Directors in Competition with Their Companies

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Introduction

The duty of directors to act in good faith and in the best interests of the company is beyond dispute. Where to draw the parameters of this obligation is at times a little more difficult. Uncertainties in this area include the scope of the obligation (if any) after the director's resignation, the extent to which a director may compete with her company, and how far a director may go in setting up a competing business in contemplation of resignation from office. These issues were recently considered by the Chancery Division in England in *British Midland Tool Ltd v Midland International Tooling Ltd and Others* ([2003] 2 BCLC 523 (ChD)).

The Facts

Grinding Aids Ltd was a specialised engineering company that carried on the business of manufacturing and supplying cutting tools to the automotive industry in England. Some time after it changed its name to British Midland Tools, the company went into receivership. The business was then bought from the receivers by British Midland Tool Ltd ('BMT') which had been formed for that purpose by MJ Allen Holdings Ltd ('Allen Holdings'). Allen Holdings was based in Ashford, Kent. BMT was based in Tamworth, Staffordshire and employed about thirty people from the local community on its shop-floor. Most of them were skilled

operators of the various types of specialist tool-making machinery used in BMT's business and had been with the business from long before its acquisition by Allen Holdings. Four of the defendants, collectively referred to in the judgment as the 'Tamworth 4', had also been with the business from well before its acquisition and had served the new company as managing, administrative, works and sales directors respectively.

The Tamworth 4 were, for various reasons, dissatisfied with their relationship with Allen Holdings. They therefore developed a plan to leave their positions with BMT and to set up a rival company. The managing director retired in March 2000, soon after his 65th birthday. Less than two weeks after he took up retirement, he placed an advertisement in a local newspaper, inviting applications in writing to a specified postal box number for jobs with a specialist cutting-tool manufacturer. At the end of that month, the other three defendants gave notice to BMT of their resignation as directors and of the termination of their employment. The financial director of Allen Holdings held several meetings with them in an attempt to convince them to change their minds, but at the second meeting the third defendant presented him with the resignation of twelve of BMT's skilled workers. All attempts by Allen Holdings to persuade them to stay were to no avail.

It soon became apparent that a new enterprise, Midland International Tooling Ltd ('MIT') had been set up by the former managing director on premises adjacent to BMT's own workplace and during the following weeks several more of BMT's employees joined the rival company.

BMT relied heavily on one of its clients, the Ford Motor Co, for its business. It could not retain this business and eventually had to close down in August 2001. By contrast, MIT had some success in attracting business from former BMT customers, including Ford. However, it had made some serious miscalculations when working out its business plan and had incurred substantial trading losses. The company was, in due course, taken over by Bradford Tool and Gauge Ltd ('BTG'), the director of which (McGrath) had raised the initial finances for MIT. By that time two of the defendants had resigned from the company.

The Claim

The plaintiff claimed compensatory damages from the Tamworth 4, MIT, BTG and McGrath for the loss of BMT's business, trading losses incurred in the period following the exodus of the workforce up to the closure of the business, and closure costs, all claimed to have been caused by unlawful conspiracy to damage BMT. It was alleged that the conspiracy involved the setting up of MIT as a vehicle to carry on a competitive business; the copying or taking of drawings in the competing business of drawings in hard copy and electronic form, computer programs for the control of some of the machine tools, BMT pricing information and information relating to BMT's customers; inducing a

company subcontracted by BMT to produce drawings for it to supply MIT with drawings that had been produced for BMT; enticing away nineteen of BMT's employees; approaching BMT's customers to advise them of the fact that most of BMT's workforce and management had formed a new business and inviting them to do business with that enterprise; and concealing from the other directors of BMT and Allen Holdings the steps which they were taking.

No claim regarding copyright, database right or design right was made. The claim was, instead, based on the confidentiality of the BMT drawings and on breaches of directors' and/or employees' duties (see at 530 [16]), which BTG and MIT had allegedly knowingly induced.

Under English tort law, there are two kinds of actionable conspiracy: conspiracy to injure by lawful means and conspiracy to injure by unlawful means. They are sometimes referred to as conspiracy to injure and conspiracy to use unlawful means. The requirements of the latter tort are that the claimant must prove that it has suffered loss or damage as a result of unlawful action taken pursuant to an agreement between the defendant and another person or persons to injure her by unlawful means, whether or not it is the dominant intention of the defendant to do so (see, generally, *Kuwait Oil Tanker Co SAK & Another v Al Bader & Others* [2000] 2 All ER (Comm) 271 (CA) at 312).

The three essential elements which had to be proved here were, therefore, (*i*) unlawful means taken pursuant to an agreement; (*ii*) loss suffered as a result of it; and (*iii*) the intention to injure by unlawful means (see *British Midland Tool* at 556 [77]).

The Decision

In a detailed and rather lengthy judgment, Hart J considered the evidence in respect of the alleged electronic copying and concluded that even though such copying had undoubtedly taken place, the defendants did not know about it at the time when it was authorised. And whilst they probably were aware of the fact that hard copies of some of the drawings belonging to BMT had been made and brought to MIT, these drawings were not the exclusive property of BMT and could easily have been obtained by the defendants from customers. The taking of the drawings therefore involved little if any wrong to BMT (see at 576 [155]). With regard to the confidentiality of the drawings, the Court was of the opinion that the only use the defendants had for the information was in connection with the solicitation of customers or in fulfilling orders from customers. The customers themselves had a contractual right to the information and were legally competent to authorise its use. It was therefore difficult to see how use of the information by a third party such as MIT for the purposes and with the consent of the customer could amount to an actionable breach of confidence (see at 579 [162]). In so far as the allegation of conspiracy was involved, it was in any event not the

unlawful taking of the information that was relevant, but its unlawful use. The position of the electronic drawings did not differ from the hard copy drawings in this respect (see at 580 [167]). It had also not been proved that the defendants had deliberately taken BMT pricing information with them when they left. Nor could this information be regarded as confidential, since it could be, and had been, obtained from the clients themselves (see at 583 [179]).

However, the plaintiff had undoubtedly suffered some damage as a result of the secession of the four directors together with a large part of the workforce. It was also beyond doubt that this damage had not only been foreseeable, but had actually been foreseen. The main issue was therefore whether the means by which the secession was achieved, involved unlawful conduct (see at 556 [78]). If the implementation of the plan necessarily involved the commission of unlawful acts, then the damage suffered as a result of its implementation would be recoverable as damages resulting from conspiracy to use unlawful means (see at 556 [79]). In this regard the Court was satisfied that the former directors did not agree to use unlawful means to carry out their plan in the sense that the means which they decided upon were not known by them to be unlawful. This was borne out by the fact that they had taken legal advice in order to be able to understand where the border in these circumstances lay between lawful conduct and unlawful conduct. (The summary on pages 545-8 of the judgment of the legal advice obtained, provides a useful exposition of the legal constraints to which directors are subject.)

On the evidence, the Court found that there was a strong possibility that key and trusted members of the workforce were led into the secret at an early stage, well in advance of the publication of the advertisement inviting applications for jobs with MIT (see at 552 [67]), but it was satisfied that as far as the majority of the workforce was concerned, there was no earlier intimation of what was afoot than the advertisement itself (see at 553 [70]). It was apparent that very shortly after the advertisement appeared, it became common knowledge on the shop-floor that the management was behind the new company and was in no way discouraging applications being made for employment with it. By this means a flood of applications resulted (see at 554 [72]). The enticement of the key members of the workforce was arguably not an essential element of the plan. But the Court nonetheless found that the Tamworth 4's plan necessarily involved them in a breach of their duties as directors, and that the loss suffered by the claimant as a result of the implementation of the plan was therefore recoverable from them by way of damages for recovery. Those breaches could be identified, not as the enticement of employees, but as the keeping secret of the whole plan from the other directors of the claimant and their connivance in the solicitation of employees by the retired managing director once he had ceased, but each of the remaining three continued, to hold office (see at 556-7 [80]). The

plan could not be implemented without the active co-operation both of MIT and, on the evidence heard, McGrath. In view of this finding, the Court did not consider it necessary to consider separately the question whether implementation of the plan also necessarily involved any of them in breaches of their service contracts (see at 562 [94]). There was no basis for holding BTG liable as a conspirator in these matters because the investment made by McGrath was of a personal nature (see at 545 [52] where the Court found that when McGrath committed himself to financial participation, he did not envisage that the result of his investment would be that BMT would be destroyed and that he or BTG would succeed to its business).

The Court therefore found that the claimant was entitled to have its damages assessed under the three heads claimed. The expert evidence led on behalf of the defendants was accepted and the value of the business was determined in accordance with its maintainable earnings. An award was made for trading losses up to January 2001, the Court finding that BMT should have taken the decision to wind down the business by September 2000. The award in respect of the closure costs was similarly reduced to take account of the fact that the business should have been closed sooner.

Reasons for Judgment

The Court confirmed the fundamental duty of a director to promote the business of the company, to act with complete good faith towards it, and not to embark on a course of conduct in which her own interests will conflict with those of the company. It was assumed to be a natural consequence of this fiduciary duty that 'a director would be under a duty to alert his fellow board members to a nascent commercial threat to the future prospects of the company, and that the duty would be all the greater (and certainly no less) when he himself was planning to be part of that threat' (at 557 [81]). However, the authorities at first glance seemed to deviate from this proposition. Hart J considered the decisions in *London & Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd* ([1891] WN 165 (ChD)), *Bell v Lever Bros Ltd* ([1932] AC 161 (HL)) and *In Plus Group Ltd & Others v Pyke* ([2002] 2 BCLC 201 (CA)) and found that they stand for no more than that there is nothing objectionable in the position of a director who, in the absence of contractual restraints or disclosing confidential information, becomes involved either personally or as a director of another company in a competing business. But this could not be regarded as a licence for directors to put themselves or to remain in situations where their duties or interests could come into conflict (see at 557 [82]).

A director's intention to form a business in competition with her company after her directorship has ceased is, according to the authorities, not an interest which conflicts with that of the company. But a director's

duty to act so as to promote the best interests of the company prima facie includes a duty to inform the company of any activity, actual or threatened, which damages those interests, and where that activity involves both herself and others, there is nothing in the authorities which excuses her from it (see at 560 [89]).

The conduct of the managing director, following his resignation as director, in soliciting the resignation of the employees, viewed on its own, amounted to potentially damaging conduct that did not necessarily involve a breach of duty (see at 561 [90]). However, the conduct of the other three directors, in the Court's opinion, amounted to a breach of their fiduciary duty (at 561 [90]):

> 'The situation was one, quite simply, where to the knowledge of three of the six members of the board of BMT, a determined attempt was being made by a potential competitor to poach the former company's workforce. The remaining three at best did nothing to discourage, and at worst actively promoted, the success of this process. In my judgment this was a plain breach of their duties as directors. Those duties required them to take active steps to thwart the process. Plainly their plan required the opposite. Active steps should have included alerting their fellow directors to what was going on. Their plan required, on the other hand, that their fellow directors be kept in the dark. This plan was formed, at the very latest, by 13 March when Don Allen gave notice of retirement. At least from that date in my judgment the continuance in office of the remaining three without disclosing to their fellow directors what was afoot necessarily involved them in a breach of their duties.'

The extent of the duty to inform depends on the circumstances of each case. In circumstances such as the present ones, where the Tamworth 4 were executive directors of the company, charged and trusted by the owners with its management on a semi-autonomous basis and having the primary responsibility for relations between the company and its employees, the fact that any one of them was himself involved in a breach of duty did not absolve him from his duty to report breaches by the others (see at 561 [91]). Mere passive standing by without disclosure would, in any case, in itself have constituted a breach of their duty (see at 561 [92]).

The Legal Issues

The decision in *British Midland Tool* draws attention to several aspects related to the fiduciary duties of directors. These may briefly be commented on.

(1) Competing with the Company

London & Mashonaland Exploration Co v New Mashonaland Exploration Co (supra) is frequently cited as authority for the statement that there is no rigid rule that a director may not be involved in the business of a company which is in competition with another company of which she is a director (see, eg, *Bell v Lever Bros* supra at 193-6 where this decision was approved and applied). In *Mashonaland*, Lord Mayo had been appointed

as director and chairman of the board of directors. He had never acted as such, nor had he attended any board meetings. He had, furthermore, never agreed not to become a director of any similar company. When a second company was formed for the same purpose and issued a share prospectus advertising Lord Mayo's name at the head of its list of directors, the first company applied for an injunction. Chitty J dismissed the application, confirming that there was no contract and finding that no case had been made out that Lord Mayo was about to disclose any confidential information to the second company.

Commentators have expressed their doubt about the correctness of the statement referred to above as a general principle (see *Gore-Browne on Companies* vol 2 Suppl 46 44 ed (2003) by Lord Millet (ed in chief) in par 27.17; Michael Christie 'The Director's Fiduciary Duty Not to Compete' (1992) 55 *Modern LR* 506; *Gower's Principles of Modern Company Law* 6 ed by Paul L Davies (1997) 622).

In *In Plus Group Ltd v Pyke* (supra), the English Court of Appeal referred to the general unease with which modern textbook writers view the *Mashonaland* case (per Brooke LJ at 221 [79] and Sedley LJ at 222-4 [79-84]), but the majority regarded it as unnecessary to resolve the controversy because of the particular circumstances of the case (per Brooke LJ at 221 [75] and Jonathan Parker LJ at 227 [93]). In this instance the director had suffered a stroke and, although he had not officially resigned, he had effectively been expelled from the companies of which he was director for more than six months before the events that were the subject of the complaint. He had also not been receiving any remuneration during this time.

I have previously suggested that developments since the decision in *Mashonaland* call for a reconsideration of the complex issue of competition by directors (see Michele Havenga 'Competing with the Company – When Does a Director Breach His or Her Fiduciary Obligation?' (1995) 7 *SA Merc LJ* 435). This is particularly so in view of recent initiatives to improve corporate governance. A director's obligation to act in the company's best interests rather than her own is in jeopardy where she is on the board of competing companies. One solution is a statutory prohibition, for the director's term of office, of multiple directorships in companies who are trade competitors (see also Michele Havenga *Fiduciary Duties of Company Directors with Specific Regard to Corporate Opportunities* [vol 29 *Transactions of the Centre for Business Law*, University of the Free State] (1998) at 387). I do not suggest that the number of directorships a person may hold should generally be restricted. Conflicts of interest are likely to arise only in the case of competing companies. And, in the interests of building up expertise, executive directors should, in fact, be encouraged to hold other non-executive directorships, provided that these are not detrimental to their immediate responsibilities (see also Institute of Directors *King*

Report on Corporate Governance (2002) ('*King II*') at 57 par 8). But, as *King II* pointed out, non-executive directors should be judicious in the number of directorships they accept, in order to ensure that they do full justice to their onerous and demanding responsibilities (ibid). The vast differences in size and nature of companies make it impractical in my view to set a fixed number of directorships – this should be dictated by the circumstances.

(2) Taking Steps to Set Up a Competing Business whilst still a Director

In *British Midland Tool* the managing director set up a competing company knowing that he was going to resign from BMT. English law does not regard a director's power to resign from office as being of a fiduciary nature. She is therefore entitled to resign irrespective of the detrimental consequences it may have on the business or reputation of the company. The terms of any existing employment contract must, naturally, be observed. In the absence of special circumstances such as a prohibition in the service contract, no breach is committed merely because the director takes steps so that, on the termination of her office, she can immediately set up business in competition with the company (see *Framlington Group plc & Another v Anderson & Others* [1995] 1 BCLC 475 (ChD) at 498A-B). The director is not thereafter precluded from using her general fund of skill and knowledge, or her personal connections, to compete, but may not after the resignation pursue a maturing business opportunity of the company (see also *CMS Dolphin Ltd v Simonet & Another* [2001] 2 BCLC 704 (ChD) at 733*b-d*) or use confidential information of the company (*Dranez Anstalt & Others v Hayek & Others* [2002] 1 BCLC 692 (ChD)).

In *Balston Limited & Another v Headline Filters Limited & Another* ([1990] FSR 385 (ChD)), Falconer J considered the decisions in *Bell v Lever Brothers* (supra); *Industrial Development Consultants Ltd v Cooley* ([1972] 1 WLR 443, [1972] 2 All ER 162 (Assizes)); and *Island Export Finance Ltd v Umunna* ([1986] BCLC 460 (QB)) and concluded that a director's intention to set up business in competition with the company after his directorship has come to an end is not regarded as an interest which conflicts with that of the company if the rules of public policy as to restraint of trade are upheld. Nor is the taking of any preliminary steps to investigate or forward that intention a breach of the fiduciary obligation, provided there is no actual competitive activity like competitive tendering or actual trading while he remains a director (see at 412).

The position is the same in South African law. In *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd & Others* (1981 (2) SA 173 (T)) the Court held that the mere incorporation of a competing company on the initiative of the managing director, whilst serving his month's notice, was not a breach of his fiduciary obligation (see at 198-9).

A lesser duty should in my view not be required from a managing director when she is serving notice than at other times. This is precisely the time when her duty to the company is likely to be at its lowest point and when breaches are most likely to occur (see also Havenga 'Duties' op cit at 367; Michael Larkin 'M/D under Notice – Duty of Good Faith' 1981 *South African Company LJ* E-29-E-33; Michael Larkin 'Company Law' 1981 *Annual Survey of South African Law* 311 at 314).

Cleaver J seems to have had this in mind in his well-reasoned judgment in *Movie Camera Company (Pty) Ltd v Van Wyk* ([2003] 2 All SA 291 (C)) where he took into consideration that the director's resignation had been brought about by general unhappiness working for the plaintiff and had in no way been part of any deliberate strategy or intention to set himself up in competition with the plaintiff; that his contact with the competitor whom he joined after his resignation had been established in his personal capacity and did not relate to his position with the plaintiff; that after his resignation he had also been offered other lucrative positions; and that he had continued to work diligently and faithfully for the plaintiff during his notice period (see at 311*e-i*). Taking steps to set up a competing business during the notice period is therefore acceptable, but the director still has to be wary of actual competition with the company during this period, or of appropriating opportunities that rightfully belong to the company. Obviously she may not make use of confidential information of the company (see *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC & Others* 1988 (2) SA 54 (T)).

(3) Effect of Resignation on Fiduciary Obligation

A former director is not a fiduciary, since she no longer holds the position from which the fiduciary duty is derived. Once a person ceases to be a director, she therefore no longer owes the company a fiduciary duty (Michele Havenga 'Corporate Opportunities: A South African Update (Part 2)' (1996) 8 *SA Merc LJ* 233 at 234; Bruce Welling 'Former Corporate Managers, Fiduciary Obligations, and the Public Policy in Favor of Competition' (1990) 31 *Cahiers de Droit* 1095 at 1121).

Thus, the defendant directors in *British Midlands Tool* were liable for actions that took place during their terms as directors, namely concealing their plan from the other directors.

In South African law, too, the fiduciary obligation terminates when the directorship does. Statements to the effect that the common-law fiduciary duty of directors owed to the company subsists even after the appointment has ceased (see, eg, *Cyberscene Ltd & Others v i-Kiosk Internet & Information (Pty) Ltd* 2000 (3) SA 806 (C) at 820I, referred to with approval by the Supreme Court of Appeal in *Phillips v Fieldstone Africa (Pty) Ltd & Another* [2004] 1 All SA 150 (SCA) at 161 [31]), are unfortunate and should be regarded with circumspection, since they are usually made in the context of accountability arising from an existing

fiduciary duty where the competitive activities continued after resignation. So, for example, where directors acquired confidential information whilst owing a fiduciary obligation to the company, accountability for using it may ensue also after resignation from office (see *Sibex Construction* (supra) at 68A). The same principle applies if a corporate opportunity is acquired after resignation, where the resignation was influenced by a wish to acquire that opportunity, or where the director's position with the company, rather than a fresh initiative, led her to it (see Havenga 'Duties' op cit at 375).

Limitless accountability could, however, set too harsh a standard in this regard, especially in view of the constitutionally entrenched right to freedom of trade, occupation and profession (see s 22 of the Constitution of the Republic of South Africa, Act 108 of 1996; Michele Havenga 'Corporate Opportunities: A South African Update (Part 1)' (1996) 8 *SA Merc LJ* 40 at 234-5). Factors to be taken into account include the passage of time, the nature of the company's business and the information involved, and the circumstances resulting in the director's resignation.

(4) Duty to Inform

British Midland Tool draws a clear distinction between a director's duty to inform fellow-directors and the company of her own competitive intention and the duty when other directors are also involved in the competitive enterprise. Hart J (at 558 [85]) distinguished the decision in *Balston* (supra) on the basis that *Balston*'s case was concerned with the duty of the director or employee to diclose his own conduct: 'What the case does not deal with is the duty of a director, or an employee, to report the misconduct of a fellow director/employee.'

This issue was considered in the context of employees' duties in *Sybron Corporation & Another v Rochem Ltd & Others* ([1984] 1 Ch 112 (CA)). Stephenson LJ held that there is no general duty to report a fellow-servant's misconduct or breach of contract. Whether such a duty exists, depends on the contract and on the terms of employment of the particular employee, who may be so placed in the hierarchy as to have to report either the misconduct of her superiors, or the misconduct of her inferiors (see at 126). His lordship agreed with the trial judge that a person in a managerial position cannot possibly stand by and allow fellow servants to pilfer the company's assets and do nothing about it (see at 127).

The position as stated in *Atlas Organic Fertilizers* (supra) has been accepted in South African law. The mere creation by a director of alternative employment to be taken up after resignation is no breach of any fiduciary obligation (see at 198-9). And employees may be enticed to terminate their contract lawfully (see at 200E). It is only where the inducement is done with the object of crippling or eliminating the

competitor that it becomes unlawful (see *Movie Camera v Van Wyk* (supra) at 315 [61]). However, the managing director's canvassing of the company's employees while serving her notice month at the same company is a breach of that duty (see *Atlas Organic Fertilizer* (supra) at 201A). And, should the director be aware that other directors are also planning to leave the company and that the company is likely to suffer damages in consequence, I suggest that her fiduciary obligation to the company also compels her to disclose that information to the company.

(5) Corporate Opportunity

In *British Midland Tool* the claimant alleged that the Tamworth 4 had wrongly enabled MIT to make use of its corporate opportunities. These alleged opportunities were described (at 585-6) as 'simply the opportunities afforded by the claimant's goodwill whereby it would continue to manufacture and design goods for its existing and potential customer base'. The Court found that this amounts to no more than an allegation that the four directors had resigned in order to enable MIT to compete with the claimant in relation to its existing and potential customer base, which they were perfectly entitled to do (see at 586 [186]). There had been no ongoing negotiations in respect of any specific work between BMT and any of the potential customers which had been taken over by MIT. Therefore no corporate opportunity had been unlawfully usurped.

It is, as was pointed out by Cleaver J in *Movie Camera v van Wyk* (supra), impossible and indeed unwise to lay down any conclusive guidelines which are to be applied in assessing whether or not one is dealing with a corporate opportunity which rightfully belongs to the company (see at 309 [48]). Defining a corporate opportunity has proved to be elusive, yet it may be important to establish whether a particular advantage may be regarded as such an opportunity, since the validity of a decision to ratify or the locus standi of members to institute derivative actions may depend on the definition (see Havenga 'Opportunity 1' op cit at 42).

Generally speaking, a corporate opportunity connotes any economic or business opportunity, whether involving property or rights, which rightfully 'belongs' to the company or to which the company has some kind of claim. It can pertain to material or immaterial property, but it should at least be identifiable as a specific opportunity, which was not only in the line of business of the company but which the company was also justifiably relying upon the director(s) to acquire or to assist in its acquisition for the company (idem at 46).

Conclusion

The claimant in *British Midland Tool* elected to base his claim on a specific tort. Had it been based purely on directors' common-law fiduciary obligations, the outcome would, I think, have been the same.

Under South African law a plaintiff may also elect, in appropriate circumstances, to institute a delictual claim, in which case the elements of delict must be proved (see, eg, *Cohen v Segal* 1970 (3) SA 702 (W) where the plaintiff elected to institute a delictual claim), or base her action on the sui generis fiduciary obligation.

The decision in *British Midland Tool* shows that English and South African company law are, at least as far as directors' common-law fiduciary duties are concerned, developing along similar lines.