Gesellschaftrecht II

<u>Directors' Duties: a Case Study</u>

Re Barings Plc (No 5)[1]

The collapse of the British bank Barings in February 1995 raises important issues regarding the scope and application of director's duties under the UK Company Directors Disqualification Act 1986 (``CDDA``). The Barings case judgment[2] established a three limbed test for assessing the nature and scope of unfit conduct of directors in disqualification proceedings under the CDDA. Although this case was decided in 1998, it provides a timely and relevant case study to consider how directors' duties should be interpreted in the context of recent banking failures in the global financial crisis.[3] The Barings case upholds the use of strong sanctions against bank directors for management misconduct in the form of financial penalties, regulatory de-authorisation, and banning orders against the directors from managing any type of company.

The Barings case consisted of a number of separate disqualification actions[4]; however, the principal proceeding heard before Mr Justice Parker related to the question of whether the conduct of the bank`s three directors: Andrew Tuckey (deputy group chairman), Ronald Baker (Leeson`s product manager) and Anthony Gamby, amounted to a high degree of incompetence such that it rendered them unfit to be concerned in the management of a company under section 6, CDDA.

Section 6, CDDA requires a disqualification order to be made against a director of a company if the company at any time becomes insolvent and the director`s conduct makes him unfit to manage a company. The purpose of s. 6 is to protect the public against future conduct of directors who have proved unfit to manage a company in the past[5]. Under section 17, CDDA, however, a disqualified director can apply based on exceptional circumstances to the court for leave to act as a director of a company[6].

The conduct alleged in the claim involved the lack of director supervision and monitoring of the dealings of a rogue trader, Nick Leeson, who had been conducting a switching business (arbitrage in derivatives between markets) in Singapore. The business generated a substantial proportion of the Barings group's profits; however, it was conducted on margin and there were repeated calls for the transfer of funds from London to Singapore which in total

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[1] *Secretary of State for Trade and Industry v Baker (No. 5)* [1999] 1 BCLC 433.
[2] Per Justice Jonathan Parker, *upheld* on appeal: *Secretary of State for Trade and Industry v Baker and Others* [2000] 1 BCLC 523, CA.
[3] Senior management and director misconduct at British banks was adjudicated in regulatory enforcement actions against the Royal Bank of Scotland (RBS) and what then known as Halifax Bank of Scotland (HBOS).
[4] Seven other Barings directors were disqualified. Other proceedings include: *Secretary of State for Trade and Industry v Baker (No.1)* [1998] BCC 583; *Secretary of State for Trade and Industry v Baker (No.2)* [1998] 1 BCLC. 590; *Secretary of State for Trade and Industry v Baker (No.3)*[1999] 1 BCLC 226; *Secretary of State for Trade and Industry v Baker (No.4)* [1999] 1 BCLC 262; *Secretary of State for Trade and Industry v Baker (No.6)* [1999].
[5] At 482.
[6] At 434.

amounted to £300 million. In fact the business was not profitable but incurred losses in the order of £827 million, which caused the collapse of Barings, the UK's oldest investment bank at the time, and it was later bought for £1, by the Dutch banking and insurance group ING.

Pursuant to s. 9, CDDA, Parker J considered Schedule 1, para. 1 of the CDDA which *inter alia* requires the court to assess whether a director is unfit by reason of `any misfeasance or breach of any fiduciary or other duty in relation to the company`. The crux of the case turned on the nature and scope of directors` duties of care, skill and diligence.

Parker J expressed his three limbed formulation of directors duties as follows[7]:

(i) ‘Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company’s business to enable them properly to discharge their duties as directors.

(ii) Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.

(iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director’s role in the management of the company.’

The court emphasised that even when a director has delegated a function, he remains responsible for the delegated function and retains a residual duty of supervision and control[8].

The court characterised its approach to assessing incompetence as universal in that it would determine incompetence in any circumstances and at any management level[9]. The exact nature and scope of the above duties will vary depending on the facts of the case, including: the size and business of the company, experience or skills of the director, organisation of the business, management role assigned to the director and her duties and responsibilities and remuneration (the higher the reward, the greater the responsibilities reasonably expected)[10]. For example, the duties expected of a high earning executive director of a publicly listed company will be greater than of a less highly remunerated non-executive director of a small private company.

The key question of law in such disqualification cases is whether the director`s conduct fell below the standards of probity and competence appropriate for a `fit` director[11] and there is no requirement that the conduct caused loss, unlike in common law breach of duty actions. Parker J`s formulation appears to mirror the first limb of the test in section 214(4) of the UK Insolvency Act 1986, which involves an objective assessment of what can reasonably be expected of a director carrying out the defendant's particular function.

[7] At 436, 489.
[8] At 436, 487.
[9] At 435, 484.
[10] At 436, 484, 488.
[11] At 434.

Parker J held that a director could be deemed unfit by the court for breach of any statutory or common law duty, any dishonest conduct (want of probity or integrity) or a high degree of incompetence and examples of conduct showing unfitness included trading at creditors` risk[12] or gross lack of judgment[13]. Incompetence has been expressed invariably as `total incompetence`, `very marked degree` and `really gross incompetence`[14]. Parker J noted, ‘It is, I think, possible to envisage a case where a respondent has shown himself so completely lacking in judgement as to justify a finding of unfitness, notwithstanding that he has not been guilty of misfeasance or breach of duty’[15]. Conversely, a misfeasance or breach of duty does not automatically mean a director is unfit[16].

The court also rejected a number of defences against a finding of unfitness, including: the director is unlikely to reoffend or the director would have performed another management role competently (lowest common denominator approach)[17].

The court found that the directors` conduct involved serious incompetence in failing to understand and remain informed about the switching business. Tuckey`s conduct was described as `non-management`[18] and he was disqualified for four years. Baker was disqualified for six years and found to have `failed to make any serious attempt to discharge his management responsibilities`[19]. Gamby was disqualified for five years and criticised for his `culpable degree of inactivity`[20].

Parker J found that the three directors failed to ensure that Leeson`s proprietary trading activities were properly monitored and/or controlled in the following ways[21]:

1. Leeson was left in full control of both the front and back offices of the bank's trading subsidiary in Singapore.
2. Prior to the bank's collapse, no objective assessment of Leeson's activities was ever made despite unusually high levels of reported profitability.
3. Leeson's requests for funds on an increasingly massive scale were not challenged or investigated.

Parker J stated in his judgment, `It is a truism that if a manager does not properly understand the business which he is seeking to manage, he will be unable to take informed management decisions in relation to it’[22]. Therefore a director must keep informed of the conduct of the business to be able to manage it effectively, which includes supervising his delegates and if he fails to perform his duties of supervision and control, he exposes himself to the risk of disqualification from acting as a director of any company.

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12 Even if this would not amount to wrongful trading under s. 214, Insolvency Act 1986.
13 At 434-5. 483.
14 At 484.
15 At 486.
16 At 435, 486.
17 At 434, 483, 485.
18 Ar 528.
19 At 575.
20 At 600.
21 At 433, 481.
22 At 528.

In the recent financial crisis of 2007-2009, several British banks – including the Royal Bank of Scotland and the then Halifax Bank of Scotland (HBOS)[23] were unable to carry on independently because of weak management that had led to solvency and liquidity problems. Parker J`s approach in the Barings case could be used to impose sanctions under CDDA, including the prohibition on holding future director positions at other British companies.

[23] In October 2008, at the height of the British banking crisis following the collapse of Lehman Brothers, the British government persuaded another british bank – Lloyds TSB – to buy HBOS in order to prevent HBOS from collapsing. See Memoirs of Alistair Darling (2011).