

**DIRECTORS' DUTIES UNDER THE COMPANIES ACT 2006 -
HAVE THE LUNATICS TAKEN OVER THE ASYLUM?**

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Introduction

1. I suppose one could say that I want to talk about Postman Pat. Every small businessman, having regard to the fact that it is good for business, ensures that he maintains the best of relations with his suppliers, customers and the local community as a whole. In particular, as a by-product of his business, he materially improves the lives of his customers and the community as a whole. He may try to keep his carbon footprint to the minimum by driving a hybrid-powered van, and, when he sucks sweets, he does not drop his litter on the road or in his customers' gardens. I'm going to call this businessman "Postman Pat", because the Postman Pat of the children's stories exemplifies all these virtues, although I appreciate that I am cheating a little because Postman Pat is not a businessman. How, one might ask, can anyone criticise legislation which tries to make people behave more like Postman Pat? I have to make a confession: the main focus of this lecture is to do just that: the Postman Pats of this world, not to mention the Rowntrees, are to be applauded, just as the Von Hoogstratens and Maxwells of this world are to be despised, but I would argue it is not a proper function of the law to try to force businessmen to think as the Postman Pats think, and I emphasise that my subject today concerns recent legislation about what businessmen must think. If Parliament has any role in such matters, it should limit itself either to general exhortation or to specific measures targeted at particular social ills.
2. The Companies Act 2006 codifies for the first time the duties that directors owe. It also codifies for the first time the principal legal remedy that a minority shareholder has for seeking redress in respect of a breach of that duty, assuming that the company itself does not seek redress. I propose to look at the content of those directors duties. The consultative and legislative process by which these provisions were arrived at spans the Blair era of government and provides a fascinating insight into its peculiar characteristics. I will argue that in some important respects the provisions of the new Act with regard to directors' duties may unwittingly reflect the baneful influence of political correctness. So far as concerns the process by which these provisions were arrived at, I will suggest that this influence has been facilitated by the abandonment of the traditional processes of law reform in this specialised area of company law.
3. I must first set the scene with some introduction to the world of company law and what is now called corporate governance issues.
4. Companies have existed in this country, and indeed the large part of the rest of the world under British influence during the Victorian era, since 1862. That was the year of the first

major U.K. consolidating Companies Act. This was a model act. Many other common law jurisdictions copied it. It established a gold-standard for legislation of its type. It formed part of the common law which reached throughout the world, cementing this country's overseas trade and influence. It established a unified statutory framework for the incorporation and management of associations of persons through the vehicle of limited liability companies. The company was the vehicle for the joint venture of its members. The company had its shareholders (i.e. its members), who were the proprietors of the company, and it had its directors, who managed the company for the proprietors.

5. The crucial issue in law, and the reason why such enterprises needed a statutory framework such as the 1862 Act, was that the company was a separate legal person from its shareholders. It was this feature which distinguished the joint venture from a partnership. In a partnership the entity or "firm" is no more than a sum of its partners. In the case of a company, the entity or "firm" is separate from its members. In other words any outsider dealing with the company is dealing with the company, not the shareholders, and in particular only the company is liable for its debts. Indeed, as was confirmed by the House of Lords, the final court of appeal, in the famous case of *Salomon v. Salomon*¹, this principle applied even if there was only one shareholder, so that the company was not really a joint venture. There are exceptions to this principle where the company is being used dishonestly as a front or façade, but, in the absence of fraud, the principle prevails. There is nothing wrong with a businessman² using a limited liability company as the vehicle through which he shall carry on business.
6. The separate legal personality of the company had a by-product which the authors of the 1862 Act may not have fully appreciated and which it is important to understand for the purposes of this lecture. It is a remarkable feature of all Companies Acts until the 2006 Act that, although they make provision for the appointment and removal of directors, and more recently have made some provision for the duties that directors owe in particular situations, such as duties to disclose a personal interest in transactions involving the company, they did not make provision for what duties were owed by directors generally in the carrying out of their management functions, nor did they say to whom those duties were owed and how they could be enforced. In other words, general corporate governance issues were left for the courts to work out on a case by case basis. The judges' answer to this issue was to hold, firstly, so far as concerns the content of the duties owed by directors, that principles of equity derived from the laws of trust and partnership were to be applied, as well as the general common law duty of care, and secondly, so far as concerns the person to whom the duties were owed, the company itself was generally the only person to whom such duties were owed.
7. The latter principle is traditionally amongst lawyers traced back to and named after the case of *Foss v. Harbottle*, decided by the Vice-Chancellor of the old Court of Chancery in 1843, that is to say before the 1862 Act. Indeed, the principle is called "the rule in *Foss v. Harbottle*". The real importance of this principle, from a commercial point of view, is that only the company can sue if the directors break their duties. Shareholders cannot sue in

¹ [1897] A.C. 22

² I will be forgiven, I hope, if I assume the masculine gender: nowadays, of course, it is just as likely to be a woman.

their own right and can, in general, do nothing about a breach of duty unless they can persuade the board of directors to sue in the name of the company. Of course, this restriction does not matter if the company cannot pay its debts: for a creditor can put the company into liquidation and the independent liquidator, who takes over control of the company's management from the board of directors, can sue in the name of the company. However, it does matter very much to shareholders, because they can in general do nothing to enforce the duties owed by directors during the continuing life of the company.

8. But you will not be surprised to hear that the courts at the same time, and from the very beginning, recognised that there might be exceptions to the “rule in *Foss v. Harbottle*”, i.e. cases where shareholders could bring an action to enforce the duties owed by directors to the company, even though they could not persuade the board of directors to do so. These exceptions were labelled as cases involving a “fraud on the minority”, i.e. where it would be a “fraud”, in the sense that the word is used in equity, to allow the wrongdoing directors to get away scot-free.
9. The scope of the duties that a director of a company owes in that role, and the means by which compliance with such duties can be enforced in practice, are questions of great importance in the world of commerce. I am addressing those general duties of directors which apply to all companies, large or small, from the local ironmongers shop, assuming that it operates through a limited company, to the BP's and Unilevers. It matters greatly to all those involved in and dealing with a company in any way, be it a large or small company, that the directors should behave properly and that adequate means exist to call them to account.
10. The answer that the judges gave to the general corporate governance issue was to treat directors essentially as trustees or, perhaps more accurately, managing partners of a partnership business. The role of directors was to manage the assets entrusted to their care by the shareholders, just as the role of trustees was to manage the trust assets and the role of managing partners was to manage the firm's assets. The duties owed by trustees, and partners by analogy, were well established: (1) they had to act in good faith in what they believed to be the best interests of their trust, (2) they had to exercise their powers for the purposes for which they were conferred, and (3) they had to avoid conflicts of interest. So, the courts held, directors owed the same duties to the company.
11. It is the first duty that I wish to concentrate on today. It involves the application of a subjective test: you must look into the mind of the director and decide whether he was acting in good faith in the interests of the company. It focuses on what the director in question is actually thinking. For that reason it was an undemanding duty because it was difficult to prove that the director had acted in bad faith: sometimes of course it could be inferred from the surrounding circumstances that the director had acted in bad faith, but usually, since a dishonest director is most unlikely to disclose what he is really thinking, it will be difficult to prove to the evidential standard required of an allegation, essentially, of fraud.

12. The 2nd and 3rd duties are also in a sense subjective, but in different ways to the 1st duty. So far as the 2nd “proper purpose” duty is concerned, it will usually be easier from the surrounding circumstances to discern the true purpose of a particular act of a director, although there is undoubtedly still a subjective element involved. In the case of the 3rd duty, the director is held liable as if in breach of the 1st “good faith” duty, not because he has actually acted in bad faith but because it is irrebuttably assumed, given the conflict of interest, that his motivation was bad. Duty (3) is very rigorous. It is an inflexible rule of equity, which is the source of the law in this area, that directors and other persons in a fiduciary capacity, that is to say managing other people’s assets, must not put themselves in a position of conflict of interest of duty (to the proprietors) and self-interest. If they do so, they must account for any profit they make. It is irrelevant that the company could not have made that profit or could not have entered into the transaction in question. This is a reflection of the high moral standards of Victorian judges, and also perhaps the ecclesiastical origins of the law of equity. If fiduciaries put themselves into a position of temptation, i.e. where they might be tempted to prefer their personal interests over the interests of the owners of the assets under their management, the law would assume that they had been tempted to prefer their own personal interests without actually inquiring into their actual state of mind.
13. So it is remarkable feature of UK law relating to directors’ duties that the litmus test of a breach of such duties is essentially the state of mind and the motivation of the director.

The codification project³

14. From at least the 1980’s there has been a movement in the City, so far as concerns listed companies, to establish principles of corporate governance. These are now to be found in the Combined Code on Corporate Governance. They do not purport to be anything more than general principles, as opposed to duties with corresponding liabilities enforceable by litigation or administrative process. Companies are required either to comply or to explain why they have not complied, so it is envisaged that there may well be cases where the principles do not apply. Public reporting and transparency are of importance. Such voluntary codes are entirely laudable. They exhort and cajole – they are not coercive and they do not tell businessmen how to do business or what their thinking processes should be. Similar codes, of general application to all companies, large and small, could easily have been promulgated by the Government.
15. It is possible to trace the origins of the new provisions in the 2006 Act relating to directors’ duties to Will Hutton’s book “The State We’re In”, which was first published in 1995. This talked of the “stakeholder capitalism”, i.e. a species of capitalism which did not focus on profit for the shareholders but which instead focused on the interests of all persons who were said to be “stakeholders” in the enterprise, in particular the workers. He lambasted short-term profiteering, at the expense of the long-term. He saw British enterprise as “a

³ For an exhaustive and scholarly overview, see “*An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct*” by Williams and Conley; 38 Cornell International Law Journal 493 (2005). A fascinating, insider, account of the actual process from start to finish was given by Mr. Philip Bovey to the Statute Law Society in a lecture delivered on 2 July 2007, “A damn close run thing: the Companies Act 2006”. He likened the final passage of the Companies Act 2006 to the battle of Waterloo, and in that respect, so far as the subject-matter of my lecture is concerned, I would agree with him from the French point of view.

world of car-boot traders, dodgy second-hand dealers, estate agents and life insurance salesmen – at the top a world of ex-public schoolboys, or ex grammar schoolboys apeing public school mores” (p. 296 Vintage paperback edition). He argued that British companies needed a fundamental change in culture and organisation. In particular, and I would emphasise in this context, “new standards should be codified into law”. Voluntary codes of corporate governance, such as the City Code, were not sufficient, since they were always at risk of giving a competitive advantage to those who failed to comply. Apart from imposing new liabilities upon directors to reflect the interests of all the “stakeholders”, there should be a new Bank of England, established on a republican basis, which would see that funds should be available to companies on a long-term basis at affordable rates of interest (Chapter 12- “Stakeholder Capitalism”). One would laugh, were it not for the influence that this thinking apparently had on our political leaders.

16. In January 1996 Tony Blair gave a speech in Singapore in which, essentially echoing Hutton’s thesis but in more lofty and woolly language, he supported the establishment of what he termed the “stakeholder economy”. With regard to corporate governance, he said that it was time to “*shift the emphasis in corporate ethos- from the company being a mere vehicle for the capital market towards a vision of the company as a community of partnership in which each employee has a stake, and where a company’s responsibilities are more clearly delineated.*”
17. Once New Labour came to power, it appointed a body the like of which had never been seen before in the field of company law reform: it appointed a Company Law Review Steering Group (“CRLSG”). Although this amorphous steering group included a few very distinguished judges and legal practitioners, it is clear that its output from the outset bore a strong political and doctrinaire stamp. Its reports are marked by their reliance upon surveys of businessmen, as if such surveys were a substitute for reason, logic and justice. When reading its reports, I feel like I am listening to one of those TV programmes, where the answer to a question is based on what “Our survey says”, rather than what the best and wisest minds would consider the right answer. It was appointed with an overlapping brief to the brief of the Law Commission to consider the codification of directors’ duties.
18. The CLRS’G’s first publication was a “Strategic Framework Consultation Document” in February 1999. This considered what it called the “Enlightened Shareholder Value” model, and the contrasting “Pluralist Approach”, for corporate governance. The former is essentially the management mantra that it is good for business to take account of nice cuddly things like the community and the environment: the Postman pat model. This management mantra would be codified as a part of every director’s duty. The Pluralist Approach was more radical: it required a different view of a director’s duty as focused on the maximisation of value for the benefit of all contributors not just shareholders. This took away ultimate control of a company’s destiny from the shareholders. At the very minimum, directors should be free to further the interests of non-shareholder participants even if this was to the detriment of shareholders.
19. In September 1999 the Law Commission, which is the traditional engine of law reform, particularly in the context of a technical area such as company law, published its report.

It recommended the codification of directors' duties, partly in recognition of its statutory duty and role to codify the law. It recommended that the duties be set out in statute consistently with existing and clear case law.

20. One would have thought that this would be good enough for the CLRSG.
21. It was not, of course. The CLRSG had been set up to second-guess the Law Commission. In "Developing the Framework" published in March 2000, the CLRSG, astonishingly, doubted (para. 3.16) the wisdom of the Law Commission's recommendation that this area be left to the good sense of the judges, to see that the law developed in a sensible direction. It ignored the Law Commission's recommendation that the law be codified to reflect existing law. It concluded that its overall objective was what it called the radical Pluralist Approach (see above) but that this was best achieved so far as company law as a whole was concerned by what it called "a shareholder oriented but inclusively framed duty of loyalty". This involved the recognition by directors that, whilst their objective was to act in the collective best interests of shareholders, this could only be achieved by taking due account of wider interests (para. 2.22), in other words Postman Pat on a performance-enhancing drug. The drafting of the new duty of "good faith" was convoluted (para 3.40). Essentially, it is now reflected in s. 172 of the 2006 Act, to which I shall shortly turn.
22. The CLRSG's mission was not however complete. After taking due account of yet more surveys of businessmen, who not surprisingly complained about the strictness of the judge-made fiduciary duties for directors and amazingly claimed either ignorance or widespread non-compliance with them, rather like turkeys' attitude towards Christmas, it published two more reports: "Completing the Structure" in November 2000 and its Final Report in July 2001. This led the CLRSG to recommend the dilution of duty (3), the no-conflict rule, in an important, and I would argue insidious, way. In the case of private companies, directors could (in the absence of express contrary provision by its shareholders) obtain advance approval or absolution for breach of this duty from a non-conflicted board, as opposed to the previous law of having to obtain approval or absolution from the shareholders. Whilst directors with a personal interest in the matter could not vote, this left open the possibility that their "friends", dare one say "cronies", on the board would be inclined to approve of the transaction, without the shareholders being asked for their approval.
23. By the time of the Final Report, it had become virtually impossible to follow the CLRSG's reasoning, because this required reading four long reports and following the reasoning through all of them. It did recommend the codification of derivative claims, i.e. claims by minority shareholders to sue in respect of wrongs to the company.

S. 172 Companies Act 2006

24. This is the new codified duty "to promote the success of the company". It provides :

172 Duty to promote the success of the company

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company's employees,
- (c) the need to foster the company's business relationships with suppliers, customers and others,
- (d) the impact of the company's operations on the community and the environment,
- (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
- (f) the need to act fairly as between members of the company.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company."

The most helpful Explanatory Notes to the Act explain these provisions as follows:

"325. This duty codifies the current law and enshrines in statute what is commonly referred to as the principle of "enlightened shareholder value". The duty requires a director to act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole and, in doing so, have regard to the factors listed.

326. This list is not exhaustive, but highlights areas of particular importance which reflect wider expectations of responsible business behaviour, such as the interests of the company's employees and the impact of the company's operations on the community and the environment."

25. The vice of this meddling with the existing, judge-made, law as to a director's duty of good faith to the company is, essentially, I would argue, two-fold. First, it should not be the job of Parliament to tell businessman how they should make business decisions: that is the proper role of voluntary codes and business schools. Secondly, and linked to the first consideration, it will not make any difference in practice and is a pointless pandering to political correctness and the fashionable concept of "enlightened shareholder value". It therefore tends to bring the law, in this most central context of corporate governance, into disrepute. It will encourage box-ticking and lip-service to the "enlightened shareholder value" factors.

26. The new duty is pointless for the following reasons:

- (1) The duty to act in the interests of shareholders remains the primary duty of directors, so that the duty to have regard to the listed factors, which are not obviously

consistent with the interests of shareholders, is subordinate to and in aid of that primary and overriding duty.

- (2) The new statutory duty, like the old, is owed to the company and only the company, and only the shareholders can bring as derivative claim if the company will not sue. So all the other “stakeholders” in the business, such as employees or the wider community, for whose benefit the duty has been drafted, have no standing to sue.
 - (3) Suppose the directors fail to take into account, as part of their thinking process, the listed factors – then what? What will the court do about it? The court will not make the business decision itself and so will send it back to the directors, who will in almost all cases reach the same decision, whilst paying lip-service to the listed factors.
27. There are many other criticisms that can be made of the new duty enshrined in s. 172:
- (i) It concentrates on the peripheral and the politically-correct, whilst ignoring the obvious – e.g. why does it not mention the financial position of the company, or even prevailing economic conditions, as one of the matters to be taken into account?
 - (ii) It is unacceptably vague: e.g. who are “others” in s. 172(1)(c), i.e. the relationships with whom it is necessary for the board to foster.
 - (iii) There is no empirical evidence that it will achieve any socially desirable advantage: it is the application of political dogma.
 - (iv) It will only encourage trouble-makers to acquire shares in listed companies, in the vain hope that they can foist, for example, environmentally friendly policies on to the board.
28. I suppose my ultimate objection to s. 172 is its banality. It purports to force directors to think in a Postman Pat manner. No legislation can achieve this. The rest of the world has traditionally looked to this country for wisdom in this most important field of the law and in my opinion s. 172 lets us down badly.

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