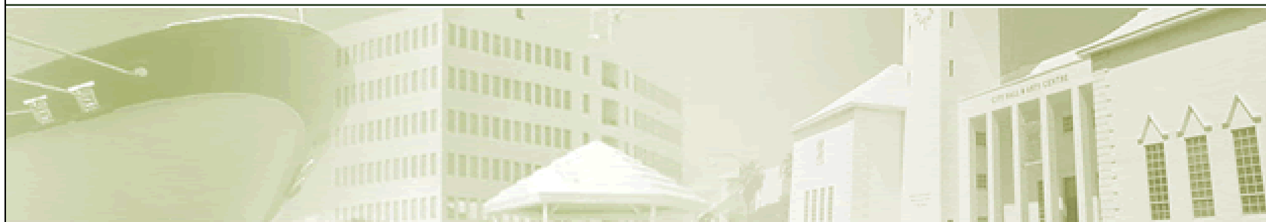
RICHMOND CORPORATE SERVICES LTD. | Lynda Milligan-Whyte & Associates
Barristers & Attorneys



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COMPANIES LIMITED BY GUARANTEE

Bermuda company law permits the incorporation of companies limited by guarantee. These companies are called "Companies limited by guarantee" and may be incorporated by registration under the Companies Act, 1981. A company limited by guarantee shall only be formed for the following purposes:-

1. If its purpose is to promote art, science, religion, charity, sport, education or any other social or useful purpose and its profits, if any, and other income is to be used in promoting its purposes and no dividends are to be paid to its members; or

2. It is a mutual company.

Charitable Type Companies

Where it is proved to the satisfaction of the Minister of Finance that an association about to be formed as a limited company is to be formed for promoting art, science, religion, charity, sport or any other useful object, and intends to apply its profits, if any, or other income in promoting its objects, and to prohibit the payment of any dividend to its members, the Minister may by license direct that the association be registered as a company, without the addition of the word "Limited" to its name. A license under this section may at any

time be revoked by the Minister provided that before a license is revoked the Minister shall give the company an opportunity of being heard.

Limited Liability of Members

Companies limited by guarantee have the liability of their members limited by the memorandum to such an amount as the members may respectively undertake to contribute to the assets of the company in the event of it being wound up. Instead of having share capital, such companies establish a reserve fund and the minimum amount of the reserve fund permitted under Bermuda company law for a company limited by guarantee is US$12,000 or its equivalent in another currency.

For more information on Companies Limited By Guarantee please contact Lynda Milligan-Whyte, Senior Partner at lmw@milligan.bm.

DIRECTORS' DUTIES

Within the last year, two reported cases of the High Court of England and Wales relating to fiduciary duties of company directors, whilst not momentous, are very instructive in reminding one of the duties of directors and are persuasive in the Bermuda Courts. Both cases were decided by Deputy Judges (lawyers, who are appointed as judges on a temporary basis), but both are well written and lucid judgments. The first case, *Extrasure Travel Insurances Ltd and another v. Scattergood and another* looks at the issues of breach of fiduciary duty, incompetence which does not amount to a breach of fiduciary duty and the test of whether a director is acting in the best interests of the company. The second case, *Collin Gwyer and Associates Ltd and another v. London Wharf (Limehouse) Ltd and others* looks at the fiduciary duties of directors in the context of an actual or pending insolvency of the Company.

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Reasons For Incorporating In Bermuda

- Respected International Business jurisdiction (built on the principle of "know your customer");
- Tax Neutral Business Environment (no income, capital gains, transfer or withholding taxes);
- Business sensitive and well established Legal System (based upon English common law);
- Minimal Government Annual Reporting except for Restricted Businesses;
- Access to Capital Markets (through Bermuda Stock Exchange listings);
- Access to one of the most successful Insurance/Reinsurance Markets in the world;
- Reliable Banking System;
- Efficient Support Services (legal, accounting, management, corporate and trust services);
- State-of-the-Art Global Internet Services and Telecommunications (connecting Bermuda to the world); and
- Friendly yet efficient business environment for holding Company Meetings.

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The Extrasure Case

The *Extrasure* case involved the inter-company transfer of funds from a subsidiary company (*Extrasure*) to the parent company where the subsidiary company was arguably solvent prior to the transfer of funds and the parent company was plainly insolvent. For the purposes of this note, the essence of the decision is whether or not the company directors of Extrasure were justified in transferring £200,000 from the subsidiary company to the parent company in purported satisfaction of an inter-company debt. The actual facts of the case and the decision are much more complicated but this note confines itself to this particular aspect. It was accepted by the Court that the transfer of funds from a subsidiary company to the parent company were for the purpose of keeping the parent company afloat and that the directors, in approving the transfer of funds, held an honest belief that without the transfer the parent company would become hopelessly insolvent and the subsidiary company would follow suit. Whilst the directors of Extrasure claimed at the trial that the transfer of £200,000 was in respect of an inter-company debt, the judge found as a fact (on compelling evidence) that the directors moved the money when they did for the purpose of assisting the parent company to stay solvent, and only classified the movement of the funds as repayment of an inter-company debt well after the fact. The question then arises: was it appropriate for the directors of the Extrasure to transfer those funds to the parent company in circumstances where such funds were, arguably, needed for the operations of Extrasure? There were, of course, complicating factors, such as the fact that there were poor accounting records from the parent company and the accounting records of Extrasure had not been reconciled in some 9 months, leading them to present a wholly false picture of the financial state of Extrasure. In any event, the judge found as a fact that no accounts of Extrasure could have been available on the date when the directors resolved to transfer £200,000 to the parent company.

What then were the directors thinking when they transferred the £200,000 to the parent company and were they in breach of their fiduciary duty to act solely for the benefit of Extrasure? It should be noted that the directors' decision was taken without reference to the managing director of Extrasure (he was not in the office that day), even though he had almost always been

involved in all previous decisions to transfer money from Extrasure to the parent company and although the sum in question (£200,000) was four times larger than any previous payment.

In a well reasoned judgment, the following principles of law are re-stated:-

> A director owes to his company a fiduciary duty to exercise his powers (i) in what he (not the Court) honestly believes to be the company's best interests, and (ii) for the proper purposes for which those powers have been conferred on him. Mere incompetence is not a breach of fiduciary duty; it might give rise to a claim for breach of a tortious or contractual duty of care, but the claim in this case was based entirely on alleged breaches of fiduciary duties.

The Plaintiffs sought to argue that a director is also in breach of his fiduciary duty if he honestly, but unreasonably and mistakenly, believes that he is pursuing the company's best interests. This argument was rejected by the learned judge. Fiduciary duties, the judge said, are not less onerous than the common law duty of care; they are of different quality. Fiduciary duties are concerned with concepts of honesty and loyalty, not with competence. In the judge's view, the law draws a clear distinction between fiduciary duties and other duties that may be owed by a person in a fiduciary position. A fiduciary may also owe tortious and contractual duties; but that does not necessarily mean that those duties are fiduciary duties. With that in mind, the judge found nothing surprising in the proposition that mere incompetence might give rise to a claim for breach of duty of care, or for breach of contract, but not for breach of fiduciary duties.

The judge thought it perfectly clear that a director's duty is to do what he *honestly* believes to be in the company's best interests. The fact that his alleged belief was unreasonable may provide evidence that it was not in fact honestly held at the time; but if, having considered all the evidence, it appears that the director did honestly believe that he was acting in the best interest of the company, then he is not in breach of his fiduciary duty merely because that belief appears to the trial judge to be unreasonable or because his actions happen, in the event, to cause injury to the company.

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The Plaintiff also sought to argue that the decisions of directors of the company should be subject to a test of reasonableness; that is, was it reasonable for the directors of a company or group of companies to have entered into some transaction without considering the separate interest of each company in the group? This, it was argued, would suggest whether or not the directors did, in fact, comply with their duties to the company. In rejecting this argument, the judge referred to a test suggested more than 30 years ago in *Charterbridge Corp Ltd v. Lloyds Bank Ltd* by Pennycuick J. In *Charterbridge* it was suggested that the correct test, in the absence of separate consideration, as to whether or not a director had complied with his duty must be whether an intelligent and honest man in the position of a director of the company concerned, *could*, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company. This test was adopted and applied in the following terms:-

The law relating to proper purposes is clear and was not in issue. It is unnecessary for a plaintiff to prove that a director was dishonest, or that he knew he was pursuing a collateral purpose. In that sense, the test is an objective one. It was suggested by counsel that the Court must apply a three part test, but the judge felt it may be more convenient to add a fourth stage. The Court, he said, must:-

1. Identify the power whose exercise is in question;

2. Identify the proper purpose for which that power was delegated to the directors;

3. Identify the substantial purpose for which the power was in fact exercised;

4. Decide whether that purpose was proper.

The third indicator, it should be noted, involves a question of fact, it turns on the *actual motives* of the directors at the relevant times.

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In summary then in any action against a company director, it is not sufficient for a plaintiff to prove that the director took action which proved to be damaging to the company, unless it can also be shown the director did not honestly believe that the action was in the best interest of the company. The fact that the director's belief was unreasonable does not put him in breach of his fiduciary duties, if that belief was honestly held. A consideration of the actual facts of any particular case, if appropriate, is capable of leading the Court to determine whether in fact there was any reasonable basis for a director to hold any particular belief. If there is no such reasonable basis, that is a powerful indicator that no such belief was in fact held by the director at relevant time.

On the facts of the case, the judge went on to conclude that the defendant directors had no reasonable basis for transferring the money from Extrasure to the parent company and that consequently they acted outside the interests of Extrasure, and in breach of their duties to that company.

Next month's note will look at the decision in *Collin Gwyer and Associates Ltd and another v. London Wharf (Limehouse) Ltd and others* and will contrast the two decisions in the context of companies which are, or are in danger of becoming, insolvent.

The information contained in this note represents the author's view of certain aspects of the decision discussed. This note is not intended to be exhaustive. Legal advice should be obtained in respect of any particular question relating to the duties of directors.

For further information on the duties owed by directors to a company, please contact Paul A. Harshaw, Senior Associate at paharshaw@milligan.bm.

RICHMOND GROUP LIMITED AND ITS AFFILIATES

Richmond Corporate Services Ltd. - provides corporate administration and compliance services to Bermuda companies, partnerships and trusts.

Richmond Financial Managers Ltd. - provides a wide range of management services to its clients. It can also assist in advising insurance professionals on the Bermuda regulatory environment, particularly the capital requirements, solvency margins and liquidity ratios.

Richmond Investments (Bda) Limited - provides investment advisory services to clients of the Richmond Group of Companies who are institutional and high net worth clients.

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