directors' business judgment. The first challenge was assessing what to look for: because there is no business judgment rule in England and Wales and the courts rarely use the term 'business judgment', determining what cases concern directors' business judgment required an assessment by us as to what cases to include. Below we explain the rationales underpinning the categories of cases we selected for the database.

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33 See for example Parliamentary Committee on Banking Standards, *Changing Banking for Good* HC 175-1 (2013), 10.

34 R Mulgan, *Holding Power to Account: Accountability in Modern Democracies* (Palgrave MacMillan, 2003) 9.

35 On deterrence and shareholder litigation see E Kamar, 'Shareholder Litigation Under Indeterminate Corporate Law' (1999) 66 *University of Chicago Law Review* 887.

We included all cases in which the cause of action includes a claim for a breach of duty of care at common law and under section 174 of the Companies Act 2006, or failure to take reasonable care, or negligence by a director. It has been judicially recognised that duty of care claims involve reviewing business judgment.[36] In Australia, the statutory business judgment rule is associated with breach of duty of care claims only.[37] The courts must assess whether directors acted with competence, and not solely, as with the other duties, whether decisions were improper, or actually or potentially self-serving. This entails challenging the substance and/or process of directors' judgment.

All wrongful trading cases under section 214 of the Insolvency Act 1986 were included. Under section 214(2)(b) a director of a company that has subsequently become insolvent may be liable for wrongful trading if they allowed the company to continue trading and 'at some time before the commencement of winding up of the company, [the director] knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.' As decisions to allow companies in financial difficulties to continue trading have been classified by the courts as business judgments,[38] section 214 cases involve decisions by directors that are business judgments and/or involve courts determining what a reasonable business judgment would have been.

Also included were cases involving the common law duty to act in good faith in the company's interests and its codified replacement in the Companies Act 2006, section 172(1), and cases involving the director's common law duty to take account of creditor interests where a company is insolvent, nearly insolvent or in bad financial circumstances, which is now included in the Companies Act 2006, namely section 172(3). Cases in which directors breached

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[36] *Optaglio Ltd v Tethal* [2015] EWCA Civ 1002 at [23]*;Carlyle Capital Corporation Ltd.* v. *Conway* Judgment of the Royal Court Guernsey of 4th September 2017 not yet reported, at [546], [1223] [1923]. (applying English law)

[37] Corporations Act 2001 (Aust), s 180(2).

[38] *Re Uno plc Secretary of State for Trade and Industry v Gill* [2006] EWHC 1846 (Ch); [2007] BCC 288.

either of these duties in bad faith were not included because they require the courts to review the propriety of directors' conduct and motives, rather than the merits of a judgment made on the company's behalf. We only included cases in which directors had inadvertently overlooked, or turned a blind eye to, considering the company's or creditor interests.[39] In determining whether there is a breach of duty in these circumstances, the courts assess whether a reasonable director exercising their judgment to act in the company's interests, could have acted in the way the respondent director did.[40] If not, the director will be liable. This requires the court to assess whether what the director did could have been the product of a reasonable business judgment, had a judgment been made. Thus, while these cases do not, strictly, involve a review of an actual judgment, they do involve the courts assessing the merits of what directors did, as if such a judgment had been made. In relation to section 172(1) we also included cases where a director failed to take account of a relevant factor (those in section 172(1)(a) – (f)) when making a decision.[41]

Cases in which directors have been disqualified from being a director, acting as receiver of a company's property or being concerned or taking part in the promotion, formation or management of a company in any way, directly or indirectly were included.[42] The most common ground for disqualification is section 6 of the Company Directors' Disqualification Act 1986 which provides for disqualification where a person's conduct as a director of a company that has become insolvent makes them unfit to be concerned in the management of a company. Disqualification was included in order to examine the courts' approach to business judgment in public enforcement proceedings (proceedings are instigated by the Insolvency

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39 *Extrasure Travel Insurances Limited v Scattergood* [2003] 1 BCLC 598.

40 *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1969] 2 All ER 1185; *Colin Gwyer v London Wharf (Limehouse) Ltd* [2003] 2 BCLC 153, [74].

41 These include: the likely consequences of any decision in the long term; the interests of the company's employees; the need to foster the company's business relationships with suppliers, customers and others; the impact of the company's operations on the community and the environment; the desirability of the company maintaining a reputation for high standards of business conduct; and the need to act fairly as between members of the company.

42 Company Directors Disqualification Act 1986 s 1(1)(a).

Service on behalf of the Secretary of State for Business Energy and Industrial Strategy). Section 6 disqualification cases have also been treated as leading cases of the standard of care expected of directors in relation to their duty of care and so complement and augment section 174.[43]

However there are large numbers of disqualification cases and many involve fraud or breaches of fiduciary duties, or other provisions of the companies legislation. To make the best use of resources, we only included cases that used the terms 'business judgment', 'commercial judgment' 'commercial decision'[44], or that referred to directors' judgments[45] or that identified issues as being a 'business matter'.[46] We also included cases in which the courts determined that the judgments concerned were not, or not merely, commercial misjudgments. The boundaries of the concept of business judgment in England and Wales are so undefined that it was not clear whether these were really not business judgments, or were business judgments that the courts will not defer to. The courts themselves disagree on this point.[47] We may not therefore have captured all disqualification cases involving business judgment. Nevertheless examining how courts respond when business judgment is expressly mentioned may be a more accurate guide to judges' attitude to business judgment than cases in which it is an invisible issue.

Finally unfair prejudice cases were included under section section 459 of the Companies Act 1985 and under section 994 of the Companies Act 2006 which replaced it unchanged.[48] This minority protection remedy is the most commonly used shareholder litigation remedy and so the most common private accountability mechanism against directors. Cases were selected on the same basis as the disqualification cases.

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43 *Re Barings plc (No 5)* [2000] 1 BCLC 523.

44 We did however exclude *Re Brand Management Services Ltd* [2016] EWHC 2821 (Ch) as it was a serious fraud case, and business judgment was only mentioned in passing.

45 *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, 835.

46 *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407, 408.

47 See for example the difference of opinion between the first instance judge and the Court of Appeal in *Secretary of State for Trade and Industry v Gray and another* [1995] 1 BCLC 276.

48 The provision replaced the oppression remedy found in the Companies Act 1948.

Initially cases under the Companies Act 2006 for permission to bring a derivative claim were included but were subsequently removed. The decision whether to allow the company to pursue an action has been described as a commercial decision.[49] In determining whether to permit a claim to proceed, the courts ask what decision a reasonable hypothetical director would have made.[50] However as they do not necessarily review an actual director's judgment, these cases did not assist with whether the courts are prepared to review and impose liability for directors' judgments

Cases often included multiple causes of action. For example a duty of care case could includes claims for breach of fiduciary duty,[51] or a wrongful trading case might include a preference claim.[52] Such cases were included, but were read carefully to track how the courts approached the 'business judgment' cause of action separately from the other causes of action and to ascertain if liability was imposed for the business judgment cause of action (whether or not it was also imposed on other grounds). Only the 'business judgment' causes of action were coded. Our final dataset comprised 130 cases, the earliest dating from 1742[53] and the latest in November 2017.[54]

2. Coding the database.

The cases were coded across 25 categories. The most relevant for this article are Causes of Action, claimant, type of company, Basis for Liability, and Time Bands. The Cause of Action

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49 *Re Wishart* [2009] CSIH 65; 2009 SLT 812, [37].

50 Companies Act 2006 s 263(3)(b)

51 See for example *Bairstow v Queens Moat Houses plc* [2000] BCC 1025, 1041-1042.

52 See for example *Re DKG Contractors Ltd* [1990] BCC 903.

53 *The Charitable Corporation v Sutton* [1742] 9 Modern 349 88 ER 500

54 Because we were measuring incidence of review of business judgment, there are twelve cases included in the database which include first instance and appeal decisions in the same matter ie 25 entries.

identified which of the 'business judgment' causes of action were present in a case. There could be more than one: a case could involve duty of care and wrongful trading claims for example. The Basis of Liability category recorded whether liability was imposed for the causes of action included in the category Causes of Action. Thus if a case involved a duty of care claim and a conflict of interest claim, and liability was imposed for breach of the duty of care, this was recorded as the Basis for Liability and not conflict of interest (though this might also have succeeded). However recording disqualification or unfair prejudice as a Basis for Liability would not indicate whether liability had been imposed for business judgment claims or on another basis. To address this, if liability was imposed for reasons unrelated to business judgment, the Basis of Liability was recorded as 'Other', thus removing those cases from the disqualification/unfair prejudice liability data.

One team member searched for cases to include in the database using the case selection rationale outlined above. Between July-September 2017 and January 2018, two team members independently coded the cases. The researchers then reconciled any coding differences between September to November 2017 and in January 2018 by referring to independent coding notes and by returning to the case reports. Whilst there was a high level of inter-coder reliability, a sample of the cases were reread by two other team members including the Principal Investigator. When any coding inconsistencies were found all cases potentially affected were reread and recoded if necessary.

It will be clear that while some of our data was objectively descriptive, for example, claimant identity, other aspects involved more complex choices, including the identification of cases for inclusion in the database. We do not therefore claim that our study represents an absolute truth. For example, in the absence of an agreed definition of what a business judgment is, or other empirical studies exploring this, there is room for different views about what cases should have been included, but our choices were based on considered rationales. Importantly the process adopted ensured consistency in how cases were analysed and coded. Given that the aim of this paper is to analyse whether outcomes of challenges to business judgment have altered over time, coding consistency and consistent application of the case selection rationales allows us to be confident that we compared like with like over time. The fact that others might construct the database differently does not affect this.

3. Time band rationales

A critical part of this paper is to examine whether challenges to and liability for directors' business judgments altered over time. We placed cases into one of five time bands reflecting critical points in company law over the time, to test whether any changes correlated with developments in company law. The five bands were: (1) the period up until 1923; (2) 1924-90; (3) 1991-97; (4) 1998-2007; (5) 2008 –30 November 2017.

The reason for the first band ending is that in 1924 the case of *Re City Equitable Fire Insurance Company Ltd* was decided.[55] This was one of the major cases addressing directors' liability for breach of their duty of care and skill in the history of directorial liability. The action was brought by the Official Receiver as liquidator of the directors' former company. He claimed that the directors, though honest, had been negligent in not ascertaining that the chairman had made, on behalf of the company, investments and loans, and paid dividends out of capital, and these actions were tantamount to fraud. Romer J said that directors had not only to act honestly, but must exercise some degree of care and skill.[56] The case was subsequently regularly relied upon by judges, practitioners and academics for many years as the leading authority on the director's duty of care, and for the fact that Romer J established several

55 [1925] Ch 407
56 Ibid, 427.

propositions that encapsulated the law and acted as guiding principles for 60 years. For present purposes the most pertinent was that directors need not exhibit in the performance of their duties greater skill than may be reasonably expected from a person of their knowledge and experience, meaning that directors were not liable for mere errors of judgment, and they only needed to exhibit as much skill as someone as competent or as inexperienced as they were. [57]

The second band runs from 1924 until 1990. In 1991 the decision in *Norman* v *Theodore Goddard* was decided which commentators have identified as providing a turning point in relation to the way that the courts handled the duty of care. [58] In that case Hoffmann J stated that section 214 of the Insolvency Act 1986, dealing with wrongful trading, correctly stated the common law duty of care of a director.[59] No case had, previously, taken this approach, although section 214 had only commenced operation in 1986. Arguably this decision and subsequent English case law in the early 1990s saw a change in the approach of the courts rather than an essential change in the law. [60] The courts merely applied the law in cases such as *Re City Equitable Fire Insurance*[61] in a modern context.[62]

The third period ends in 1997. In 1998 *Re Barings plc (No5)* was decided. [63] Although a disqualification case, many of the comments of the judge, Jonathan Parker J, related to the decisions of directors and breaches of duty, making it a leading case in relation to director's duties.[64] Disqualification proceedings were brought against three directors of Barings Bank following its collapse. It was found that they were unfit to act as directors (with no allegations

57 Ibid, 428–429.

58 [1992] BCC 14. See, P Davies and S Worthington, *Gower: Principles of Company Law*, 10th ed., (Sweet & Maxwell, 2016), 479; J Loughrey, 'The Director's Duty of Care and Skill in the Financial Crisis' in J Loughrey (ed.), *Directors' Duties and Shareholder Litigation in the Wake of the Financial Crisis*, (Edward Elgar, 2013) 14; A Keay, *Directors' Duties*, 3rd ed., (LexisNexis, 2016), 225-226

59 [1992] BCC 14, 15.

60 Such as *Re D'Jan of London Ltd* [1993] BCC 646.

61 [1925] Ch 407.

62 S Worthington, 'The Duty to Monitor: A Modern View of the Director's Duty of Care' in F Patfield (ed), *Perspectives on Company Law: 2* (Kluwer Law International, 1997), 189.

63 [1999] 1 BCLC 433.

64 J Loughrey, 'The Director's Duty of Care and Skill in the Financial Crisis' in J Loughrey (ed.), *Directors' Duties and Shareholder Litigation in the Wake of the Financial Crisis*, (Edward Elgar, 2013), 17.

of dishonesty being made) because they were guilty of serious failures of management and this demonstrated incompetence of a high degree. The judge provided some useful propositions summarising his view of the law concerning directors' obligations, including that directors have a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them to discharge their duties to the company.[65] This statement did not exempt non-executives, unlike many earlier cases.

The fourth period runs until 2007. Most of the directors' duties codified in the Companies Act 2006 came into force on 1 October 2007. As directors could only be liable under the codified duties for actions committed after 1 October 2007, it is highly likely that no actions against directors would have been commenced until 2008 and certainly no judgment handed down until well into 2008.[66] Codification of directors' duties is clearly a critical point in this area of company law. Before this the duties were only based on common law rules and equitable principles. However section 170(3) and (4) of the Companies Act 2006 provide that the general duties will be interpreted and applied in the same way as the common law rules and equitable principles, and regard is to be had to these corresponding rules and principles in the process of interpreting and applying the codified general duties. Thus, while codification is a significant stage in the development of UK company law, the law applied today relies to a substantial extent on past decisions.

The fifth band covers cases from 2008 until November 2017.

E. Results

1. Company and Claimant Type

65 [1999] 1 BCLC 433, 489.

66 For example, see *Re Southern Countries Fresh Foods Ltd* [2008] EWHC 2810 (Ch) where judgment was delivered on 20 November 2008.

As Figure 1 shows the majority of claims involved private companies, most of which (72) were owner-managed. There were only six listed public companies, and eleven unlisted public companies.

Figure 1-Types of company in database

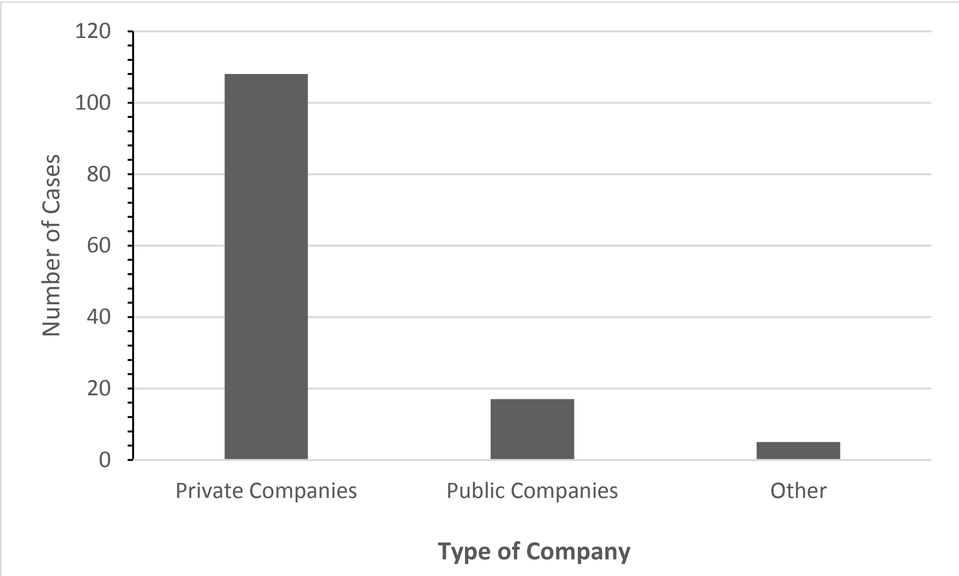
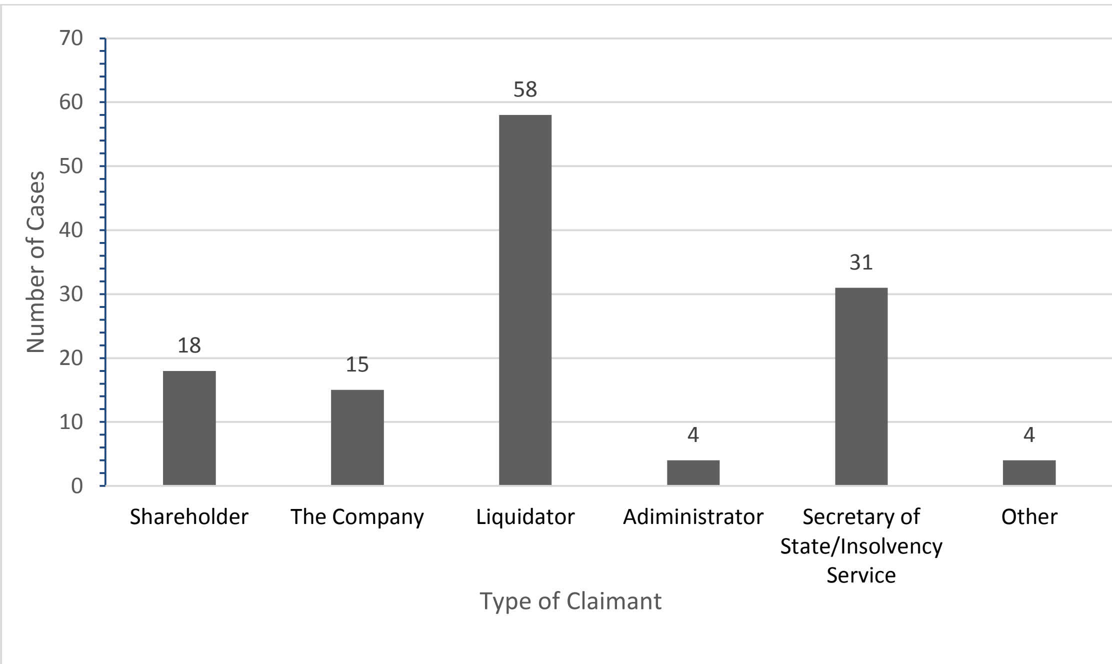


Figure 2-Types of claimant

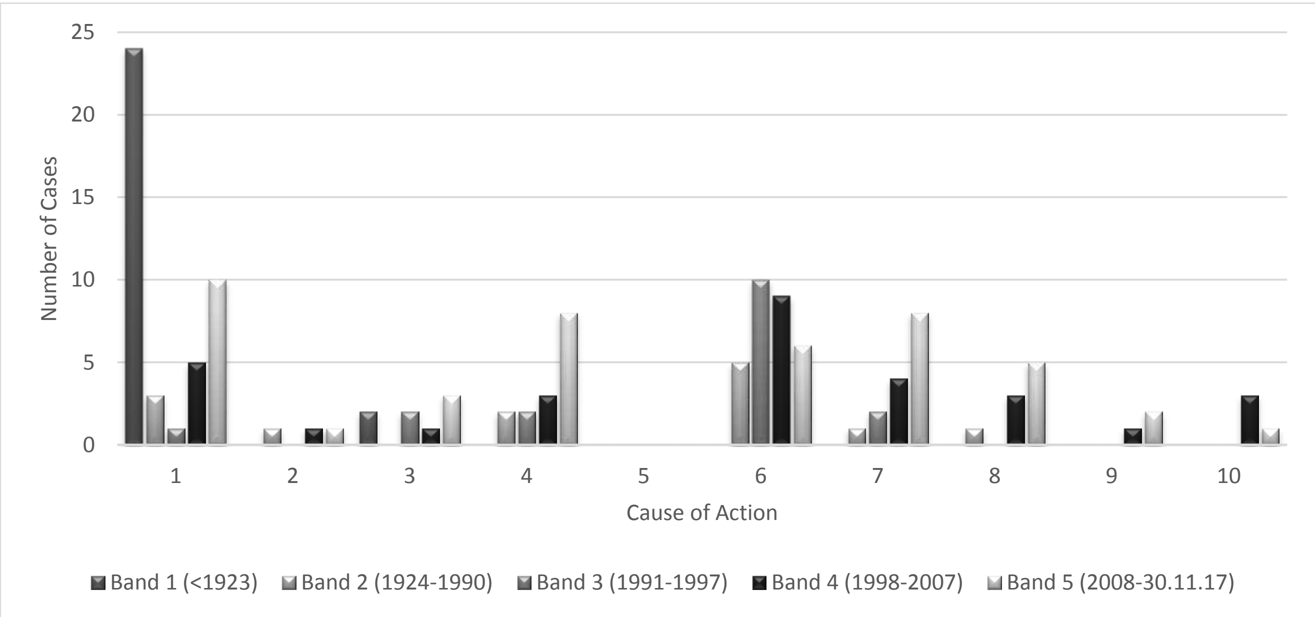


Liquidators brought the most claims, followed by the Insolvency Service, indicating that most claims occur in insolvent companies.

2. Levels of Challenge Over Time

Figure 3 records the number of cases of each Cause of Action brought against the directors across different time bands. It records separately cases involving a single Cause of Action and those involving multiple Causes of Action. For example cases in Codes 1, 2, 3 and 9 all include duty of care claims but 2, 3 and 9 also include another Cause of Action. Code 5 is zero as it was the code for the removed disqualification cases.

Figure 3 –Numbers of cases for each Cause of Action per time band.



Codes (1-10): 1. Duty of Care (DoC) 2. DoC plus Wrongful Trading (WT) 3. DoC plus duty to act in good faith in the company's interests s 172(1) 4. WT 5. Derivative 6. Disqualification 7. Unfair Prejudice. 8. Failure to take account of creditor interests / S S172 (3). 9. Failure to take account of creditor interests / s 172(3) /DOC and / or WT. 10. Duty to act in good faith in the company's interests s 172(1).

The number of solo duty of care challenges overall is highest in Band 1 (code 1, first column, *x* axis), possibly because alternative causes of action to challenge business judgment were not available at this time. Apart from disqualification and duty of care, the highest number of challenges were brought in Band 5. Band 5 also contained the second highest number of challenges based on duty of care.

To address the unevenness of the Time Bands, we calculated the average number of cases per year brought in each of the different time bands. It records a steady increase in cases brought since Time Band 3. We found in Band 1, 0.45 cases were brought per year, in Band 2 0.10, in Band 3, 2.43, Band 4, 3.3 and in Band 5, 4.4. Thus there is a steady increase in numbers of challenges from Band 3.

Part of the reason for this pattern could be increased case digitisation. A search of Westlaw demonstrated that the numbers of cases classified under the key terms 'directors' and 'directors powers and duties' increased sharply from 2012. However because our data is filtered against the case selection rationale, it does not mirror this increase: for example only one case in our database dates from 2012, whereas from 2003 there are 7 (when there were 23 cases and 9 cases respectively for directors' powers and duties). Again, numbers of disqualification cases involving business judgment have falled since Band 3. This suggests that increased data capture is not the sole reason for the findings. Furthermore, importantly, even if increased data capture has contributed to the higher number of cases recorded in Band 5, it does not account for increased *rates* of liability, a matter we explore below.

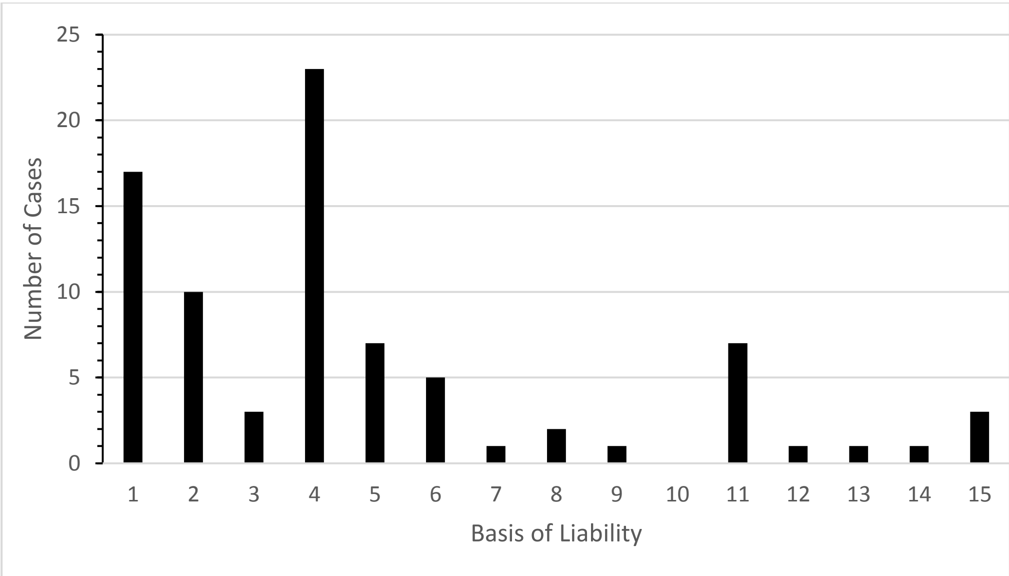
3. Liability v Non – Liability

Figures 4a analyses whether directors were found liable for one or more of the Causes of Action recorded in the database, or for some other reason.

There are 15 codes for liability (rather than the 10 codes for Cause of Action) in order to capture what liability was imposed for, if not for a 'business judgment' Cause of Action. Codes 7 -11 comprise these additional grounds. Five cases that appear in these codes are unfair prejudice/disqualification cases in which liability was imposed but on grounds other than business judgment matters –for example for failing to file accounts. Codes 12-13 are multiple bases of liability for the Causes of Action.

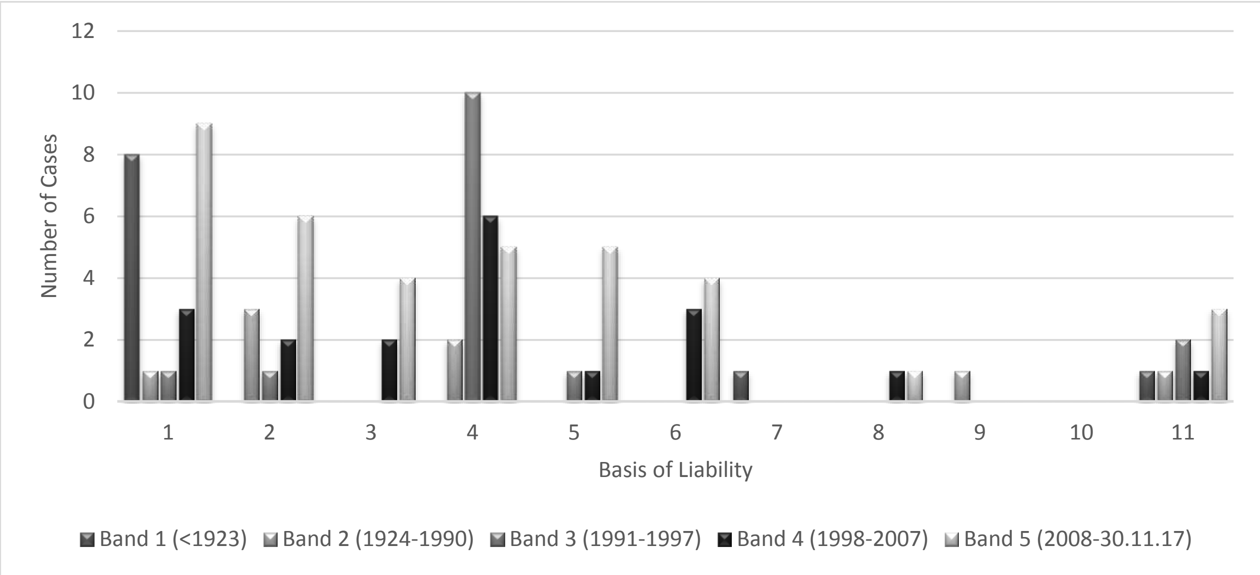
Liability is imposed for disqualification (Code 4 *x* axis) more than any other cause of action, but the next highest Cause of Action is duty of care (Codes 1,12,14 and 15, *x* axis).

Figure 4a Overall number of cases for each basis of liability



Codes: 1. Duty of Care (DoC) 2.WT. 3. Duty to act bona fide in company's best interests / s.172. 4. Disqualification 5. Unfair Prejudice. 6. Failure to take account of creditor interests / s. 172(3). 7. Breach of constitution/s. 171(a) 8. Breach of the duty to act for a proper purpose/s. 171(b) 9. Breach of no conflict/no profit duties s.175-177, s. 181 10. Duty to exercise independent judgement/ s. 173 11. Other 12. WT/DOC 13. Creditor interests/ Other 14. DOC/WT/Creditor interests 15. DOC/Good faith.

Figure 4b – The number of cases for each Basis of Liability in each time period



Codes: 1. Duty of Care (DoC) 2. Wrongful trading (WT). 3. Duty to act in good faith in the company's interests/ s. 172(1) 4. Disqualification 5. Unfair Prejudice. 6. Failure to take account of creditor interests / s. 172(3). 7. Breach of constitution/s. 171(a) 8. Breach of the duty to act for a proper purpose/s. 171(b) 9. Breach of no conflict/no profit duties s.175-177, s. 181 10. Duty to exercise independent judgement/s.173 11. Other.

Figure 4 (b) shows the basis of liability over time when the cases that are recorded in codes 12 -15 involving multiple Causes of Action are added to the single Causes of Action. It shows how often liability was imposed overall for each Cause of Action. In all Causes of Action, liability was highest in Band 5. The exception is disqualification (code 4, *x* axis) which was highest in Band 3 but has been declining.

Increased liability may be attributable to more cases being brought, (for reasons explored in Part F below), or as discussed, being digitised and so available for analysis. But this cannot account for the rates of liability in the cases shown in Table 1 below. This demonstrates that the overall increase in liability in Band 5 is not only because more cases were brought or reported, but also because liability was more likely than not to be imposed when cases were brought.

Cause of Action	Band 1 Up to 1923	Band 2 1924-91	Band 3 1992-97	Band 4 1998-07	Band 5 2008-17
Duty of care	31%	33%	33%	42%	56%
Wrongful Trading	N/A	100%	50%	40%	60%
Creditors Interests/s. 172(3)	N/A	0%	0%	75%	57%
Duty to act in good Faith /s. 172(1)	0%	0%	0%	50%	75%
Unfair prejudice	N/A	0%	50%	25%	63%
Disqualification	N/A	40%	100%	67%	83%

Table 1: Percentage of cases in each Cause of Action in each time band in which liability was imposed for that Cause of Action. Disqualification and unfair prejudice cases in which liability was imposed for reasons unrelated to business judgment have been excluded.

F. Analysis

1. General Reasons for Increased Liability

The majority of cases in which liability has been imposed involved claims brought by office-holders of the companies that have been wronged (Figure 2). Nearly all are liquidators where the company is insolvent, and the liquidator's role is primarily to recover as much as he or she can for creditors, which usually involves investigating the actions of the directors of the insolvent company. The number of companies that have been subject to insolvent regimes, primarily for our purposes administration and liquidation, has increased in the past 30 years.[67] For instance in 1988 there were approximately 8,000 liquidations but in later years that has risen to as many as around 20,000 in some years and regularly well in excess of 12,000. In 2017 there were 15,660.[68] In contrast in 1960 there were only 1,563, 3,689 in 1970 and 6,890 in 1980. Liquidations have been increasing for many years.

Administrators and liquidators can bring proceedings if they believe that directors breached their duties or were engaged in activity that was in contravention of some legislative provision, such as wrongful trading under section 214 of the Insolvency Act and office-holders are more likely to initiate proceedings than companies for several reasons.[69] Companies rarely litigate against their directors as they take action by way of board decision, and wrongdoing directors and their associates often control boards or boards are embarrassed about proceeding against one or more of their own number.[70] While office-holders are cautious about instituting proceedings, they have a highly investigative role which often leads to uncovering evidence that suggests that directors are liable for one or more causes of action. Not infrequently in insolvent companies directorial action that might be impugned has contributed to the plight of directors' companies.

Given that the office-holders' job is to recover as much money for creditors as they can, providing that they are advised by their lawyers that the action against a director has a

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67 <http://webarchive.nationalarchives.gov.uk/20140716212200/http://www.insolvencydirect.bis.gov.uk/otherinformation/statistics/historicdata/HDmenu.htm> accessed 25 February 2018.

68 <https://www.gov.uk/government/uploads/system/uploads/attA.C.hment_data/file/675931/Insolvency_Statistics_-_web.pdf> accessed 25 February 2018.

69 Administrators have only recently been able to bring wrongful trading proceedings: Insolvency Act 1986 s 246ZB.

70 For a discussion of such reasons and others, see A Keay, 'An Assessment of Private Enforcement Actions for Directors' Breaches of Duty' (2014) 33 *Civil Justice Quarterly* 76

reasonable chance of success they will almost be obliged to institute proceedings. Courts respect the discretion of office-holders to decide what they do in the course of administering the affairs of an insolvent company and are reluctant to say that office-holders have acted wrongly in not taking a particular kind of action. However, if an office-holder fails to do something which creditors believed should be done, creditors have the power to apply to the courts for the office-holder's action or lack of action to be reviewed.[71]

In sum, greater numbers of insolvencies in the last 30 years are likely to have led to more actions by liquidators and administrators, which will have a significant effect on overall levels of claims brought against directors (Figure 3) because these are the most likely parties to institute claims against directors. Furthermore, as a result of their investigative powers, such claims may be stronger than those brought by, for example, shareholders, and may therefore explain increasing rates of director liability (Table 1). Yet the substantial increase in the amount of proceedings commenced by insolvency office-holders might, for two reasons, be regarded as surprising.

First, funding is a critical issue for liquidators and it might be thought that it would be difficult to obtain. Yet over the past 15 years or so office-holders have been able to secure litigation funding.[72] Litigation funding has, notwithstanding the introduction in April 2016 of the 'Jackson reforms' appeared to be quite readily available for insolvency litigation.[73] When the reforms were first applied to civil litigation, insolvency litigation was provided with a temporary 'carve-out' until April 2016. Since April 2016 office-holders are no longer entitled, as they once were, to claim besides a damages award, the legal costs, the cost of any conditional

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71 For example, see Insolvency Act 1986, s 168(5) and Sch B1, para 74.

72 K Crinson and S Morphet, 'Funding for Actions rought by Insolvency Officeholders' (2011) 24 *Insolvency Intelligence* 108; A Jay, 'Funding Insolvency Litigation : a New Dawn' (2015) *Corporate Rescue and Insolvency* 183; C. Bowman and K.Hurford, 'Litigation Funding for Insolvency Claims' (2016) 13 *International Corporate Rescue* 11.

73 Contained in *Review of Civil Litigation Costs: Final Report* (TSO, 2009) and found in the Legal Aid, Sentencing and Punishment of Offenders Act 2012

fee agreement (CFA) uplift, and the cost of the after the event (ATE) insurance premium from the respondent.[74] To make up for some drop off in CFA and ATE funding, there are indications that since April 2016 there has been an increase in third party funding of office-holders and also office-holders, particularly those who are members of the largest accounting firms, establishing their own funds for use in insolvency litigation.[75] In June 2018 the Law Society stated that there is a vigorous market for the funding of insolvency claims.[76]

Secondly, literature has suggested that it is questionable whether bringing proceedings against directors would be worthwhile, as a good portion of directors who might be subject to proceedings are likely to be impecunious.[77] Many directors of smaller companies will themselves become bankrupt as, inter alia, they will have given personal guarantees for their insolvent company's debts,[78] and thus any claim against them would not be paid at all or only to a limited extent, depending on any payout from the directors' bankruptcies.

It is possible that the codification of the general duties of directors in the Companies Act 2006 could have contributed to increased rates of liability between Band 4 and Band 5 (Table 1). Codification made the duties more accessible to directors and others alike. Yet although an important step, it seems unlikely that codification would be the sole reason for

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74 For discussion of it and the potential effect on insolvency practitioners, see the reports prepared by P Walton for R3: 'The Likely Effect of the Jackson Reforms on Insolvency Litigation – an Empirical Investigation' (April 2014) : <https://www.r3.org.uk/media/documents/policy/JA.C.kson_Campaign/JA.C.kson_Reforms_Insolvency_Litigation_April_2014.pdf> accessed 9 July 2018; 'Insolvency Litigation and the Jackson Reforms : An Update', April 2016: <https://www.r3.org.uk/media/documents/policy/research_reports/bus_distress_index/Insolvency_Litigation_and_the_JA.C.kson_Reforms_-_An_Update_April_2016_FINAL.pdf> accessed 9 July 2018.

75 P Walton, 'Insolvency Litigation – Past, Present and Future', paper presented to the Insolvency Lawyers' Association Academic Forum, LSE, March 2017.

76 June 2018 (in response to Question 5 of the BEIS consultation) <https://www.lawsociety.org.uk/policy-campaigns/consultation-responses/beis-consultation-on-insolvency-and-corporate-governance/ > accessed 9 July 2018.

77 See, R Williams, 'What Can We Expect to Gain from Reforming the Insolvent Trading Remedy?' (2015) 78 MLR 55, 73, 77- 78. Also, see R Williams, 'Civil Recovery From Delinquent Directors' (2015) 15 *Journal of Corporate Law Studies* 311.

78 Ibid. Julian Franks and Oren Sussman found that in 50-60 per cent. of small bank-financed companies, directors had granted guarantees in relation to money owed to banks : 'An Empirical Study of Financial Distress of Small Bank-Financed UK Companies : A Reassessment of English Insolvency Law,' paper presented at the 16th Annual Meeting of the American Finance Association, New Orleans, 2001.

the increase in directors being held liable, because, for the most part, codification did not lead to a major change of law. The Companies Act 2006 section 170(3) states that the codified duties are based on common law rules and equitable principles, which remain highly relevant as the codified duties are to be interpreted and applied in the same way as the corresponding common law rules and equitable principles and regard is to be had to these in the process of interpreting and applying the codified duties.[79] Much of the judicial discussion of the codified duties has been informed by these common law rules and equitable principles.[80] This is well-illustrated by some of the cases addressing the duty to promote the success of the company in section 172(1) such as *Cobden Investments Ltd v RWM Langport Ltd,* included in the database. In this case Warren J said that: 'They [the previous duty and section 172(1)] come to the same thing with the modern formulation giving a more readily understood definition of the scope of the duty.' [81]

Having said that, codification might indeed have affected levels of litigation. One study, undertaken just before the codified duties came into force, examined the public views of practitioners from large commercial law firms concerning how directors should act in light of the new duties and found that there was uncertainty and diverging opinions amongst the firms. The study found that most lawyers were agnostic about whether section 172, for instance, would alter the outcome of directors' decisions in the ordinary course of business.[82] On the one hand this might have caused both lawyers advising directors to settle any proposed or actual claims made against them for breach of duty, as the attitude of the courts could not be predicted, and lawyers advising prospective or actual claimants to be circumspect in taking action, certainly in going as far as a trial. On the other hand, it might

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79 Companies Act 2006 s 170(4)
80 A Keay, *Directors' Duties*, 3rd ed., (LexisNexis, 2016), 86.
81 [2008] EWHC 2810 (Ch), [52].
82 J Loughrey, A Keay and L Cerioni 'Legal Pracitioners, Enlightened Shareholder Value and the Shaping of Corporate Governance' (2008) 8 *Journal of Corporate Law Studies* 79, 90.

have led lawyers to advise directors who were threatened with action to defend the proceedings fiercely given the uncertainties, and it might have encouraged some of those advising prospective claimants to recommend instigating proceedings against directors.

The increase in liability could be a consequence of the fact that over the past 30 years we have experienced the gradual emergence of new causes of action or a revision of existing ones (Figure 3). An example of the latter is director disqualification. In the mid-1980s the Company Directors Disqualification Act 1986 (CDDA) was enacted and it made disqualification more of a possibility, for while disqualification was originally introduced in legislation in 1947 it was not until the CDDA that disqualification was regularly sought against directors and had real teeth.

As far as new causes of action, the Insolvency Act 1986 introduced wrongful trading[83] and in the late 1980s the Court of Appeal accepted that directors must, when their company is in severe financial difficulties, take into account the interests of their company's creditors when making decisions.[84] The addition of new causes of action gave claimants more weapons to wield against directors. Claimants can plead more than one cause of action in proceedings against directors and liability has been imposed on more than one basis (Table 4a).[85] Consequently it could be submitted that directorial accountability has increased in the sense that directors' action may now be challenged on more bases, making it more difficult for directors to avoid liability. It certainly grants potential claimants more room to manoeuvre when considering what can be alleged against directors when considering whether to initiate proceedings against directors.

Liquidators, who, as mentioned above, are the most frequent claimants against directors who are found liable, can rely on section 212 of the Insolvency Act 1986 and this

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83 Insolvency Act 1986 s 214.

84 *Liquidator of West Mercia Safetywear v Dodd* (1988) 4 BCC 30.

85 For example *Roberts v Frohlich* [2011] EWHC (Ch) 257; [2012] BCC 407.

can facilitate the pursuit of proceedings. Section 212 covers 'misfeasance' and permits a liquidator to bring proceedings against directors where the latter have 'misapplied or retained, or become accountable for, any money or other property of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company.' It was designed to facilitate recovery of assets improperly dealt with, and to enable liquidators to obtain compensation for misconduct which had caused loss to companies.[86] Section 212 itself does not provide for a cause of action but merely gives liquidators a summary procedure to bring matters to court.[87] This permits liquidators to avoid some of the expense and delay which inevitably attends the prosecution of ordinary legal proceedings.[88]

The provision enables liquidators to rely on several causes of action in any proceedings, including anything that can be regarded as a breach of duty or breach of trust. The case of *Roberts v Frohlich*[89] is a prime example of the use of the provision. In that case the liquidator took action against directors under section 212 for breach of the duty of care and breach of the duty to act in the best interests of the company and not taking creditors' interests into account when the company was insolvent. Also, the liquidator argued that there was a breach of the wrongful trading provision. The judge found the directors liable under all three causes of action.[90]

It is possible that more cases of liability were recorded in the last two time bands (Figure 4b) as there was likely to have been an increase in commercial activity during these periods. Arguably if there are more transactions entered into and other actions occurring, there will be a commensurate increase in liability.

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86 *Re Kingston Cotton Mill Co (No.2)* [1896] 2 Ch. 279, 283 and 288; *Re London & Colonial Finance Co* (1897) 13 TLR 576

87 *Cavendish-Bentinck* v *Fenn* (1887) 12 App Cas 652, 669; *Re City Equitable Fire Insurance Co* [1925] Ch 407, 527; *Re B. Johnson & Co (Builders) Ltd* [1955] Ch 634, 647-648; *Cohen v Selby* [2001] 1 BCLC 176, 183.

88 Proceedings are not initiated in the ordinary way but through streamlined procedures in the Business and Property Courts.

89 [2011] EWHC (Ch) 257; [2012] BCC 407.

90 ibid, [109], [113].

However overall there has also been an increased rate of liability in the cases that are brought, particularly in Band 5 (Table 1). The causes are not obvious, as canvassed above: it is not due to changes in the substantive law. Possibly claimants and advisors have become better at identifying which cases are more likely to be successful, and at framing claims in order to have better chances of success. Another possibility arises from the fact that business judgment Causes of Action are pleaded alongside other causes of action such as conflicts of interest. When this occurs, the courts' approach to business judgment claims may be coloured by their views of the directors' behaviour more generally. If claims coming before the courts are more serious then this would explain increased rates of liability. It is also possible that courts may have become more willing to impose liability in challenges to business judgment.

A further caveat is that while our findings show an increase in proceedings instituted against directors for the Causes of Action identified in this study, (Figure 3, especially bands 4 and 5), this only covers cases that have ended up with a hearing as our findings are based on reported cases. We did not determine the number of cases that were instituted and that did not come to a hearing as this information is not publicly available.[91] Actions could be commenced and then discontinued for various reasons, such as the case was settled between the parties before reaching a hearing. While levels of reported cases may reflect actual levels of litigation against public company directors, experience tells us that there will be many actions involving private companies that will settle out of court. [92]

2. Reasons for increased liability related to particular causes of action

[91] See J Armour, B Black, B Cheffins and R Nolan 'Private Enforcement of Corporate Law: United Kingdom vs United States' (2009) 6 *Journal of Empirical Legal Studies* 687, 697-698 outlining how they accessed this information in the context of public companies.

[92] Ibid, 700.

(a) Duty of Care and Duty to take into account the interests of the company/Section 172(1)

Figure 4c shows that, excepting disqualification, the cause of action that was most successfully employed against directors overall was breach of the duty of care, albeit only by one case in each of the second and third time bands. While the number of cases in which directors were found liable for a breach of the duty of care in the first band was not exceptionally high, it was the highest of all the bands. This was a long period, covering 55 years, from the time of the reporting of the first group of cases in 1869 (this is leaving aside the 1742 decision of *The Charitable Corporation v Sutton*[93]) until 1923. Also, of importance was the fact that during this period there were fewer causes of action available to claimants. At this point the legislature had not intervened very much in how directors acted, and it was left to the common law and judicial development to provide for liability. Breach of the duty of care is an example of this.

The second band covered an even longer period of 67 years, but recorded only one verdict against directors. The likely reason is that the decision in *Re City Equitable Fire Insurance* in 1924 (and reported in 1925) which marked the beginning of our second band, was held by courts, and stated in academic and practitioner literature, as laying down a subjective test as far as determining whether a director was liable or not. [94] Thus, courts were reluctant to hold directors liable unless it could be demonstrated clearly that a director had acted in a manner that they should not have, given the director's personal circumstances, experience and skill. [95] In light of this it is probable that lawyers would have advised potential claimants that the case provided for a subjective test and, hence, establishing liability against

93 [1742] 9 Modern 349; 88 ER 500.
94 [1925] Ch 407.
95 S Worthington, 'The Duty to Monitor: A Modern View of the Director's Duty of Care' in F Patfield (ed), *Perspectives on Company Law: 2* (Kluwer Law International, 1997), 189.

a director was difficult, and action was best avoided. This undoubtedly dissuaded potential claimants from initiating proceedings and it is notable that there is a collapse in the number of duty of care claims brought in Band 2 compared with Band 1 (Figure 3).

The duty of care then remained ill-defined for many years.[96] The rise in liability in Band 4 (Figure 4b) occurred after the decisions delivered in *Norman v Theodore Goddard*[97] and *Re Barings Bank (No5)*.[98] The former, while holding that the respondent director was not liable, laid down the principle, subsequently applied by several cases, that directors could be liable for a breach of duty if they either failed to attain a standard of care in line with their experience and skill or if they failed to act in a way that a reasonable person in their position would have acted. This, therefore, enabled claimants to succeed if they could establish the fulfilment of an objective test as well as, or as an alternative to, a subjective test. This meant that directors not only had to act in line with his or her own ability and experience, but also as reasonable directors would have acted in the circumstances, even if the respondent director was inexperienced or lacked certain skills or abilities. *Re Barings Bank (No5)*, inter alia, a disqualification case, placed more restrictions on directors delegating responsibility to others and made them more accountable for what their delegates had done or not done.[99] Jonathan Parker J in this case indicated that he required directors to supervise delegates appropriately.

Table 1 suggests that directors are more likely to be held liable in respect of a claim for breach of duty of care in more recent times. The reason for the increase in liability could be, as adverted to above, that the test, since 1991 when *Norman v Theodore Goddard* was decided, has been a mixed subjective and objective test and arguably it is easier to establish liability.

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[96] *Daniels v Anderson* (1995) 13 ACLC 614, 656

[97] [1992] BCC 14.

[98] [1999] 1 BCLC 433.

[99] J Loughrey, 'The Director's Duty of Care and Skill in the Financial Crisis' in J Loughrey (ed.), *Directors' Duties and Shareholder Litigation in the Wake of the Financial Crisis*, (Edward Elgar, 2013), 25–26.

However the increase between Bands 4 and 5 is difficult to explain by reference to the substantive law. Table 1 shows that there was an increase in liability in the fifth band in cases when a claimant sought relief on the basis of a breach of duty of care and a breach of the duty to act in the best interests of the company. The only thing that changed with the last time band compared with earlier ones in terms of legal developments was the codification of the duties, which may have impacted on levels of litigation. However, the two sections that cover duty of care and duty to act in good faith, sections 174 and 172 respectively, did not appear to usher in new law. Section 174 is almost identical to the test for whether there was a breach of duty set out in *Norman v Theodore Goddard* and applied in subsequent cases. Hoffmann J had said in *Norman v Theodore Goddard* that a mixed objective and subjective approach was to be applied to the common law breach of duty of care and this point was replicated in section 174, so that it does not differ in substance from the law as it stood under the common law at the time of the enactment of the codified duties.

While section 172(1) is not expressed in the same terms as its precursor, the former duty to act in good faith which was provided for under case law, the cases decided under section 172 have held that the duty encompassed by section 172 is merely a modern formulation of the duty to act in good faith that existed pre-codification.[100] There was however a great deal of discussion and uncertainty about section 172 when it was introduced which, as canvassed earlier, may have encouraged more litigation.[101]

(b) Wrongful Trading

[100] For example, see *Re West Coast Capital (LIOS) Ltd* [2008] CSOH 72; 2008 Scot (D) 16/5; *Cobden Investments Ltd v RWM Langport Ltd* [2008] EWHC 2810 (Ch); *Madoff Securities International Ltd (in liq) v Raven* [2013] EWHC 3147 (Comm); [2014] Lloyd's Rep FC 95, [260]; *Re HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch.); [2014] BCC 337.

[101] J Loughrey, A Keay and L Cerioni 'Legal Pracitioners, Enlightened Shareholder Value and the Shaping of Corporate Governance' (2008) 8 *Journal of Corporate Law Studies* 79.

Figure 4b reveals that as far as the cases where wrongful trading constituted at least one of the causes of action, there was a healthy number of cases in which directors were held liable in Band 2. The number of cases decreased in Band 3, and then in Bands 4 and 5 they increased. While numbers were relatively low, the increase in Band 5 was sizeable with the number of cases growing by 150 per cent when compared with the Band 4. The reason for the decrease from Band 2 to Band 3 could well be because wrongful trading was introduced in Band 2 and commentators expressed optimism about this new cause of action having an effect on errant directors,[102] which could have been reflected by the judges. By Band 3 there was more pessimism about the usefulness of wrongful trading,[103] certainly in relation to the way that the section had been drafted. Arguably this continued in Band 4, and in particular following cases like *Re Continental Assurance Co. of London,* where the liquidator failed in his action after a very long and expensive trial.[104] It is unclear why there was an increase in cases brought and rates of liability in Band 5 (Table 1). There has been no change in the provision or substantive case-law addressing wrongful trading. The increase is, in some ways, surprising as establishing wrongful trading is not easily done, for a several reasons,[105] and commentators have commented regularly on the relative impotence of the provision.[106] Given the high number of liquidations in the years between the enactment of section 214 and the present, the 12 cases of liability across Bands 2-5 (Figure 4b) does appear to be relatively low, but we must take into account the relatively low number of proceedings instituted.[107] The low number of cases commenced is surprising given the high numbers of liquidations in

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102 For example, see D Prentice, 'Creditors' Interests and Director's Duties' (1990) 10 OJLS 265, 277; F Oditah, 'Wrongful Trading' [1990] LMCLQ 205, 222.

103 For example, see R Schulte, 'Enforcing wrongful trading as a standard of conduct for directors and a remedy for creditors: the special case of corporate insolvency' (1999) 20 *Company Lawyer* 80, 81

104 [2001] BPIR 733.

105 See, A Keay, *Company Directors' Responsibilities to Creditors* (Routledge, 2007); A Keay, 'Wrongful Trading: Problems and Proposals' (2014) 65 *Northern Ireland Legal Quarterly* 63.

106 See, ibid; R Schulte, 'Enforcing wrongful trading as a standard of conduct for directors and a remedy for creditors: the special case of corporate insolvency' (1999) 20 *Company Lawyer* 80.

107 R Williams, 'What Can We Expect to Gain from Reforming the Insolvent Trading Remedy?' (2015) 78 MLR 55.

the past 30 years. As mentioned earlier, during this period the number of liquidations exceeded 12,000 every year and more often than not was near 20,000.

(c) Disqualification

The number of disqualification cases brought against directors in our database has decreased since Band 3 (Figure 3). The introduction of undertakings in the Insolvency Act 2000 in Band 4, which enabled disqualifications to occur without court involvement could be a significant factor in this.[108] It is also possible that, as we only included cases in which business judgment is mentioned, there has been a decrease in directors pleading a business judgment defence or justification in disqualification cases. It might mean that in many cases the Secretary of State who brings proceedings for disqualification might be alleging grounds for disqualification that did not involve any business judgment being exercised by directors. Nevertheless in Band 5 the rate of liability is the second highest of the time bands (Table 1).

(d) Unfair prejudice

While Figure 4b shows that there was only one unfair prejudice case in which a director was liable in each of Bands 3 and 4 (it was not an option in the years covered by Band 1 as it was only introduced, in a different form, in 1948), where the term business judgment or similar has been used in the judgment of the court, there was a large increase (by eight fold) in Band 5. The fact that there were so few cases in Bands 3 and 4 in which business judgment was referred to is surprising given the fact that there were large numbers of unfair prejudice claims reported overall. There is no apparent reason linked to the substantive law for the increase in numbers of cases brought (Figure 3) and the increased rate of liability (Table 1) in Band 5.

[108] Company Directors Disqualification Act 1986 s 7(2A) amended by Insolvency Act 2000 s 6.

(e) Failure to take account of creditor interests/section 172(3)

Figure 4b also records a clear increase in the number of cases where directors have been held liable when failing to take into account the interests of creditors. The failure to take into account the interests of creditors was first recognised in England and Wales as the basis for a director's liability in 1988 (at the end of the years covered by Band 2) in the decision of the Court of Appeal in *Liquidator of West Mercia Safetywear v Dodd* .[109] This decision was not included in the database as it involved a lack of good faith, nor were other cases in which it was clear that the court had reached a decision based on the directors' lack of good faith. It is perhaps surprising that there were not any cases during Band 3 involving a director being found liable or not liable. The reason could be that the decision in *Liquidator of West Mercia Safetywear v Dodd* did not set out the nature of the duty in any detail (the judgment was relatively brief) and prospective claimants did not feel confident in bringing proceedings. It is arguable that during the 1990s there was substantial uncertainty as to when the duty was triggered, not only in England but in other common law jurisdictions.[110]

The increase in the number of cases where there was liability, from Band 4 to Band 5, could be due to one or two reasons. First, the decisions in Band 4 had provided further explanation concerning the duty which enabled lawyers advising potential claimants to provide better indications of what needed to be proved.[111] For example the decision in *Colin Gwyer v London Wharf (Limehouse) Ltd* set out the test that should be applied if the directors had not considered creditor interests but there was no finding that they lacked good faith, namely that the courts should consider whether a director in the position of the respondent

[109] (1988) 4 BCC 30

[110] See A Keay, 'The Director's Duty to Take into Account the Interests of Company Creditors : When is it Triggered?' (2001) 25 *Melbourne University Law Review* 31.

[111] For example, *Re Pantone 485 Ltd* [2002] 1 BCLC 266; *Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] BCC 885; *Re MDA Investment Management Ltd* (Ch) [2004] EWHC 42 (Ch); [2005] BCC 783.

directors could have reasonably considered the impugned action to be in the interests of the company.[112] Secondly, the duty was codified in section 172(3) of the Companies Act 2006. While codification did not involve a change in the law, but was a confirmation of the common law developments, the existence of a specific provision might have highlighted the duty more and it might have encouraged more liquidators to take proceedings. The relatively high employment of this cause of action is perhaps surprising given the fact that arguably there still remain several uncertainties in relation to what has to be established in bringing proceedings under this cause of action.[113]

In sum, most cases where liability was imposed on directors in Band 2 was at the end of the period due to the advent of new causes of action such as wrongful trading in 1986 and the toughening up of disqualification in 1986 when the CDDA became law. We find a gradual increase in liability beginning with Band 3 (see Figure 4b), perhaps because of a number of factors, including the increased corpus of causes of action which can be employed against directors. This point seems to be borne out by the fact that, as far as the cases where liability was imposed in each band, there is a greater spread of liability across causes of action through the time bands. It is possible that the widening of the tests for liability for breach of the duty of care (with the inclusion of an objective test) also led to an increase in successful cases. Rates of liability across the combined Causes of Action is highest in Band 5 which suggests that directors being held more accountable than in previous eras for business judgment (Table 1).

G. Conclusion

[112] [2002] EWHC 2748 (Ch); [2003] BCC 885. In some cases although the director appeared to lack good faith, the test in *Colin Gwyer* was nevethless applied. These cases were included.

[113] See, A Keay, *Company Directors' Responsibilities to Creditors* (Routledge, 2007); A Keay, 'Directors' Duties and Creditors' Interests' (2014) 130 LQR 443.

This paper analysed how the numbers of reported cases involving i) causes of action that challenge directors' business judgment have altered over time, and ii) how levels and rates of liability have altered over time.

We found evidence that legal developments have had some influence on numbers of cases brought in relation to business judgment. Thus in relation to duty of care, the study found that following the case of *Re City Equitable Fire Insurance* in 1924, which was interpreted as making it difficult to succeed in a duty of care claim against a director, the numbers of cases involving the duty of care cause of action collapsed, recovered a little after *Re Barings*, a high profile case involving public company directors, and then significantly increased after 2007, in line with a general trend across most causes of action in this time period. Meanwhile numbers of disqualification cases brought dropped in Band 4 after the introduction of undertakings in 2001 that provided for disqualification without court involvement. In addition the availability of more causes of action upon which to mount a challenge to directors' business judgment may be a factor in the overall increase in cases brought. Increases in the number of insolvencies could be another factor, as could changes in the numbers of cases captured by the electronic databases.

Turning to liability, we found that not only absolute levels of liability but also overall proportionate rates of liability have risen since 2007, and rates of liability in duty of care cases has steadily climbed across time. These changes are not always linked to changes in the substantive law. Increases in absolute levels of liability could be linked to increases in numbers of cases brought or cases reported but increased rates of liability cannot be linked to these factors. This finding opens up avenues for future empirical research as to the causes of this phenomenon, which could be linked to changes in the judicial approach to applying the law; more carefully crafted and evidenced claimant cases; or that the behaviour coming before the courts is more worthy of sanction.

Finally we found that the proposition that courts will not review directors' business decisions is incorrect. Across all time bands and causes of action, challenges to business judgment were brought, and liability imposed, following review of business judgment. Sometimes liability was determined solely on considerations of (poor) business judgment, whereas in other instances, liability for business judgment was enmeshed with factors such as conflicts of interest. Litigation was concentrated in private, primarily insolvent, companies Directors of large public companies remain largely insulated from being held accountable in the courts for business judgments, but this is not because those business judgments are immune from judicial review.