

Directors, be careful what you sign

“There are certain situations where courts are prepared to lift the “veil of incorporation”, and ignore the separate legal personality of a company...”

Parmjit Bhogal
Associate solicitor
020 8221 8038
parmjit.bhogal@bowlinglaw.co.uk

With the economic downturn showing no immediate signs of recovery and talk of green roots appearing as something of a fallacy at present, it is a timely reminder for directors to understand the extent of their liability in their attempt to keep their company afloat in the current economic climate.

As shareholders and directors of a company limited by shares are distinct ‘legal persons’ separate from the company itself, the direct liability of shareholders and directors to outsiders with whom the company has dealt is usually nil.

The concept whereby a company has a separate liability to its directors and shareholders is referred to by a number of different references, including the “company’s legal personality”, the “corporate veil” and “separate legal entity”. All of these terms reflect the common idea that a company has a completely separate legal existence to its subscribers, shareholders, directors and company officers. Indeed it was the existence of the corporate veil which drove the popularity of the company limited by guarantee.

There are certain situations where courts are prepared to lift the “veil of incorporation”, and ignore the separate legal personality of a company.

The Court of Appeal’s decision in **Contex Drouzhba Ltd v. Wiseman and another** [2007] is an example of lifting the corporate veil. The CA held a director personally liable for deceit, where he had signed an agreement on behalf of the company committing the company to making payment for goods, knowing that it had no prospect of being able to afford to do so. The decision sends a clear message to all directors to be careful what you sign.

The Facts

Mr Wiseman (W) was the director of Scott Daniel Limited (S Ltd). W signed, on behalf of S Ltd, a purchase agreement with Contex Drouzhba (Contex) to pay for goods to be ordered in the future. W knew that S Ltd could not meet the requirements of the agreement as it was insolvent and had no prospect of ever being able to pay for the goods. When this became apparent Contex brought a claim against W.

The trial judge found that W’s act of signing the agreement created an implied representation that S Ltd had the capacity to pay for the goods and that W’s representation was fraudulently made as W was aware that S Ltd was insolvent and had no prospect of an injection of capital to resolve this.

W appealed and the Court of Appeal held that where the director was effectively the “mind of the company”, as W was, and where he signed a document on behalf of the company containing a representation he “knew to be fraudulent”, it was clear that the director could be personally liable for his own fraud.

In this case, W had impliedly represented that S Ltd had the capacity to pay. W had known this to be untrue and made a fraudulent representation in writing.

The Implications for Directors

Much depends on whether the courts are prepared to apply the principal of director’s personal liability in deceit to factual situations that differ materially from the circumstances in the Contex case.

continued

Directors, be careful what you sign (continued)

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The case is important for what it says about the potential liability of directors who sign agreements on behalf of their company and the following guidance can be drawn from the case:

- Although each case will depend on its own facts, there is a good chance that in other cases a director (who is the controlling mind of the company) who makes a fraudulent representation that the company can make a payment (i.e. when it can't) by signing a contract on behalf of the company, will be personally liable in deceit. The defrauded creditor may now have a direct cause of action by claiming against the director personally in deceit.
- This represents another possible route, additional to the fraudulent and wrongful trading provisions of the Insolvency Act 1986, for creditors of an insolvent company to obtain redress against its directors. The decision is a particular concern for directors trading in insolvency situations or situations of doubtful solvency and who are considering taking on credit to maintain the business while a solution is sought.

- W was the controlling mind of the company, so that his knowledge was that of the company. It is not clear whether the principal of liability in deceit will remain restricted to these types of director or extend to any director who makes a representation on behalf of the company.

Directors of companies in trading difficulties need to consider carefully their personal position when committing companies to long term commitments. The key question is whether they genuinely believe that the company will be financially able to meet its commitments.

For more information contact Parmjit Bhogal on 020 8221 8038 or email him at :
parmjit.bhogal@bowlinglaw.co.uk