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THE DUTY OF LOYALTY OF COMPANY DIRECTORS: BRIDGING THE ACCOUNTABILITY GAP THROUGH EFFICIENT DISCLOSURE

JOHN LOWRY*

INTRODUCTION

THE core fiduciary duty of loyalty to which company directors are subject forms part of the general duties of directors which now appear in Chapter 2 of Part 10 of the Companies Act 2006.¹ The statutory restatement is set at a fairly high level of generality and in part seeks to reform the common law upon which it is based.² As a means of assessing the scope of the reformulated duty of loyalty found in s.172 of the Act, it is instructive to view the provision against the policy considerations underlying the Government's decision to place the general duties of directors on a statutory footing and, more generally, the wider objectives underpinning the company law reform project which, after eight years of consultations,³ culminated in the 2006 Act.

* Professor of Law, UCL. This article is based on my paper delivered to the [Australian] Corporate Law Teachers Association 2009 Conference held in Sydney. I owe a debt of gratitude to the delegates for their insightful questions and comments. I also thank Arad Reisberg for his views on an earlier draft, I-san Tiaw for her research assistance and the anonymous referees for their helpful comments. The usual disclaimer applies.

¹ In *Item Software (UK) Ltd v. Fassihi* [2005] 2 B.C.L.C. 91, Arden L.J., at [41], having noted that “the fundamental duty [of a director]... is the duty to act in what he in good faith considers to be the best interests of his company” concluded that this duty of loyalty is the “time-honoured” rule (citing Goulding J. in *Mutual Life Insurance Co of New York v. Rank Organisation Ltd* [1985] B.C.L.C. 11, at 21). Part 10 of the 2006 Act restates seven duties: duty to act within powers (s.171); duty to promote the success of the company (s.172); duty to exercise independent judgment (s.173); duty to exercise reasonable care, skill and diligence (s.174); duty to avoid conflicts of interest (s.175); duty not to accept benefits from third parties (s.176); duty to declare interest in proposed transaction or arrangement (s.177); (the duty to declare interest in an existing transaction or arrangement is laid down by s. 182).

² *Company Law for a Competitive Economy: Final Report*, July 2001 (DTI/Pub 5552/5k/7/01/NP), para. 3.7.

³ In addition to its *Final Report*, Consultation Documents issued by the Company Law Review Steering Group, the body established by the then DTI (now DBERR) to oversee the reform process, include: *The Strategic Framework* (URN 99/654) February 1999; *Company General Meetings and Shareholder Communication* (URN 99/1144) October 1999; *Company Formation and Capital Maintenance* (URN 99/1145) October 1999; *Reforming the Law Concerning Overseas Companies* (URN 99/1146) October 1999; *Developing the Framework* (URN 00/656) March 2000; *Capital Maintenance: Other Issues* (URN 00/880) June 2000; *Registration of Company Charges* (URN 00/1213) October 2000; *Completing the Structure* (URN 00/1335) November 2000; and *Trading Disclosures* (URN 01/542) January 2001.

The mechanics and policy objectives of the company law review

The Act had a particularly long gestation period, being conceived in March 1998 when the Labour Government announced what proved to be the most far-reaching review of company law since Gladstone's Joint Stock Companies Act 1844 and the introduction of limited liability in 1855.⁴ In her Foreword to the first consultation document which formally launched the review process,⁵ Margaret Beckett, then Secretary of State at the Department of Trade and Industry, (since renamed the Department for Business, Innovation and Skills) described the UK company law regime then in force as a complex regulatory amalgam founded upon mid-19th century legislation as amended over the intervening century and a half by numerous additions⁶ (including EC Directives) and consolidations which no longer served the needs of the Government's strategy for national competitiveness. The principal objective of the review was stated as being to devise:

... a framework of company law, which is up-to-date, competitive and designed for the [new] century, a framework that facilitates enterprise and promotes transparency and fair dealing.⁷

The political objective, as stated by Gordon Brown, then Chancellor of the Exchequer, in a speech delivered in June 2001 launching new measures to tackle the productivity gap with Britain's major competitors, was to "create in Britain a true enterprise culture where the chance to start and succeed in business is genuinely open to all."⁸ As part of this goal, the Government sought to make the UK the choice of location for doing business. Although the CLR recognised that fiscal, operational and macro-economic considerations rather than company law regimes are the critical factors taken into account when deciding whether or not to locate a business in a particular state, it nevertheless took the view that company law reform had a place in the Government's drive for regulatory reform.⁹

⁴ The Limited Liability Act 1855.

⁵ *Company Law for a Competitive Economy*, March 1998 (DTI/Pub 3162/6.3k/3/98/NP).

⁶ Such additions were generally introduced to address deficiencies of the existing legislation in protecting investors and as knee jerk reactions to particulars scandals of the day. See, for example, the White Paper, "The Conduct of Company Directors" (Cmnd. 7037, 1977).

⁷ Above, n. 5. The UK has not been alone in its quest for a modern economically efficient regime for companies. For example, a corporate law reform programme along similar strategic lines has been ongoing in Australia since 1990: see the Corporations Law Scheme which commenced operation on 1 January 1991; the Corporations Legislation Amendment Act (No 1) 1991; the Corporate Law Reform Act 1992; the Corporate Law Reform Act 1994; the Company Law Review Act 1998; the Corporations Act 2001. See also, the policy discussion papers of the Corporate Law Economic Reform Programme (Canberra, AGPS, 1997).

⁸ http://www.hm-treasury.gov.uk/press/2001/p67_01.html

⁹ See the *Strategic Framework*, above, n. 3, para. 5.6.3. For a detailed analysis of the policy objectives see, E. Ferran, "Company Law Reform in the UK" [2001] *Singapore Journal of International and Comparative Law* 516.

The mechanism which the Government put in place for undertaking the reform exercise was devised to maximise “openness and independence” together with ensuring wide consultation.¹⁰ The review was administratively independent from the then Department of Trade and Industry. The Company Law Review Steering Group (hereafter the CLR), which stood at centre stage in the reform process, was charged with ensuring that the review’s outcome was “clear in concept, internally coherent, well articulated and expressed, and workable.”¹¹ The CLR’s consultation exercise was wide ranging,¹² and its *Final Report* was presented to the Secretary of State for Trade and Industry on 26 July 2001.¹³ The first White Paper, *Modernising Company Law*, which contained a draft Companies Bill, was published in July 2002.¹⁴ After a period of consultation, the second White Paper was published in March 2005,¹⁵ and the Company Law Reform Bill, subsequently renamed the Companies Bill,¹⁶ was introduced into the House of Lords on 1 November 2005. It received Royal Assent in November 2006 and was implemented in stages spanning a three year period, which ended October 1st 2009.

From the outset the CLR stated that company law should be enabling and facilitative so that the new regime should allow enterprise “to flourish freely in a climate of discipline and accountability.”¹⁷ Achieving this objective, in its view, involved several core policy considerations that served to inform its specific recommendations. Underpinning the CLR’s approach towards the scope and nature of the review was the axiom “think small first”. The point was stressed that the vast majority of UK companies are small, private and generally owner managed,¹⁸ so that from the economic perspective the role of such companies is critical in laying the foundations for future growth. Accordingly, the law governing small private companies should “provide an optimal framework for the establishment, efficient operation and development and growth of these companies.”¹⁹ The new companies’ regime should, therefore, be constructed on the basis that it corresponds with the reasonable expectations of business people so that

¹⁰ Above, n. 5, para. 7.1.

¹¹ Above, n. 5, para. 7.2.

¹² For the range of consultation documents issued by the CLR, see n. 3, above. The list of respondents to the CLR’s consultations can be found on the DBIS website, see <http://www.berr.gov.uk/whatwedo/businesslaw/co-act-2006/clr-review/page22794.html>

¹³ *Company Law for a Competitive Economy: Final Report*, above, n. 2.

¹⁴ Published in two volumes, *Modernising Company Law* (Cm 5553-I); and *Modernising Company Law—Draft Clauses* (Cm 5553-II).

¹⁵ *Company Law Reform* (Cm 6456).

¹⁶ The title of the Bill was changed during committee stage in the House of Commons in July 2006.

¹⁷ *Final Report*, above, n. 2, para. 9.

¹⁸ At the end of the 1997/98 year, when the CLR was launched, there were 1.32 million companies on the (UK’s) Companies House register of which 12,000 (amounting to 1%) were public limited companies. See *The Strategic Framework*, above n. 3, Annex D.

¹⁹ *Final Report*, above, n. 2, para. 1.27.

regulatory traps for the unwary are avoided while, in times of crisis, the response of the law is both predictable and constructive.²⁰ The guiding principle was expressed as being “simplification and accessibility” so that the objective was to remove unnecessary detail together with excessive regulation.²¹ The CLR noted that many of the provisions of the Companies Act 1985, as was the case with its predecessors, do not apply to small private companies while those that do are not tailored to meet their specific needs. The 1985 Act thus proceeds on the false assumption that the paradigm company is a large publicly quoted business. It is peppered with detailed adaptations and derogations introduced on a piecemeal basis.²² The CLR thus concluded that the cumulative effect of this process had been to leave the present law in a state which is obtuse, overly complex and inaccessible for small business users.²³

Restating directors' duties

With respect to director duties, the Government stated in the March 2005 White Paper that it believes that companies work best where the respective roles and responsibilities of directors and shareholders are clearly understood.²⁴ It was stressed that directors may not appreciate what their duties were under the law and, similarly, that such obligations may be misunderstood by shareholders, in whose interests the directors should be acting. As a means of making the relevant law “consistent, certain, accessible and comprehensible” – key policy factors underpinning the wider company law reform process – the Government opted for a statutory restatement of directors' duties.

Whether or not the duties of directors should be restated in the statute had generated considerable debate. It was a central issue that was explored in the work of the English and Scottish Law Commissions in 1999. They found that the case against restatement was founded upon loss of flexibility, while in its favour there were obvious advantages in terms of certainty and accessibility.²⁵ Ultimately, the

²⁰ *Final Report*, para. 1.53.

²¹ *Final Report*, para. 1.54.

²² For example, the Financial Reporting Standard for Smaller Entities and the DTI's (as it was called) work on simplifying SME accounts. See the Companies Act 1985 (Accounts of Small and Medium-sized Companies and Minor Accounting Amendments) Regulations 1997.

²³ *The Strategic Framework*, above, n. 3, para. 5.2.5. The point is reinforced at para. 5.2.13 where the CLR concludes that the complexity of the 1985 Act is such that, from the perspective of smaller companies, it is burdensome and unwieldy: “These are general concerns, but smaller companies are precisely those which do not have the time or funds to devote to legal advice; their owners and managers cannot delegate and must focus on day-to-day survival and growth.”

²⁴ *Company Law Reform* (Cm 6456), at 16.

²⁵ See the joint consultation paper, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties*, Consultation Paper No 153; Discussion Paper No 105. See also, the Law Commission and the Scottish Law Commission joint report, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties* (Nos 261 and 173, respectively), Cm 4436, (London, TSO, 1999).

Commissions' conclusion was that the case for legislative restatement was made out,²⁶ and the recommendation was taken up by the CLR for three principal reasons.²⁷ First, directors should know what is expected of them and therefore such a statement will further the CLR's objectives of reforming the law so as to achieve clarity and accessibility. Indeed, these objectives underpin a core principle of the CLR's vision that company law should provide "an accessible framework" for wealth generation.²⁸ Second, the process of formulating such a statement would enable defects in the present law to be corrected "in important areas where it no longer corresponds to accepted norms of modern business practice"²⁹ Third, such a statement would underpin the question of "scope" of the proposed company law regime: "scope" being defined as relating to the question of in whose interests should companies be run. Both the 2002 and 2005 White Papers³⁰ accepted that directors' general duties should be codified,³¹ and the Government sought to settle the matter of whether the restatement should be exhaustive by noting that it will so drafted as to "enable the law to respond to changing business circumstances and needs."³² It is stressed that the restatement will leave scope for the courts to interpret and develop its provisions in a way that "reflects the nature and effect of the principles they reflect."³³

The focus of this article is on the restatement of the core duty of loyalty together with the obligation on directors to produce a business review which, amongst other things, is designed "to inform members of the company and help them assess how the directors have performed their duty under the Companies Act 2006, s.172."³⁴ It assesses the contours of s.172(1) with a view to determining whether the duty of loyalty it seeks to encapsulate merely replicates the common law

²⁶ The Law Commissions favoured partial codification: a statement of the main, settled duties, including the director's duty of care. It would not be exhaustive so that the general law would continue to apply in those areas not covered by statute.

²⁷ All of which are rehearsed in the *Final Report*, above, n. 2, para. 3.7. See also the March 2005 White Paper, above n. 4, at 20.

²⁸ *Final Report*, above, n. 2, para. 9 of the Foreword. Although the Companies Act 1985 and its predecessors did contain provisions regulating directors' duties, particularly in relation to shareholder approval of conflict transactions, these operated as a "gloss" on the common law and could not be readily understood absent a sound understanding of the jurisprudence spanning some 150 years or more. See P. Davies and J. Rickford, "An Introduction to the New UK Companies Act" [2008] E.C.F.R. 49, at 61.

²⁹ *Final Report*, above, n. 2, para. 3.7.

³⁰ Above, ns. 14 and 15, respectively.

³¹ In 2004 the DTI launched a further consultation exercise, *Company Law: Flexibility and Accessibility*, <http://www.dti.gov.uk/cld/condocs.htm>, which reiterated the Government's commitment to introduce a major Bill, albeit after further consultation, clauses of which will provide: "... clarity on the responsibilities of directors by making statutory provisions setting out the duties of directors via a statement of duties, and introducing related reforms to the rules governing directors' conflicts of interests."

³² See the March 2005 White Paper, above, n. 15, at 21.

³³ See, in particular, the Companies Act 2006, ss.170(3) and (4), considered below.

³⁴ Companies Act 2006, s.417(2).

position or whether it holds the potential, as some have argued, to go beyond the pre-existing law by exposing directors to the risk of increased liability.³⁵ Certainly the duties in Part 10 of the Act are not self-contained,³⁶ and breach of s.172 will very likely give rise to the additional claim that the directors are in breach of their duty of care and skill under s.174.³⁷ But the concern here is not with the range of claims which a breach of the duty of loyalty may trigger, but rather to consider the policy underlying the disclosure obligation imposed by s.417. A further anxiety lies with whether the drafting of s.172 results in a duty likely to be better understood by directors than its common law counterpart so that compliance and, more particularly, the self-assessment undertaken by directors in the business review goes beyond mere box ticking.

1. THE SCOPE AND NATURE OF THE GENERAL DUTIES

Section 170 provides the starting point for considering the ambit of the duty of loyalty in s.172 and, indeed, for any of the duties restated in Part 10 of the Act. Section 170 which, it will be recalled, was viewed by the CLR as the key “scoping” provision, lays down what has long been the orthodoxy,³⁸ namely that the general duties restated in sections 171–177 are owed by a director of a company to the company.³⁹ It therefore follows that a breach of duty is a wrong to the company and the proper claimant is the company itself.⁴⁰

Before leaving s.170, it is noteworthy that the provision also seeks to settle the criticisms, raised principally by the professional bodies

³⁵ See, for example, the concern expressed by the Law Society to the effect that the statutory duty could raise the spectre of courts reviewing business decisions taken in good faith by subjecting such decisions to objective tests, with serious resulting implications for the management of companies by their directors: the Law Society’s “Proposed Amendments and Briefing for Parts 10 & 11”, (issued 23 January 2006). Doubtless s.172 generated more debate in Parliament than any other of the duties contained in Part 10 of the Act.

³⁶ As is made clear by s.179.

³⁷ Which provides:

- 1) A director of a company must exercise reasonable care, skill and diligence.
- 2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with-
 - (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
 - (b) the general knowledge, skill and experience that the director has.

³⁸ Section 170(1). See *Percival v Wright* [1902] 2 Ch. 421.

³⁹ This begs the proverbial question, what is meant by “the company”? The question itself has long been debated. One possible solution was put forward by Lord Evershed M.R. in *Greenhalgh v. Arderne Cinemas Ltd* [1950] 2 All E.R. 1120, where he said, at 1126, “the phrase “the company as a whole” means the corporators as a general body”. He therefore seemingly rules out a free floating corporate interest that corporate realists would advocate and identifies the company’s interests with the shareholders as a general body indicating a contractarian bias. The debate is likely to continue unless s.172 is taken as settling the matter.

⁴⁰ See Part 11 of the Companies Act 2006 which places the derivative action on a statutory footing. See A. Reisberg *Derivative Actions and Corporate Governance* (Oxford 2007), ch. 4.

during the CLR's consultations on the restatement, to the effect that setting the duties at a high level of generality would do nothing but cause confusion over the relationship between the statutory restatement and the existing jurisprudence surrounding directors' duties. The provision addresses these concerns in two ways. First, subsection 3 makes it clear that while the general duties are "based on certain common law rules and equitable principles", the statutory restatement has "effect in place of those rules and principles". Future claims for breach of duty by a director will need to be aligned with one or more of the duties set out in the Act unless the duty in question has not been restated, as is the case with, for example, the duty owed to creditors where the company's fortunes are declining into insolvency.⁴¹ Secondly, subsection 4 directs the courts to interpret and apply the general duties having regard to the pre-existing case law. Much of this case law, of course, developed by analogy with the duties of trustees and other fiduciaries and so it seems that the intention here is to maintain the relationship of the law on directors' duties with its wider equitable foundations. However, if s.170(3) and s.170(4) are read together, considerable doubt remains over the extent to which the restated duties actually do replace the pre-existing duties. One reason why such uncertainty arises is because the draftsmen use different terminology from that found in the judicial formulations of the duties contained in the case law. The problem is compounded by the omission to set out precisely where the restatement diverges from settled common law and equitable principles. Notwithstanding the clear terms of subsection 4, the courts are given no legislative assistance for determining when or to what extent the pre-existing jurisprudence can be harnessed as an aid to interpreting the statutory restatement.⁴² This represents a major lacuna which runs counter to the declared objectives of the Company Law Review's recommendations to provide greater clarity on what is expected of directors.⁴³

II. THE DUTY OF LOYALTY

As commented above, perhaps more than any other of the duties contained in Part 10, the framing of the fundamental duty of loyalty generated considerable debate both during the CLR's consultations

⁴¹ See n. 52, below.

⁴² This is particularly true for s. 177 (duty to declare interest in proposed transaction or arrangement). The decision to cast this as a disclosure duty rather than a situational disability is not well documented and can be confusing in relation to remedies. On the other hand, although the statutory formulations of the no-conflict duty (see ss. 175 and 176) depart from the common law rules or equitable principles, the decision to incorporate deliberate policy changes in relation to these particular duties is explained in the consultation papers and the Explanatory Notes to the Act.

⁴³ See Chapter 3 of the *Final Report*, above n. 2.

and when the Companies Bill was going through Parliament. The statutory formulation has two elements. First, s.172(1) begins by stating that a “director 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...” The provision thus aligns the interests of the company with its members “as a whole”. While the Explanatory Notes which accompany the Act see this as codifying the common law position, there is, in fact, a point of departure from the classic formulation of the duty by Lord Greene M.R. in *Re Smith & Fawcett Ltd.*⁴⁴ He noted that directors “must exercise their discretion *bona fide* in what they consider – not what a court may consider⁴⁵ – is in the interests of the company”.⁴⁶ The CLR rejected the notion that success should be defined solely by reference to the “interests of the company,” on the basis that this would leave it to the good faith discretion of the directors to determine what the interests of the company are. It was felt that this would allow directors the discretion to set any interest above that of shareholders whenever their view of what is needed to promote the company’s success require it.⁴⁷ While at first sight the objective of this first element of s.172(1) appears to be aimed at limiting the discretion of directors, it does no more than reflect the common law position that a decision of the board to promote, for example, sectional interests within the company would be incompatible with the duty to promote the interests of the company.⁴⁸ Nevertheless, within these strict confines it has long been settled that it is for the directors to decide, in good faith, on how best to promote the success of the company. The orthodoxy is that the court will not substitute its own view about which

⁴⁴ [1942] Ch. 304. A century earlier Lord Cranworth LC in *Aberdeen Railway Co v. Blaikie Bros* (1854) 1 Macq. 461, noted, at 471, that: “The directors are a body to whom is delegated the duty of managing the general affairs of the company. A corporate body can only act by agents, and it is of course the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting.”

⁴⁵ This non-interventionist policy (the internal management rule) was explained by Lord Eldon L.C. in *Carlen v. Drury* (1812) 1 Ves. & B. 154, who said: “This Court is not required on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom.” Indeed, Lord Greene M.R. in *Smith & Fawcett*, placed particular emphasis on the point.

⁴⁶ Above, n. 44, at 306. The meaning of the term “company” in this context was construed by the courts as referring to present and future members: see, for example, *Gaiman v. Association for Mental Health* [1971] Ch. 317, at 330, in which Megarry J. said “I would accept the interests of both present and future members of the company as a whole, as being a helpful expression of a human equivalent.” Similarly, in *Dorchester Finance v. Stebbing* [1989] B.C.L.C. 498, at 501–502, Foster J. stated “[a] director must exercise any power vested in him as such, honestly, in good faith and in the interests of the company...”

⁴⁷ See *Developing the Framework* above n. 3, para. 3.52.

⁴⁸ *Mills v. Mills* (1930) 60 C.L.R. 150. In the Lords Grand Committee, 6 February 2006 (column 256), Lord Goldsmith summarised the scope of s.172 thus: “it is for the directors, by reference to those things we are talking about – the objective of the company – to judge and form a good faith judgment about what is to be regarded as success for the members as a whole...the duty is to promote the success for the benefit of the members as a whole – that is, for the members as a collective body – not only to benefit the majority shareholders, or any particular shareholder or some of shareholders, still less the interests of directors who might happen to be shareholders themselves.”

course of action the directors should have taken in place of the board's own judgment,⁴⁹ although this is subject to the overriding jurisdiction of the courts to assess objectively the conduct in question. As explained by Arden L.J. in *Item Software (UK) Ltd v. Fassihi*,⁵⁰ if a director embarks on a course of action without considering the interests of the company and there is no basis on which he or she could reasonably have come to the conclusion that it was in the interests of the company, the director will be in breach.

The second element of the duty is that in promoting the success of the company a director should "have regard (amongst other matters)" to the non-exhaustive factors listed in subsection (1):

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company's employees,⁵¹
- (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.⁵²

To gain some insight into the meaning of this provision it is instructive to consider the CLR's deliberations on how best the duty of loyalty should be formulated. A major anxiety was whether to maintain the settled notion of shareholder primacy or whether this should be substituted with a pluralist approach towards corporate governance. It was felt that this particular duty held the key for the proper determination of the true scope of company law.⁵³ More particularly, this is linked to the question of what is meant by the somewhat obtuse phrase

⁴⁹ See *Howard Smith Ltd v. Ampol Petroleum Ltd* [1974] A.C. 82, PC; and *Regentcrest plc v. Cohen* [2001] 2 B.C.L.C. 80.

⁵⁰ [2005] 2 B.C.L.C. 91.

⁵¹ This provision replaces s.309 of the Companies Act 1985.

⁵² A notable omission from the list is any reference to creditors. However, s.172(3) goes on to provide that: "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." It therefore leaves space for the continued operation of the "wrongful trading" provision in the Insolvency Act 1986, s.214; and the common law (that the CLR noted should be left to develop), which recognises that where the company is insolvent or is of doubtful solvency, the interests of creditors supersedes those of the company's members so that the focus of the duty switches accordingly. See, for example, *West Mercia Safetywear Ltd v. Dodd* [1988] B.C.L.C. 250, in which the Court of Appeal cited, with approval, the view expressed by Street CJ in *Kinsela v. Russell Kinsela Pty Ltd* (1986) 10 A.C.L.R. 395, at 401, that "where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration..." See also, *Winkworth v. Edward Baron Development Co Ltd* [1987] B.C.L.C. 193, HL.

⁵³ See *The Strategic Framework*, above n. 3.

“the interests of the company” (terminology which, as we have seen, is omitted from the statutory formulation) which represents the reference point contained in the case law for determining to whom directors owe their duties.⁵⁴ This, of course, is bound up with the critical issue of whether or not the UK should adopt what the CLR referred to as “the stakeholder model”,⁵⁵ or adopt the wider “pluralist” model whereby directors are to take account of all relevant constituencies but give primacy to none.⁵⁶ Although the CLR recognised the merits of a stakeholder approach it did not recommend its adoption as such but opted for a modified model whereby the core duty of directors would be founded upon the need to promote “enlightened shareholder value”.⁵⁷ Under this approach, directors, whilst ultimately required to promote shareholder interests, must take account of the factors affecting the company’s relationships and performance. The CLR took the view that the duty should be formulated in such a way as to remind directors that shareholder value depends on successful management of the company’s relationships with other stakeholders.

The statutory re-conceptualisation of the duty does not mean that non-shareholder constituencies rank equal to shareholders or have some independent priority in directors’ decision-making, but rather consideration of their interests should only extend to the point where this promotes the success of the company for the benefit of its members. To this extent the CLR’s approach towards the scope of the duty resonates with the reasoning of the Supreme Court of Canada in *People’s Department Stores v. Wise*,⁵⁸ in which Major and Deschamps JJ. explained:

We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, *inter alia*, the interests of the shareholders, employees, suppliers, creditors, consumers, governments and the environment ... At all times,

⁵⁴ See *Percival v. Wright*, above n. 38 and *Greenhalgh v. Arderne Cinemas Ltd*, above, n. 39. See further the text in n. 39, above.

⁵⁵ That is to say, whether UK company law should continue to uphold the primacy of members’ long term interests as the driver underlying directors’ duties, but with the proviso that the interests of others should be taken into account. See, J. Parkinson *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford 1993). See also, J. Parkinson, “Inclusive Company Law”, in J. de Lacy (ed), *The Reform of United Kingdom Company Law* (London 2002).

⁵⁶ See G Kelly and J. Parkinson, “The Conceptual Foundations of the Company: A Pluralist Approach” in J. Parkinson, G. Kelly and A. Gamble (eds), *The Political Economy of the Company* (Oxford 2001).

⁵⁷ See, *Developing the Framework*, above, n. 3, paras. 2.19–2.22; *Completing the Structure*, above, n. 3, para.3.5). The pluralist theory was rejected because it would have required the law to be fundamentally reformed so that a company would be required to serve other constituency interests in their own right. See *Strategic Framework*, above, n. 3, at para. 5.1.13.1.

⁵⁸ [2004] 3 S.C.R. 461.

directors and officers owe their fiduciary duties to the corporation. The interests of the corporation are not to be confused.⁵⁹

As s.172(1) makes clear, the interests of members continues to be the primary concern of directors in promoting the success of the company. This does not mean the individual interests of members but their interests as members of an association with the purposes and mutual arrangements enshrined in the constitution.⁶⁰

While the Government's "enlightened shareholder" approach towards the duty of loyalty goes beyond the strict confines of the common law, its scope is arguably more modest than was feared by the respondents to the CLR's consultations and those in Parliament who were concerned that it might open the floodgates of liability for directors. The decisions in *Hutton v. West Cork Rly Co*⁶¹ and *Parke v. Daily News Ltd*,⁶² holding that generosity to employees had no place in the boardroom unless it furthered the interests of the shareholders, have long been viewed as belonging to a different age.⁶³ Indeed, the modern approach towards directors taking account of factors going beyond the narrow objective of profit maximisation was explained by Berger J. in *Teck Corporation v. Millar*:⁶⁴

If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting bona fide in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to that policy as a result, it could not be said that they had not considered bona fide the interests of the shareholders.⁶⁵

Nevertheless, the anxiety over increasing directors' liabilities was such that Margaret Hodge, the Minister of State, was moved to allay the fear that directors would be exposed to increased litigation by publishing a compilation of ministerial statements on the meaning of "enlightened shareholder value". This publication, in itself, suggests

⁵⁹ [2004] 3 S.C.R. 461, at [42]–[43]. It is noteworthy that in *Re West Coast Capital (Lios) Ltd* [2008] C.S.O.H. 72, a Court of Session decision, Lord Glennie expressed the view that although there was no equivalent in the earlier Companies Acts, this section does "little more than set out the pre-existing law on the subject" (at para. [21]). It will be interesting to see whether this interpretation is followed, because the provision sets out, for the first time in the companies legislation, certain factors that directors are required to consider.

⁶⁰ *Developing the Framework*, above, n. 3, para. 3.51.

⁶¹ (1883) 23 Ch. D. 654, CA.

⁶² [1962] Ch. 927.

⁶³ That said, the specific duty to have regard to the interests of employees introduced by the Companies Act 1985, s. 309 gave employees no means to enforce the obligation against directors. Other statutory controls such as the power to provide for company employees on cessation or transfer of the company's business contained in s.719 of the 1985 Act were framed in permissive rather than mandatory terms (see now s.247 of the 2006 Act).

⁶⁴ (1972) 33 D.L.R. (3d) 288.

⁶⁵ (1972) 33 D.L.R. (3d) 288, at 314.

that the law is far from clear notwithstanding that certainty, accessibility and simplification were key CLR objectives. In the Minister of State's introduction to the document, *Duties of Company Directors*,⁶⁶ she places particular emphasis on s.172 explaining that it "captures a cultural change in the way in which companies conduct their business." She states that there was a time when business success in the interests of shareholders was thought to be in conflict with society's aspirations for people who work in the company or supply chain companies, for the long-term well-being of the community and the environment: "pursuing the interests of shareholders and embracing wider responsibilities are complementary purposes, not contradictory ones." The position taken is that businesses "perform better" when they have regard to a wider group of issues in pursuing success and it concludes by noting that it makes "good business sense" to have regard to the various factors listed in the provision and thereby embrace "wider social responsibilities."

While s.172 can be seen as doing no more than merely encapsulating the way in which the law and commercial practice has developed since *Hutton* and *Parke*, a key issue which remains is how is the notion of "enlightened shareholder value" to be enforced? Certainly the derivative action in Part 11 of the 2006 Act does not extend *locus standi* to employees or to any of the other constituencies listed in the provision.⁶⁷ Enforcement of the duty is limited to the board of directors, a majority of members, a minority of members *via* a derivative claim under Part 11 of the Act, and liquidators acting on behalf of an insolvent company. Accordingly the concern that the provision would open the floodgates of liability is, indeed, ill-founded though,⁶⁸ admittedly, employees and environmental groups do hold shares in companies and may possibly be so moved as to risk launching a claim.⁶⁹

Rather, the CLR took the view that the duty will acquire its force not through the threat of litigation, but through increased disclosure obligations. In this respect there is an obvious synergy between the CLR's emphasis on disclosure as an enforcement device and the reasoning of the Court of Appeal in *Item Software (UK) Ltd v. Fassihi*.⁷⁰ Arden L.J., delivering the leading judgment, explained that a director who is in breach of the duty of loyalty may be under a further

⁶⁶ June 2007. See www.dberr.gov.uk/files/file40139.pdf

⁶⁷ A point emphasised during the parliamentary debates: see HL Rep, Hansard HL 681 9/05/06 Cols 845–846.

⁶⁸ See further A. Reisberg, "Derivative Claims under the Companies Act 2006: Much Ado About Nothing?", in J. Armour and J. Payne (eds), *Rationality in Company Law: Essays in Honour of D. D. Prentice* (Oxford 2009).

⁶⁹ As will be seen below, the real test here lies with whether the courts will adopt a liberal approach towards the leave requirements for bringing a derivative claim now contained in Part 11 of the 2006 Act.

⁷⁰ [2005] 2 B.C.L.C. 91. Noted by J. Armour and M. Conaglen, [2005] C.L.J. 48.

(or super-added) duty to disclose the breach to the company on the basis that a duty of disclosure is an incident of the core duty of loyalty.⁷¹ On the facts, the Court was confronted with a claim for compensation for loss sustained by the company as a result of the defendant's breach of the duty to disclose rather than the more typical claim commonly encountered in corporate opportunity cases to recover profits. Of particular interest are the policy reasons harnessed by Arden L.J. to support her conclusion. These certainly appear to have had some influence on the framing of the statutory obligations on directors to disclose and explain in the business review, at least from an operational standpoint, how they have discharged their s.172 duty. Arden L.J. explained that the duty to disclose misconduct in no way discourages legitimate entrepreneurial activity.⁷² She stressed that to hold that a director was under no such duty would be inefficient in economic terms.⁷³ It would result in the company expending resources in investigating the director's conduct and that "the enforcement of a liability to compensate the company for misconduct depends on the happenchance of the company finding out about the impropriety."⁷⁴ Recognising that the "consciously misbehaving director" is unlikely to comply with the duty, her response is that this "is not a logically sustainable reason for not imposing it if it is otherwise appropriate."⁷⁵ Arden L.J. is firmly of the view that the consequence of non-disclosure may be that the company makes erroneous business decisions because it lacked material information. A legal rule which condones this would condone inefficient outcomes.⁷⁶ From a pragmatic standpoint, the reasoning is compelling, and viewed against this background the requirement to produce a business review becomes more readily comprehensible.

The Business Review

Setting the CLR's proposals and *Item Software* apart, the move towards increased disclosure obligations on directors also gained

⁷¹ It is notable that American judicial and academic views are cited in reasoning towards this conclusion: see Cardozo J. in *Meinhard v. Salmon* 164 NE 545, at 548; and Professor R. C. Clark, *Corporate Law* (New York 1986), respectively. See also, *British Midland Tool Ltd v. Midland International Tooling Ltd* [2003] EWHC 466 (Ch).

⁷² [2005] 2 B.C.L.C. 91, at [63].

⁷³ [2005] 2 B.C.L.C. 91, at [65].

⁷⁴ [2005] 2 B.C.L.C. 91, at [65].

⁷⁵ [2005] 2 B.C.L.C. 91, at [65].

⁷⁶ Efficiency in economic terms had informed the Law Commission and the Scottish Law Commission's proposals for increased disclosure obligations in their joint report, *Company Directors: Regulating Conflicts of Interests And Formulating A Statement Of Duties* (Nos 261 and 173, respectively), above, n. 25. Perhaps it is no coincidence that at this time Dame Mary Arden DBE was Chair of the English Law Commission. For a fuller discussion of the proposals, see, J. Lowry and R. Edmunds, "Section 317: Injecting Rationality into Directorial Disclosure", in D. Sugarman and M. Andenas (eds), *Developments in European Company Law* (London 2000).

considerable momentum as a result of the EU Accounts Modernisation Directive.⁷⁷ The Directive, in part, explains that a business review

...requires a balanced and comprehensive analysis of the development and performance of the company during the financial year and the position of the company at the end of the year; a description of the principal risks and uncertainties facing the company; and analysis using appropriate financial and non-financial key performance indicators (including those specifically relating to environmental and employee issues)....

This will include information on environmental matters and employees, on the company's policies in these areas and the implementation of those policies. Moreover, key performance indicators must be used where appropriate (including those specifically relating to environmental and employee issues).

The general objectives of the Directive are embraced by s.417(3), (4), (5) and (6). Put simply, the business review, forming part of the annual directors' report, is a narrative report of the company's business activities designed to flesh out the figures contained in the accounts. The intent behind the provision seems to be more of a declaration rather than an obligation on directors. It certainly explains how the requirements in s.417(5) and (6), which refer, amongst other things, to certain matters being included in the review such as the main trends and factors likely to affect the future development, performance and position of the company's business (including information about environmental matters, the company's employees, social and community issues and the company's relationship with its suppliers) are directed towards giving members "an understanding" of such trends and factors.

Companies subject to the small companies' regime are exempted from the business review requirement.⁷⁸ In this regard it is noteworthy that the CLR took the policy decision that the wider reporting obligations it envisaged for directors should be directed towards the boards of public and listed companies "and... other very large companies with real economic power".⁷⁹ It was felt that the emphasis had to be on the need to provide "adequate transparency of qualitative and forward looking information which is of vital importance in assessing performance and potential for shareholders, investors, creditors and others."⁸⁰ The focus here is therefore not on the "think small first" axiom which underpinned the company law review but is directed

⁷⁷ Directive 2003/51/EC.

⁷⁸ See s.417(1). There are also specific exemptions for medium sized and larger unquoted companies: see ss.465–467 and 385.

⁷⁹ *Developing the Framework*, above, n. 3, paras. 2.19–2.26, 3.85, 5.74–5.100. See also, the *Final Report*, Vol. 1, above, n. 3, paras. 3.28–3.45; and *Completing the Structure*, above, n. 3, paras. 3.7–3.10; 3.32–3.42.

⁸⁰ *Developing the Framework*, above, n. 3, para. 5.74.

instead on constructing a disclosure mechanism which serves to reinforce the duty of loyalty for directors of companies whose activities impact not just on shareholders' interests but on wider stakeholder interests. In a sense, the business review is designed to encapsulate the essence of corporate social responsibility.

As has been noted, the statutory objective of the business review is declared in s.417(2) which provides that:

The purpose of the business review is to inform members of the company and help them assess how the directors have performed their duty under section 172.

It is therefore made clear that the review is an integral part of the duty of loyalty, at least in so far as the duty applies to directors of listed companies. In informing the members about the directors' performance of this duty, s.417(4) states that the review must give a balanced and comprehensive analysis and to achieve this subsection (6) requires the use of key performance indicators (KPIs) relating to financial matters and to environmental and employee matters. Although the particular KPIs used are left to the discretion of the directors, they must be effective in measuring the development, performance or position of the business.

Since directors are required to have regard to the non-exhaustive list of "factors" specified in s.172(1),⁸¹ the effect of the reporting requirements in s.417 will, at the minimum, focus the minds of directors on stakeholder interests. One effect of the requirement to have regard to constituencies outside the narrow realm of members' interests in promoting the success of the company is it that it will allow directors to defend almost any *bona fide* decision aimed at promoting the success of the company. For example, where directors in good faith favour the interests of employees over, for example, the making of short term profit, that decision will be immune from attack. This is not a radical departure from the common law. For example, in *Re Welfab Engineers Ltd*,⁸² Hoffmann J. held that the directors' failure to realise the best price for the company's principal asset, its freehold premises, was an honest attempt to save the business and the jobs of the employees. He therefore dismissed the liquidator's misfeasance summons brought under s.212 of the Insolvency Act 1986.

⁸¹ The provision does not adopt the term 'stakeholders' presumably on the basis that it could lead the courts towards holding that the requirement amounted to a change in the law.

⁸² [1990] B.C.L.C. 833. See J. Lowry and R. Edmunds, "The Continuing Value of Relief for Director's Breach of Duty" [2003] M.L.R. 195.

CONCLUSION

It seems clear that the anxiety expressed by those who see s.172 as holding the potential to expose directors to increased litigation is misplaced given the requirements laid down in Part 11 of the 2006 Act governing derivative claims.⁸³ But placing the difficulties of enforcement to one side, it is noteworthy that the framing of s.172 does go further than the pre-existing law it replaces. At common law the considerations to be taken into account in discharging the good faith duty were seen as matters of process or diligence. Whereas the factors listed in the provision are matters which go to the issue of a director's good faith or loyalty. In other words, action otherwise than in good faith, which will now, but did not at common law, include the failure to consider the various factors listed in s.172(1), will be treated as a breach of trust which carries the full range of remedies, not merely compensation for incompetence.

Given the likelihood that the new derivative claim will not lead to the spectre of directors being routinely hauled before the courts, the real significance of s.172(1) may well lie not with the question of its enforceability, but rather in its value as serving a normative function that the "long term should predominate over the short, not vice versa, but that both should be evaluated and balanced, in determining what contributes best to company success".⁸⁴ And as part of this function the attention of directors is now specifically drawn to the stakeholder interests listed in the provision,⁸⁵ a process which is reinforced by s.417 when the directors come to choose the particular KPIs which best measure the development, performance or position of the business. The emphasis on long-term wealth generation, albeit not at any price, is nothing new,⁸⁶ and perhaps it is only where directors decide to favour short-term interests against the wishes of the company's shareholders that they will be confronted with a derivative claim. Most certainly, the inter-relationship between sections 172 and 417 does much to further the objective of constructing a disclosure regime which underpins the core duty of loyalty and which is economically efficient in its operation.

⁸³ Early indications suggest that the courts will be loath to grant permission under s.263(3) to continue a derivative claim: see, *Mission Capital plc v. Sinclair* [2008] EWHC1339 (Ch); and *Franbar Holdings Ltd v. Patel and others* [2009] 1 B.C.L.C. 1.

⁸⁴ *Developing the Framework*, above, n. 3, at para. 3.54. See also Lord Goldsmith's speech in the House of Lords Grand Committee, 6 February 2006 (column 258).

⁸⁵ As commented above, the "factors" are now matters of substance going to good faith.

⁸⁶ See, for example, H. Hansmann and R. Kraakman, "The End of History for Corporate Law" [2001] *Georgetown Law Journal* 439; and M. Jensen, "Value Maximisation, Stakeholder Theory and the Corporate Objective Function" [2001] *European Financial Management* 297.