

SECTION 320 COMPANIES ACT 1985

HOW BIG WILL THE BILL BE?

The legislation

1. Everyone is familiar with section 320 – which is here to stay – the new Companies Bill contains its provisions virtually unaltered. It is basically a statutory version of the fiduciaries’ self-dealing rule. It covers only ‘arrangements’ for the acquisition of ‘non – cash’ assets¹ by or from directors and persons connected with them – so that it has nothing to do with the conflict of interest cases like *IDC v Cooley*². Section 320 forbids companies to enter into such arrangements unless ratified in general meeting – either beforehand or within a reasonable time thereafter. ‘Arrangement’ has been held to cover arrangements with no contractual force³ and even, dubiously, arrangements, such as heads of agreement, expressly stated to be subject to contract and non-binding⁴.
2. Section 320 is over and in addition to disclosure duties to the board, statutory or in the Articles of Association and any other rule of law or equity affecting the conduct of directors⁵. It is also additional to the FSA rules governing related party transactions by listed companies and to the LSE rules governing similar transaction by AIM companies.
3. If an arrangement falls foul of section 320, the arrangement itself *and any transaction entered into pursuant to the arrangement* is voidable (subject to the usual bars) at the instance of the company.

¹ subject to certain minimum value thresholds

² [1972] 1 WLR 443

³ *Duckwari Plc* [1999] Ch 253

⁴ *Murray v Leisureplay Plc* Unreported 5 Aug 2004 (Stanley Burnton J)

⁵ section 322(4)

4. *Whether or not the company avoids the arrangement or relevant transaction* the director or connected person party to the arrangement, and any other director who authorised the arrangement or transaction carried out pursuant to it is liable to account to the company for any gain he has made directly or indirectly by the arrangement or transaction and to indemnify the company against any loss or damage resulting from the arrangement or transaction⁶.

The problem

5. What does that extend to? So far as I know, there are no reported cases dealing with the ambit of the liability to account for gains, but there are cases dealing with what losses are covered by the indemnity. Examination of the problems thrown up by those cases suggests that similar difficulties may arise in a case involving a director having to account for gains.
6. In *Duckwari*⁷ a company connected to the director had a contract to buy a commercial property from an unconnected third party for £495K. The benefit of the contract was informally passed to the company. That was the 'arrangement'. The company then completed the contract. None of this was put to shareholders for approval. The company accepted that the property was worth £495K when purchased, but when sold some seven and a half years later, it fetched only £178K. The director argued that since the company got what it paid for, there had been no loss and that the subsequent depreciation was due not to the company entering into the arrangement or completing the transaction, but to the company continuing to hold the property during a period of recession in the commercial market.

⁶ section 322 (3) and (4)

⁷ [1999] Ch 253

7. The judge at first instance agreed. He thought that section 320 was directed at disposals/acquisitions at over or under valuations. The Court of Appeal disagreed. They thought that the indemnity must be read so that it did not produce a worse return for the company than avoidance (which was no longer available as an option) would have. Since on a avoidance of the arrangement the company would never have parted with its £495K (plus an additional £10K acquisition costs), the loss suffered as a result of the transaction's completion was £505K minus £178K proceeds of realisation. They thought that the position was like that of a trustee who makes an investment in breach of trust, who is liable on a similar basis.
8. Not satisfied, the company returned to the charge⁸. It wanted not only the difference between cost and sales proceeds (plus interest – compounded – on the outstanding purchase price), but the amount of interest not only that it had actually paid to its mortgage lender on money borrowed for the acquisition, but the amount of such interest which it had failed to pay and still owed (some £677K); plus loss of notional compound interest (claimed to be £184K) on the part of the purchase money that it had paid from its own funds.
9. The director conceded that he was liable for simple interest on the outstanding balance of the purchase price. The battle was over the borrowing costs and loss of notional interest. The Court of Appeal rejected that claim. They said that the contravening *arrangement* was the agreement for the company to take over the benefit of the director's contract, and neither the company's borrowings nor the application of its own money in the purchase was part of that arrangement. Similarly, the only *transaction* entered into pursuant to the arrangement was the acquisition of the

⁸ [1999] Ch 268

property. The Court of Appeal went on to hold in terms that the only loss recoverable was that *resulting from the acquisition itself* – i.e. shortfall plus simple interest – even though section 322(3)(b) speaks of loss or damage resulting from the arrangement *or* transaction and even though the statutory language does not require the cause of the loss to be ‘part’ of the arrangement – it merely requires that the loss should have resulted from the arrangement.

10. Oddly, however, the Court of Appeal went on to give the company the costs of rates and insurance while it held the property and also the costs of a successful planning appeal, on the grounds that these costs must be taken to have contributed to achieving the best price possible on realisation. But that is not the same thing as saying that these costs ‘*resulted from the acquisition itself*’.
11. A similar problem arose in *Murray v Leisureplay Plc*. The director had entered into heads of agreement for the acquisition by the company of his shares in a company wholly owned by himself. Professional costs, including the costs of obtaining a due diligence report and the costs of engaging an additional director, were incurred with a view to the proposed acquisition, which in fact never happened. The company claimed those costs under section 320. At first instance, (although he said that he could not follow the reasoning of the Court of Appeal) Stanley Burnton J followed the clear language of *Duckwari No 2*⁹ and held that since those costs flowed from contracts made with the relevant professionals and were not payable under the heads of agreement, they did not fall within the statutory indemnity. The judge also made the excellent point that it seemed capricious, in the circumstances of a proposed acquisition of this sort, to make liability depend upon whether there was or was not an arrangement in the form of heads of agreement. The due diligence might well

⁹ [1999] Ch 268

have been carried out in the absence of, or, for that matter, before, any sort of arrangement at all had been entered into. He therefore rejected the claim.

12. The company appealed this decision. The Court of Appeal¹⁰ (while observing that it did not sit easily with some of the reasoning in the earlier case) purported to reaffirm *Duckwari No 2*, holding that only losses resulting from the offending *transaction* were recoverable. In *Murray* there never was a transaction. Having said that, the Court of Appeal went on to hold that since the costs of obtaining a due diligence report were foreshadowed in the heads of agreement they were losses suffered ‘as a result of’ the heads of agreement; on the other hand, since the costs of hiring an additional director were not so foreshadowed, they were not so recoverable.
13. This seems to be a misapplication of *Duckwari No 2*, which in terms (and despite the wording of section 322(3)(b)) limits recovery to losses suffered as a result of the *acquisition*. In *Murray*, there was no acquisition at all. On the other hand, *Murray* seems easier to fit with the language of the statute, which provides for recovery of losses resulting from both the arrangement and/or the transaction which flows from it.

Conclusion

14. The thing is a muddle. In *Duckwari No 2* the Court of Appeal plainly flinched from awarding borrowing costs, no doubt in part because by that stage the company was under the control of the mortgage lender. However, the analysis, although clear enough as a matter of language, is unsatisfactory and fails to give full weight to the words of the statute. In *Murray v Leisureplay* Buxton LJ said that the decision in *Duckwari No 2* ‘undoubtedly causes

¹⁰ [2005] EWCA Civ 963

difficulties in interpreting section 322' and was obviously uneasy about even the decision to award the costs of due diligence. The moral to be drawn is that there remains plenty of scope, on any given set of facts, for uncertainty about the precise effect of the section 322 indemnity (and, equally, of the extent of the liability to account for gains). That makes the need for compliance all the more compelling.

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