Law and Liability Law as well as the Main Paper by Professor John Adams of Queen Mary College entitled 'Insurance and Property'.

Finally it is pleasing to comment on the good news that the Government's Legal Review Body proposes four possible changes in Conveyancing Law to clarify the 'anomaly' that home buyers need to insure the property they are purchasing from the date of the exchange of contracts whilst the vendor continues to insure until completion. The new law will oblige vendors to hand over the property at completion in the same condition as it was at the time of the exchange of contracts, thus avoiding double insurance. It will be interesting to see whether this will apply to trees in the garden which may have blown down between exchange of contracts and completion as happened to one of my acquaintances during last October's storms when the new owner had to pay for the cost of the tree removal which was not covered under either policy in force at the time!

D.G.C.

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LIABILITY ISSUES ARISING ON INCORPORATION OF PROFESSIONAL PRACTICES

Roger S. Doulton, Solicitor, Winward Fearon & Co.

1. **Introduction**

My intention is to answer the question:-

> "Does this mean that I no longer have to convey the equity in my house to my wife or husband and to lose it all in subsequent divorce proceedings?"

A proper answer to this question would involve a comprehensive analysis of a considerable proportion of company law, combined with a similar exercise in respect of the law relating to professional negligence. In preparing this paper, therefore, I hope it will be understood that I have had to make one or two strategic decisions! In particular I have decided to concentrate primarily on directors' duties of skill and care rather than their fiduciary duties since, as a matter of practice, unless there is a wholesale abandonment of professional standards this is the area most likely to give problems.

This is not to stay that fiduciary duties are unimportant. The incorporation of a professional practice would bring that practice into contact with a whole range of liabilities, civil and criminal, not previously encountered. Schedule 24 of the Companies Act 1985 lists over 200 criminal offences most or all of which would be applicable to a defaulting but incorporated professional practice (see also the Insolvency Act 1986, the Data Protection Act 1984, the Financial Services Act 1986 and the Company Directors Disqualification Act 1986). There are certain fiduciary duties owed by directors to their companies which forbid, in the absence of proper authorisation, directors of companies doing acts which are common place in professional practices. I have picked out those that seem most important in Section 11.

The answer to the question, incidentally, is "No!". Whilst it *may be* the case that following incorporation the primary target of any litigation would become the company rather than the individual director, this does not mean that there are are circumstances in which director or employee may not be personally liable to a third party. Nor does it mean that a director or employee is safe from an action by the company to recover its own loss. Indeed it may be the case that, in certain circumstances, directors of the company would have a duty to sue, in which case a failure to sue could render them personally liable for acts for which they would otherwise not be liable. One curious aspect here is that the position of a negligent director is (or rather may be) rather better than that of an employee.

I say that it "may be" the case that the company will become the primary target of litigation because, in fact, it does not seem to me that this is a necessary consequence of incorporation at all. It is commonplace in medical negligence actions for the doctor to be named as well as the Area Health Authority notwithstanding that the issue of the vicarious liability of the Area Health Authority is never really in doubt (notwithstanding also the dissenting judgment in Essex Area Health Authority v. Wilshire). Where an injured third party is contemplating proceedings in respect of professional negligence against a small incorporated professional practice with a small share capital – the liability of shareholders being restricted to the amount uncalled, if any, on their shares – it would certainly not be an irrational decision on the part of the injured third party to include as a defendant in his action the director or employee who has caused him his loss. It is not a universal proposition that the company is the better target because of its wealth.

This does not mean that there are no advantages at all from a liability point of view to incorporation. The principle of the company as a separate legal entity may enable a group of companies to be set up in such a manner that the risk of insolvency (and hereby a means of earning one's living) is restricted to just a part of one's business. In general terms the director is not liable for the acts of his co-director. Thus, although – as we shall see – you may still be rendered bankrupt by your own negligent act, you are likely to be rendered bankrupt by someone else's.

Lastly, I am aware that in this paper I raise several issues but give no answer. As a solicitor specialising in professional indemnity law I would be interested to hear from those of you who specialise in company law or insolvency law what you feel the answers to these questions might be. There are many areas of law as currently developed which sit rather uneasily with the concept of an incorporated professional practice and which have not yet been developed in that context.

2. The company as a legal person

The principle of the company as a separate legal entity is, of course, well enough known to all of us and I do not, therefore, propose to spend much time on this aspect.

Limited liability is, however, surprisingly recent and could not be assumed by a company until 1855. Prior to this time, as the following passage from Lindleys L.J.'s judgement in *R v. Registrar of Joint Stock Companies (1891)* shows clearly, the position of shareholders was not much different from that of partners:-

"I understand by a company – an unincorporated company – some association of members, the shares of which are transferable. As distinguished from the partnership I know of nothing else accept the tranferability of shares."

The separate persona of a company and its entity as distinct from its shareholders was famously established by the House of Lords in the famous old case of *Saloman v. Saloman & Co (1897) A.C.* in which it was held that, however large the proportion of shares and debentures held by one man, even if the other shares were held in trust for him the company's acts were not his acts and nor were its liabilities his liabilities: nor is it otherwise if he has full control or is governing director. In the famous words of Lord McNaughton:-

"The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act. That is, I think, the declared intention of the enactment. If the view of the learned Judge were sound, it would follow that no common law partnership could register as a company limited by shares without remaining subject to unlimited liability."

Thus:-

(a) Whilst in a partnership each partner is personally responsible for all the debts contracted by the firm, in an incorporated company the members have no individual liability to its creditors for debts owing by the company and their personal liability is satisfied if they pay the calls properly made on them by the company or its liquidator; and

(b) The company, as a distinct legal persona, can own and deal with property, contract on its own behalf and sue in its own name. The members are not personally entitled to the benefits or, except in limited circumstances, liable for the burdens arising: their rights are confined to recovering from the company their share of profits or, after a winding up, of the surplus assets, and their liabilities are confined to the paying of the amounts due from them to the company.

(c) On the other hand the company will, in normal circumstances, be vicariously liable for the torts of its directors and employees when committed in the course of their employment, and contractual liability will normally attach to the company the contracts made on its behalf, subject always, of course, to the ultra vires doctrine and that special adaptation of the principles of agency known to company lawyers as the "rule in Turquand's case": subject, also, to any weakening of that rule that may have been precipitated by Section 9 (1) of the European Communities Act 1972 now enshrined in Section 35 of the Companies Act 1985.

The principle of the Saloman case, that a company is a legal entity distinct from its members, is strictly applied by the courts whenever it is sought to attribute the rights or liabilities of the company to its shareholders or regard the property of the company as belonging in law or equity to the shareholders unless, that is, it is dealing with one of those rare situations where the courts are willing to lift the veil of incorporation. It is well established that the courts will not allow the corporate form to be used for the purposes of fraud or as a device to evade a contractual or other legal obligation.

See also:

(a) Wallersteiner v. Moir (No. 1) (1974) 1 Q.B.

(b) Lonrho v. Shell Petroleum Ltd (1980) 1 W.L.R.

(c) Multinational Gas and Petrochemical Co v. Multinational Gas and Petrochemical Services Ltd (1983) 3 W.L.R.

(d) Dimbleby v. N.U.J. (1984) 1.W.L.R.

(e) Re a Company (1985) B.C.L.C.

3. **Groups and subsidiaries**

As I said in my introduction to this paper there do seem to be two distinct advantages from a liability point of view available to professional practices upon incorporation. The first of these arises from the independent legal persona of a company and is the capacity to protect the major part of one's business from insolvency by reason of a negligence claim in excess of one's insurance cover by means of setting up a group of companies rather than conducting the whole of one's business out of the aegis of a single company. The Law Society's Incorporated Practice Rules specifically envisage this possibility by allowing a recognised body to be a shareholder of another recognised body.

It is a commonplace of commercial life today that businesses are conducted not only in the form of a single private or public company but also in the form of a group of companies consisting of a holding company and a number of wholly owned subsidiaries. Whilst many of the statutory obligations in the Companies Acts (re the filing of accounts, loans, quasi-loans, insolvency etc) take account of the group form as an everyday fact of corporate life, one area in which the tendency of Parliament to put the obligation of a company onto a group basis has stopped short is that of the liability of the holding company for the debts and/or liabilities of its insolvent subsidiaries. Here neither the

legislature nor the courts are willing to depart from the strict corporate entity principle and its attendant privilege of limited liability. The fact that all or a majority of the shares in the company are owned by a holding company makes no difference to the ordinary rule that the shareholders in a limited company are not liable for its debts beyond the amount paid up (or to be paid up) on the shares held by them.

This does, of course, ignore reality. It ignores, also, the fact that very often the subsidiary is under-capitalised for the most cynical of reasons nor does it prevent many holding companies granting secured loans to their subsidiaries and thereby obtaining priority in a subsequent insolvency. Nonetheless it remains the law as things stand at present.

The result, so it seems to me, is that the answer to the last question which I pose:-

> "Should I make my conveyancing department a wholly owned subsidiary?"

which I will rephrase:-

> "Should I make those of my departments which most expose me to the risk of insolvency subsidiaries?"

may be "yes" subject only to the observation that you may find it quite hard to get anybody to trade with you on that basis and subject to the observation, also, that, to my mind, this could be perceived as an immediate departure from professional standards hitherto expected. I wonder how this particular aspect of incorporation would develop. I wonder how the Law Society would view such structures in deciding whether or not to recognise a body.

I now ask my first questions and these relate to several other parts of this paper also:-

(a) Is an incorporated firm of solicitors with a major negligence action against it, where damages are likely to exceed its insurance cover and its capital base, trading with "no reasonable prospect of avoiding insolvent liquidation in the context of S214 of the Insolvency Act 1986?"

(b) Could an incorporated firm of solicitors be held to be so trading if it had completely inadequate insurance cover?

(c) If a subsidiary was in this position could the holding company be viewed as a shadow director i.e. "a person in accordance with whose directions or instructions the directors of the company are accustomed to act?"

My answer to these questions is as follows:-

(a) Yes;

(b) No;

(c) Perhaps, but see Section 741 of the Companies Act 1985 and Section 251 of the Insolvency Act 1986. If the answer is no it would not necessarily mean the directors of the holding company were not so trading.

What is going to be the inter-relationship of the insolvency legislation to professional incorporated practices? They are, of course, in a very different position to that of a normal trading company.

4. **Third party rights against directors and employees**

The advantage to the members of a company on incorporation and of group organisation does not necessarily extend to its directors. Although for a long time this was very much a live issue following the case of *Elder Dempster & Company v. Paterson Zochonis & Co (1924) All E.R.* (a case in which ship owners were held entitled to the protection of an exemption clause in a bill of lading signed for and on behalf of the company which had chartered the ship), it is now clearly the case that directors and employees may incur a personal liability to those persons with whom they come into contact on behalf of the company.

A similar problem to that encountered in *Elder Dempster & Company v. Paterson Zochonis & Co (1924) All E.R.* arose in *Scruttons v. Midland Silicons Ltd (1962) 1 All E.R.* where negligent stevedores also sought the protection of an exemption clause in the bill of lading with very different results. I quote from the speech of Viscount Simonds:-

> "I come finally to the case which is said to require us to decide in favour of the appellants. The Elder Dempster case has been the subject of so much analytical criticism and so many different conclusions that one may well despair of finding out what was decided by which of the five noble and learned Lords who took part in it."

To my mind this absolves me from any responsibility whatsoever! More important, the judgment of Viscount Simmonds is particularly helpful and clear:-

> "If the cargo-owner sues a stevedore for negligence, he sues him not as a dependent or independent tortfeasor but just as a tortfeasor. It may be that, if he is a "dependent" tortfeasor in the sense that he is the servant or agent of a master or principal, the latter may be vicariously liable, but that does not touch his personal liability. From that he can only escape if there is a contractual relation between him and the cargo-owner which provides him with immunity for his tort or a principle of law which entitles him to rely on a contract made by another."

Notwithstanding this judgment, and, I suspect, because there is a natural repugnance against making employees, in particular, dig deep into their pockets, the point has continued to arise with consistent regularity. I list in the abstract in your notes a number of cases in which it has been considered and always, so far as I can see, in this jurisdiction with the same result.

Adler v. Dickson (1955) 1. Q.B., an employee case, was a case in which a negligent master and boatswain were held not to be entitled to the provision of an exemption clause in the contract between the ship owners and the plaintiff who had injured herself on the ship's gangway. *Fairline Shipping Corporation v. Adamson (1975) 1.Q.B.*, a directors' case, is a case where a negligent director was held to be disentitled to the protection of an exemption clause. The judgment of Mr Justice Kerr is as clear on the point as was that of Viscount Simonds:-

> "The fact that he was a director of game & meat and the company was the contracting party does not necessarily exclude his personal liability. The legal position in this connection can be conveniently illustrated by reference to two cases, which examples could easily be multiplied. In *Adler v. Dickson (1955) 1.Q.B.* the plaintiff's contract with the defendant's employers, although excluding all liability for negligence, nevertheless did not preclude her from recovering damages in negligence from the defendant, a servant of the company with which she had contracted, because he owed her a personal duty of care apart from his contractual obligations to his employers and because he was held to be in breach of that duty. That was a case of personal injury but I do not see why a case of damage to the plaintiff's property must be regarded differently in law. Take the

facts of *Morris v. C.W. Martin & Sons Limited (1966) 1.Q.B.*. In that case the plaintiff's fur coat was stolen by a servant of the defendant who was sub-contractor and sub-bailee of the coat without any contractual or other nexus existing between the Plaintiff and the defendant. The plaintiff recovered damages against the defendant for the loss of her coat because they were held responsible for the act of their servant. It is, however, clear that if she had chosen to sue the servant personally in the tort of conversion she would equally have succeeded, indeed with less difficulty. But would the position on this basis have been any different if, instead of stealing the coat the servant had negligently caused or allowed it to be ruined in the process of cleaning it? If he had carelessly plunged into a vat of green dye or left it in cleaning fluid for so long that it became destroyed by some foreseeable chemical action could he not have been made liable in negligence as well as his employers? I do not see why it should follow as a matter of law that in such cases an action could only be maintained against his employers. A duty of care by somebody else's servant to the owner of goods and a breach of that duty by a particular servant may, of course, be much more difficult to establish than a wrongful conversion of the goods by such a servant. But this depends on the facts. Generally speaking, if an employer is liable to a plaintiff in tort on the basis of the doctrine respondeat superior, the servant can also be held personally liable, though in practice it is, of course, usually much more convenient and worthwhile to sue his employers. If this is the law as regards servants it cannot logically be more favourable to company directors."

As we shall see in Sections 6 and 7 of this paper logic is not always so dominant! But what of the director who does not himself commit a tort but who "authorises, directs and procures" someone else to commit a tort? This point has been considered in a number of cases and, recently, in the case of *C. Evans & Sons Limited v. Spritebrand Limited (1985) 2 All E.R.*. The following passage from the judgment of Slade L.J. is instructive:-

"The authorities, as I have already indicated, clearly show that a director of a company is not automatically to be identified with his company for the purpose of the law of tort, however small the company may be and however powerful his control over its affairs. ....in every case where it is sought to make him liable for his company's torts it is necessary to examine with care what part he played personally in regard to the act or acts complained of. Furthermore, I have considered sympathy with judges, particularly

when dealing with commercial matters, who may be anxious to avoid or discourage a necessary multiplicity of parties by the joinder of directors of limited companies as additional defendants in inappropriate cases.... I would accept that, if a plaintiff has to prove a particular state of mind or knowledge on the part of the defendant as a necessary element of the particular tort alleged, the state of mind or knowledge of the director who authorised or directed it must be relevant if it is sought to impose personal liability on the director merely on account of such authorisation or procurement; the personal liability of the director in such circumstances cannot be more extensive than that of the individual who personally did the tortious act. If, however, the tort alleged is not one in respect of which it is incumbent on the plaintiff to prove a particular state of mind or knowledge (e.g. infringement of copyright) different considerations may well apply."

As we shall see later, these points may be particularly important because the capacity of a company, as opposed to a partnership, to insure its directors and employees against such liability may be limited by Section 310 of the Companies Act 1985.

See also:-

(a) *Rainham Chemical Works Limited v. Belverdere Fish Guano Company Limited (1921) All E.R.*

(b) *Performing Rights Society Limited v. Ciryl Theatrical Syndicate Limited (1924) 1.K.B.*

(c) *Genwys v. Matthews & Another (1965) 3 All E.R.*

(d) *Mentmore Manufacturing Company Limited v. National Merchandising Manufacturing Company Inc. (1978)*

(e) *White Horse Distillers Limited v. Gregson Associates Limited (1984)*

(f) *Sealand Pacific v. Robert C McHaffie Limited (1975) B.C.C.A.*

5. Directors' liability for the acts of co-directors

Here we turn to what would seem to be the second advantage of incorporation from a liability point of view.

The primary rule is that a director is not the agent of his co-director and that other officers of the company are not the agents of the directors. Accordingly, if my co-director commits an act of negligence so great that

it exceeds my company's insurance cover the injured third party can recover nothing from me other than the amount uncalled, if any, on my shares in the company.

Qua solicitor the position is, of course, a significant advantage of incorporation over partnership unless, that is, one is unlucky enough to be the author of the negligence! As a matter of practice, therefore, one is unlikely to incur a personal liability in respect of professional misconduct unless one either commits the negligence oneself; negligently supervised the person who commits the negligence or it comes to one's knowledge that someone is in the process of being negligent at a time when one has an opportunity to prevent them from causing a client a loss.

Qua director, and whilst the law remains the same, the opportunity for becoming involved in the torts of one's co-directors is somewhat greater. A director will be liable if he has failed to supervise the activities of another director or officer in circumstances in which his duty of care, as fixed by contract or by general law, placed him under an obligation to do so or where, with his knowledge, he has participated to some degree or has given his sanction to conduct which constitutes a breach of duty. A relatively slight degree of participation will suffice. Thus a chairman of directors who signed minutes in relation to an ultra vires investment of company funds and announced the investment to the company in general meeting in terms indicating his assent thereto was held liable as a participant in the misapplication of company funds. Similarly a director who signed a cheque for part of a loan not authorised by the articles was held liable in respect of the whole amount lent even though he had protested strongly against it being lent at all *(Ramskill v. Edwards (1885) 30 1 Ch D.).*

6. **The Company's rights against its employees**

Suppose, however, that one has been lucky enough as an employee to avoid a writ and that the injured third party has obtained judgment against your company. Can the company sue you?

Answer, yes!

The right of a company to recover from an employee damages suffered by that company as a result of the employee's breach of an implied contractual obligation of care to his employers was famously, but narrowly, established in the case of *Lister v. Romford Ice and Cold Storage Company (1957) A.C.*. In this case a lorry driver employed by

the company took his father with him as a mate. In backing his lorry he injured his father, who, in an action against the company, recovered damages. The company (or rather insurers exercising rights of subrogation) brought an action against the son claiming that, as joint tortfeasor, it was entitled to contribution and damages for breach of an implied term in the contract of service that he would use reasonable skill and care whist driving. In the words of Viscount Simonds once more:-

> "I conclude then the first stage of the argument by saying that the appellant was under a contractual obligation of care in the performance of his duty, that he committed a breach of it, that the respondents thereby suffered damage and that they are entitled to recover that damage from him unless it is shown either that the damage is too remote or that there is some other intervening factor which precludes the recovery."

The "second stage of the argument" was the interesting but rejected proposition by the dissenting judges Lord Radcliffe and Lord Somervell that it was an implied term of such contract of employment that the employer will see that the driver was protected by insurance from any third party liability arising from his driving and, accordingly, that neither the employer nor his insurers could sue the driver in respect of the liability!

Not surprisingly a considerable furore then ensued! Indeed, and immediately following the judgment, an inter-departmental committee was appointed by the Minister of Labour and National Services to study its implications. Its conclusions were as follows:-

> "The decision in the Lister case shows that employers and their insurers have rights against employees which, if exploited unreasonably, would endanger good industrial relations. We think that employers and insurers, if only in their own interest, will not so exploit their rights .... we do not, therefore, think that the decision in the Lister case has exposed a practical problem or that there is any need for legislation at present."

The report and the conclusion of the committee were then considered by the Legislation Committee of the British Insurance Association with the result that on 23rd October 1959 the Deputy Chairman sent a letter to all members in terms that:-

> "Insurers generally would agree that the common interest of all demands that, save possibly in cases of collusion or wilful misconduct, no action should come before the courts which would redirect attention to the issues involved in Lister's case."

Further, the letter invited adherence to a "gentlemen's agreement" as follows:-

> "Employers liability insurers agree that they will not institute a claim against the employee of an insured employer in respect of the death or injury to a fellow employee unless the weight of evidence clearly indicates (i) collusion or (ii) wilful misconduct on the part of the employee against whom a claim is made."

Insurers have kept their promise. Indeed it is a feature of the L.I.B. scheme that insurers' rights of subrogation against employees are specifically excluded though, paradoxically, for example, not that of most architects' schemes. Employers, on the other hand, have not been so reticent and, indeed, as I discuss below, it seems to me that directors of a company, in the absence of any appropriate legislation, may be in a rather difficult position in this respect.

Banks have a particularly nasty habit of suing their employees and, as any insurers will know, there are a number of "mega-buck" cases proceeding in the United States at present. Nearer to home is the case of *Janata Bank v. Ahmed (1981) I.C.R.* in which the bank sued its employee claiming damages for losses it has suffered as a result of his negligence. It was held that the employee was in breach of the implied term in his contract of employment to exercise care in the performance of his duties and the bank recovered damages. In the words of Ackner L.J.:

> "I add but a few observations upon the first contention advanced by Mr Pardoe. He has gallantly submitted that when an employee represents that he had a particular competence, a serious incompetence on his part will only entitle the employer to terminate the relationship of employment. The employer has no right to claim damages for breach of contract. This, he submits, is because the employee, in the absence of a specific provision in the contract, owes no contractual duty of care. However, this submission is in flat contradiction with the view of the majority in the Court of Appeal and the unanimous view in the House of Lords in *Lister v. Romford Ice and Cold Storage Company (1957) A.C.*.... I therefore do not accept Mr Pardoe's submission that the law is incorrectly set out in Chitty on Contracts.... where it is stated:-

> "The employee may be held liable in damages for the breach of any term of his contract of employment, whether express or implied, such as by his failure to use dure care or skill. The employer is entitled to damages for those consequences which might reasonably be expected to have been in the contemplation of the parties (at the time when the contract of employment was made) as likely to result from the breach."

and

> "Mr Pardoe is, of course, quite correct in stating that there are few cases to be found where the employer has sued the employee for damages for breach of his contractual duty of care. This is not surprising. If the law is clear, then there is little if any virtue in reporting such cases. But from a practical point of view the employer, rather than suing for damages, which he is unlikely to recover, is more likely to dismiss the employee summarily. The submission that the "common expectation" of employees is that they will not be sued for damages for breach of their contractual duty of care, unless perhaps the breach was intentional, may well be right. There is, after all, no point in throwing goodmoney after bad and the need to maintain harmonious industrial relations is likely to be considered of greater importance than achieving a barren judgment."

See also:-
Morris v. Ford Motor Co Ltd (1973) 1 Q.B. in which the decision in Lister was strongly criticised by Lord Denning.

to be continued

In Part II:

7. The company's rights against its directors – the historical position
8. The company's rights against its directors – the current position
9. The director's position
10. The company's right not to sue and its effect.
11. Other points – Insolvency & Loans
12. Insurance points

"D & F ESTATES – THE FLOODGATES CLOSE"

By Nicholas J Carnell
Solicitor, Winward Fearon & Co

In a recent article, Roger Doulton posed the question "Who then is my neighbour now?" He concluded that far fewer people were now in law his neighbours than would have been the case as little as two years ago. Since publication of that article, the House of Lords has delivered its reasons for dismissing the Plaintiff's appeal in *D & F Estates Limited and Others v. Church Commissioners For England and Wales and Others* (The Independent, 15th July 1988). On the basis of that decision it is plain that Mr Doulton's neighbourhood has suffered extensive further depopulation.