

Regulating Fiduciary Duties of Directors Towards Company Property in England and Saudi Arabia: a Comparative Analysis

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by

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Dedication

To all my teachers,
To my family, my parents, my brothers and sisters
To the memory of my late uncle (Saud)
To my wife and son

Abstract

This thesis investigates the regulation of fiduciary duties of directors towards company property in England and Saudi Arabia. The analysis concentrates on the statutory law of both countries as the main legal instrument to prevent exploitation of company property by company directors. The study follows a functionalist approach to compare the legal systems of England and Saudi Arabia, taking into account the socio-cultural ramifications for the application of law to regulate the fiduciary duties of company directors towards company property. The study argues that despite belonging to different law families and having developed in different socio-cultural environments, the legal systems of both countries face a similar issue of effective prevention of company property exploitation by company directors. Further, it is noted that the statutory provisions aimed at regulating the fiduciary duties of company directors towards company property are not completely effective. The main contribution to knowledge provided by the thesis consists in making suggestions for statutory amendments in England and Saudi Arabia for a more effective regulation of directors' fiduciary duties towards company property. A further original contribution of the study is in exploring the different features in each legal system that can be effectively transferred and applied to the other system in order to improve the regulation of directors' fiduciary duties towards company property.

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List of Abbreviations

BLG – Basic Laws of Governance 1992
CDDA 1986 - Company Director Disqualification Act 1986
CA 2006 – Companies Act 2006
CGC 2010 – Corporate Governance Code 2010
CGR 2006 – Corporate Governance Regulations 2006
CL 1965 – Companies Law 1965
CMA – Capital Market Authority
GCC – Gulf Cooperation Council
IA 2000 – Insolvency Act 2000
KSA – Kingdom of Saudi Arabia
LR 2004 – Listing Rules 2004
NED – Non executive director
OECD – Organisation for Economic Co-operation and Development

Chapter One: Introduction

1.1. Background of the Study

Good practices of corporate governance should be one of the major goals of the company law in each country, because such practices ensure effective and practical management of a company's assets that can boost investors' confidence, increase competitiveness, and promote long term success. However, as recent history shows, corporate governance models, even in the most developed countries, are far from being ideal¹. An inevitable consequence of the events connected to the collapse of companies like Enron, WorldCom, Lehman Brothers, and Madoff Investment Securities has been an increased interest in the further development of legal means to promote more effective corporate governance models. The focus of these models has been better protection of corporate assets from inappropriate behaviour of company directors linked to asset manipulation, non disclosure, and fraud resulting from the conflicts of interest between personal benefits and what is best for the company².

Even though recognised as separate legal entities in many countries, corporations are governed by human beings through the institution of the corporate board of directors. Corporate directors are normally given full powers in managing company assets, which, in turn, should bring a certain degree of responsibility and care on their side³. However, there is always a possibility that directors may act in their own interests, which are in contrast with

¹ For a comprehensive discussion on the limitations of the contemporary corporate governance models in the wake of the current recession see, in general: Sun W, Stewart J and Pollard D (eds) *Corporate Governance And The Global Financial Crisis: International Perspectives* (Cambridge Press, 2011); also see Kirkpatrick G, 'The corporate governance lessons from the financial crisis' (2009) OECD Publications: Financial Market Trends <<http://www.oecd.org/dataoecd/32/1/42229620.pdf>>, accessed 1 October 2011.

² See, for example, the reports of the Treasury Committee discussing government efforts in different countries to improve corporate governance environment: HC 416 (2009) <<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/416/416.pdf>>; accessed 1 October 2011, HC 462 (2009) <<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/462/462.pdf>>, accessed 1 October 2011.

³ Whether the interests of the company match those of the company shareholders is debatable, as it is questionable whether shareholders are legally associated with a company. Many countries, including England and Saudi Arabia, which are considered in this study, have recognised that companies are separate legal entities. Both English and Saudi legal systems acknowledge that company directors owe duties to the company alone, while considering the interests of other parties, including shareholders. See, in this regard, Section 172 of the English Companies Act 2006 and Articles 1 and 76 of the Saudi Companies Law 1965.

those of their companies⁴. Resolution of such conflicts cannot be left entirely to the employment contract, because, eventually, due to cognitive limitations, all of such contracts remain incomplete⁵. Nor can the power of the company members to vote on directors' dismissal or replacement be considered sufficiently strong, because in public companies it is common that there are many shareholders with small stakes in the company⁶. As a result, the corporate governance framework established within a particular legal system has to include provisions that ensure that company directors act in a way that does not compromise what is entrusted to them by the nature of their position in the company.

The fundamental duties of directors, based on their position of trust⁷ to act in the best interests of the company and not to acquire, without the consent of the company, material benefits from that position, are referred to as fiduciary duties⁸. The critical aspect of imposing and regulating fiduciary duties within a corporate governance framework is that directors, as fiduciaries, agree to act on behalf of the company in exercising their powers to use the assets that do not belong to them, but to the company. The company in this case is in a vulnerable position because it entrusts its assets into the hands of the directors. Therefore, the goal of regulating fiduciary duties of company directors is to oblige company directors to act in the interests of the company.

According to the law and economics school of thinking in corporate law, regulation of fiduciary duties is important not only from the legal, but also from the economic perspective.

⁴ For the reasons named above, the interests of the company are considered as separate from the shareholders. Chapters 5 and 6 provide more detailed discussions distinguishing companies from shareholders in both England and Saudi Arabia.

⁵ See Andrew Keay and Hao Zhang, 'Incomplete Contracts, Contingent Fiduciaries, and a Director's Duty to Creditors' (2008) 32 Melbourne University Law Review 141: '...cognitive limitations of contracting parties and asymmetric information between these parties. In other words, the contracting parties are not able to foresee the future perfectly, although some may know more about something than others. Because of these problems, contracting parties (who are inherently self-interest seeking) cannot make complete provisions in a contract for every eventuality and all contracts are, therefore, incomplete'.

⁶ This results in individual shareholders having very weak voting power.

⁷ This thesis follows the argument that while directors are recognised as agents in both England and Saudi Arabia, some aspects of the relationships between a company and its directors closely resemble relationships under a constructive trust. See Section 4.5 in this thesis.

⁸ Cary Cooper and Chris Argyris, *The Concise Blackwell Encyclopedia Of Management* (Oxford, Blackwell Publishing 1998) 221. The extent of fiduciary duties to the parties beyond a company and its shareholders depends on the legal system, which may or may not recognise third parties such as employees, suppliers, customers, or society in general as the parties to whom company directors owe fiduciary duties.

According to Macey⁹, regulation of fiduciary duties serves as a ‘device uniquely crafted to fill in the massive gap in [the] open-ended bargain between shareholders and corporate officers and directors’. The outcomes of such regulation, however, extend far beyond the context of corporations within which fiduciary duties are regulated. In the wake of economic crises and the scandals related to mismanagement of corporate assets by company directors, studies have demonstrated the negative social and economic impact resulting from the breach of fiduciary duties¹⁰.

As seen above, the demand for effective regulation of fiduciary duties of company directors is dictated by various factors of a legal and economic nature. However, both England and Saudi Arabia are still encountering challenges in defining the scope of these duties, their application, and, most importantly, effective codification in their major company law statutes. In England, the concept of fiduciary duties has existed for over two centuries¹¹. However, the concept itself has remained rather elusive¹², and the main principles of what can be considered a breach of fiduciary duty were never codified until their introduction in the Companies Act 2006 (hereinafter CA 2006)¹³. Some of the Act’s provisions, however, differ from what has been considered the standard in English case law for some time.

As for Saudi Arabia, regulation of fiduciary duties within the framework of corporate governance remains very unclear. There have always been obligations to follow for each individual as prescribed within the *Shariah*; however, Islamic law provides little guidance in relation to corporate governance per se, because corporate forms of business historically did

⁹ Jonathan Macey, ‘An Economic Analysis Of The Various Rationales For Making Shareholders The Exclusive Beneficiaries Of Corporate Fiduciary Duties’ (1991) 21 Stetson Law Review 23, 41.

¹⁰ Gerald Vinten, ‘The Corporate Lessons Of Enron’ (2002) 2 (4) Corporate Governance 4; Cheryl Wade, ‘Fiduciary Duty And The Public Interest’ (2011) 91 Boston University Law Review 1191; Robert Sitkoff, ‘The Economic Structure Of Fiduciary Law’ (2009) 91 Boston University Law Review 1039; Robert Flannagan, ‘The Economics Of Fiduciary Accountability’ (2007) 32 Delaware Journal Of Corporate Law 393; Robert Nolan, ‘Controlling Fiduciary Power’ (2009) 69 Cambridge Law Journal 293.

¹¹ Robert Cooter and Bradley Freedman, ‘The Fiduciary Relationship: Its Economic Character And Legal Consequences’ (1991) 66 NYU Law Review 1045.

¹² Deborah Demott, ‘Beyond Metaphor: An Analysis Of Fiduciary Obligation’ (1988) Duke Law Journal 879; William Heath, ‘The Director's Fiduciary Duty Of Care And Skill: A Misnomer’ (2007) 25 Company And Securities Law Journal 370.

¹³ The CA 2006 itself does not refer to the duties outlined in sections 170-177 as ‘fiduciary’. However, in section 178(2), they are mentioned in the context of consequences for the breach.

not exist in Islam¹⁴. In addition, the company law regulating, inter alia, directors' duties has not been developed within the Kingdom, but transplanted with few modifications from Egyptian/French company law¹⁵. Granted, the Kingdom has recently introduced a number of its own statutes to regulate the issues related to corporate governance in publicly held corporations; however, none of them directly addresses fiduciary duties of company directors. The Companies Law 1965 (hereinafter CL 1965), which is the main statute adopted from Egypt, does include certain provisions to regulate the fiduciary duties of company directors¹⁶; however, those provisions are extremely vague and inconclusive¹⁷.

The absence of full cohesion of the company law statutes with the existing case law in England and the lack of inclusiveness of the statutes in Saudi Arabia inevitably bring the question of the effectiveness of statutory regulation of fiduciary duties in both countries. At the same time, it is clear that the two countries have approached the same problem differently: while in England the nature of fiduciary duties has been developed and actively applied based on the vast experience of court decisions, Saudi Arabia borrowed legislation in the absence of its own experience in managing corporate forms of business, but consequently amended that legislation. Other differences exist as well. For example, the English system of common law, which continuously evolves as a result of case decisions, starkly contrasts with the Islamic law system in Saudi Arabia, where a certain portion of law (the *Shariah*) is considered divine and immutable. Over the course of history, the two systems have developed somewhat different views on the role of business in the economy and society, which have influenced the dominant corporate governance models existing in each country¹⁸.

The analysis of the treatment of fiduciary duties in England and Saudi Arabia can help not only to see the points of convergence and divergence between the two legal systems, but also

¹⁴ See Nicholas Foster, 'Islamic Perspectives On The Law Of Business Organisations: Part 1: An Overview Of The Classical Shariah And A Brief Comparison Of The Shariah Regimes With Western Style Law' (2010) 11 (1) *European Business Organisational Law Review* 3.

¹⁵ Maren Hanson, 'The Influence Of French Law On The Legal Developments Of Saudi Arabia' (1987) 2 *Arab Law Quarterly* 272.

¹⁶ Although, as in the CA 2006, the duties are not listed as 'fiduciary'.

¹⁷ Chapter 6 of this thesis deals exclusively with the Articles under the CL 1965, where many potential problems with interpretation are identified.

¹⁸ Lilian Miles and Simon Goulding, 'Corporate Governance In Western (Anglo-American) And Islamic Communities: Prospects For Convergence?' (2010) 2 *Journal of Business Law* 126; also see Mervyn Lewis, 'Islamic Corporate Governance' (2005) 9 *Review Of Islamic Economics* 5, 11.

to identify certain elements of law within each jurisdiction that may help to enhance the effectiveness in regulating fiduciary duties. According to the influential corporate governance studies theory of convergence, all corporate governance systems will eventually converge along the lines of the Anglo-American model¹⁹. This is because this model is often considered as the way to ensure high standards of governance, even by the governments of countries that have different legal traditions²⁰. Evidence shows that this statement is at least partially true, as many countries, including those with Islamic law tradition, have been actively adopting various corporate governance practices of the Anglo-American system, such as enhancement of reporting and transparency, assignment of independent directors to company boards, establishing auditing committees, and other practices²¹. Some of these practices have been successfully adopted in the Middle East countries²². Saudi Arabia itself has recently introduced stock exchange listing rules for publicly traded companies, which is a common practice in Anglo-American corporate governance systems²³. This means that the best corporate governance practices developed in England could be useful in the context of Saudi Arabian law.

At the same time, certain principles of Saudi law could potentially add value to English company law regulating fiduciary duties of company directors. This is particularly true in relation to moral and ethical dimensions of corporate governance practices. Many Western scholars have been advocating a new approach to business conduct, which would place more emphasis on these dimensions²⁴. In addition, recent trends in Anglo-American company law

¹⁹ See, for example, John Coffee, 'The Future As History: The Prospects For Global Convergence In Corporate Governance And Its Implications' (1999) 93 (3) *Northwestern University Law Review* 641; Sanford Jacoby, 'Corporate Governance In Comparative Perspective: Prospects For Convergence?' (2000) 22 (5) *Comparative Labour Law And Policy Journal* 5; Cally Jordan, 'The Conundrum Of Corporate Governance' (2005) 30 *Brooklyn Journal Of International Law* 983.

²⁰ Miles and Goulding (n 18) 128.

²¹ This is particularly evident in East Asian markets, such as China, Malaysia, and South Korea. See, for example, Wiparat Chuanrommanee and Fredrik Swierczek, 'Corporate Governance In ASEAN Financial Corporations: Reality Or Illusion?' (2007) 15 (2) *Corporate Governance* 272; Han Kim and Woochan Kim, 'Changes To Korean Corporate Governance: A Response To Crisis' (2008) 20 (1) *Journal Of Applied Corporate Finance* 47; Datuk Shim, 'Governance In The Markets: Malaysian Perspective' (2006) 13 (3) *Journal Of Financial Crime* 300.

²² Egypt, UAE, and Kuwait have made serious advances in this regard.

²³ The Capital Market Authority introduced the Listing Rules in 2004.

²⁴ Masudul Choudhury and Sofyan Harahap, 'Decreasing Corporate Governance In An Ethico-Economic General Equilibrium Model Of Unity Of Knowledge' (2007) 7 (5) *Corporate Governance* 599; Miles and

have marked a shift towards a ‘socially responsible corporation’ – one in which the directors’ decision making process has to take into account the consequences of their actions for third parties²⁵. Still, the idea of a socially responsible corporation has yet to be applied in English law: the CA 2006, for example, preferred the enhanced shareholder value approach instead of the stakeholder approach in relation to directors’ duties. In this sense, Islamic law can be considered more advanced, because the ideas of social responsibility, ethics, and morality are inherent in the *Shariah*. Some of these principles have been also applied within the statutory framework of Saudi company law²⁶. Therefore, these traditions of Islamic law can be found useful for application in the statutory framework of English company law.

1.2. Purpose of the Study

The purpose of this study is to conduct a comparative analysis of the ways that English and Saudi legal systems regulate fiduciary duties of company directors towards company property. While there is a sufficient number of studies that investigate corporate governance in these countries in general, regulation of fiduciary duties is often ignored, especially in the studies pertaining to Saudi Arabia. Moreover, comparative research concentrating specifically on fiduciary duties towards company property in England and Saudi Arabia is virtually absent in the legal literature. This study aims to fill this gap in knowledge. To meet this objective, the study answers three research questions: 1) What are the similarities and differences between English and Saudi legal systems in the regulation of company directors’ fiduciary duties towards company property? 2) Are the statutory provisions regulating these duties effectively in tune with the other sources of law? 3) Based on the answers to the first two questions, what changes to the law can be suggested to make the regulation of fiduciary duties in each legal system more effective?

Goulding (n 18) 129-130; Felix Pomeranz, ‘Ethics: Toward Globalisation’ (2004) 19 (1) *Managerial Auditing Journal* 8.

²⁵ Subhabrata Bannerjee, *Corporate Social Responsibility: The Good, The Bad, And The Ugly* (Cheltenham, Edward Elgar 2007); Peter Drucker, *Management Challenges In The 21st Century* (2nd edn, New York, NY: Harper Collins 2007); David Hawkins, *Corporate Social Responsibility: Balancing Tomorrow’s Sustainability And Today’s Profitability* (New York, NY, Palgrave Macmillan 2006); Dima Jamali, ‘A Stakeholder Approach To Corporate Social Responsibility: A Fresh Perspective Into Theory And Practice’ (2008) 82 (1) *Journal Of Business Ethics* 213. Consideration of the third parties’ interests is also mentioned in the CA 2006 Section 170(2).

²⁶ Arguably, the existing provisions of, for example the Companies Law 1965, only slightly touch upon the vast array of ethical and moral responsibilities imposed by the *Shariah*. Still, unlike English statutory law, the Companies Law 1965 has specific provisions extending directors’ duties beyond the corporate context and imposing penalties for failure to comply with these duties. See, for example, Article 76 of the CL 1965.

1.3. Significance of the Study

Perhaps one of the major challenges faced by legal systems in regulating fiduciary duties of company directors lies in how to ensure the effectiveness of best management practices in relation to a company's assets and interests while at the same time protecting these assets from possible exploitation. As such, a fine balance has to be established between protectionist measures related to the company property and flexibility of the decision making process that allows company directors to take reasonable risks in achieving company related goals. The search for this balance in English law has been an ongoing effort, as the courts have continuously reviewed and revised the way that certain aspects of fiduciary duties have to be treated. Much less effort seems to exist in Saudi law where only statutory provisions have the power to regulate fiduciary duties of company directors, and these statutory provisions often lack clarity and comprehensiveness²⁷. Therefore, by choosing English company law with its strong practical basis of statutory interpretation as a peer to Saudi company law, this study will provide a number of suggestions that the researcher believes will be able to contribute to the development of a new, more comprehensive and better company statute in the Kingdom. At the same time, it was found that some elements of the Saudi legal system could provide useful suggestions for improving English statutory law, thus making the work practical for both jurisdictions. The main contribution of the study, therefore, is in the insights into the issues of managing the fiduciary duties of company directors towards company property in England and Saudi Arabia and practical suggestions to reforming statutory codes in both countries.

1.4. Background: England

The choice of England as a peer country to Saudi Arabia for the purposes of the study is justified by the fact that it has a rich history in regulating corporate affairs in general and fiduciary duties of company directors in particular. Ultimately, it can be said that the country's flexible and constantly evolving company law has contributed to its economic growth and establishment as one of the leading business centres in the world. England is the largest economy in the United Kingdom and the eighteenth largest economy in the world in terms of average GDP per capita²⁸. The capital of England, London, is considered the largest

²⁷ Chapter 6 of the thesis provides a comprehensive discussion of this issue.

²⁸ £22,907 as of 2010, according to the International Monetary Fund.
<<http://www.imf.org/external/pubs/ft/weo/2011/02/>>, accessed 3 October 2011.

financial centre in the world²⁹. The London Stock Exchange is the largest in Europe, and 20% of Europe's largest 500 companies are based in London³⁰. Finally, the UK is ranked in the top ten countries for doing business³¹, an achievement which can be attributed, among other factors, to its well developed company law.

Thus the current financial and economic power of England can be largely attributed to its well developed company law system, which was established in the 19th century. Many associate the passage of the Joint Stock Companies Act 1856 with the beginning of the modern limited liability company and the companies' articles of association³². Consequent company law statutes added and extended many of the provisions of the original act, but the fundamental principles of the Act of 1856, such as the rules regarding shareholders' meetings and voting, transactions with the shares, and certain aspects pertaining to directors' disqualifications remain largely intact. Eventually, English company law served as the basis for many legal jurisdictions across the world which initiated reforms to introduce new business entities (limited liability corporations with a legal personality) and regulate them³³.

While England was the legal frontrunner in establishing and regulating corporations as business entities, it also implemented a set of rules and provisions that addressed the issue of company directors' accountability. Although the process of introducing the legal rules to curb directors' powers within the corporate context was not without obstacles³⁴, eventually English law introduced statutory provisions that regulated directors' duties and imposed liabilities in case of misconduct³⁵. The list of fiduciary duties that directors owe to a company was finally introduced in the CA 2006, the major statute regulating corporate affairs. In

²⁹ The Global Financial Centres Index (2011) <<http://www.zyen.com/GFCI/GFCI%209.pdf>>, accessed 3 October 2011.

³⁰ London. 'London As A Financial Centre' (2011) <<http://Legacy.London.Gov.Uk/London-Life/Business-And-Jobs/Financial-Centre.Jsp>>, accessed 3 October 2011.

³¹ International Finance Corporation, 'Doing Business: Economy Rankings' (2011) <<http://www.Doingbusiness.Org/Rankings>>, accessed 22 October 2011.

³² Julie Cassidy, *Concise Corporations Law* (5th edn, Sydney, The Federation Press 2004) 4; also see Stephen Griffin, *Company Law: Fundamental Principles* (Essex: Pearson Education 2006) 5-6. The history of English company law goes even further: the first companies (Hudson's Bay Company, Bank of England, British East India Company) were established as early as the seventeenth century.

³³ Examples of such countries are Australia, New Zealand, and Malaysia.

³⁴ For example, the Bullock Report 1977 suggesting inclusion of employees in the process of selecting the board of directors did not succeed.

³⁵ The Insolvency Act 2000 and the Company Directors Disqualification Act 1986.

addition, the Corporate Governance Code 2010 (hereinafter CGC 2010) established a number of recommendations in relation to internal mechanisms to control directors' acts, which include the separation of the roles of the board chairman and the CEO, auditing, and establishing remuneration committees to control directors' compensation. While the CA 2006 distinguishes public from private companies, Part 10, which deals with directors and their duties, is intended to apply to both types of companies in similar fashion³⁶. Therefore, the majority of directors' duties, as well as their relationships with the general meeting, do not vary much between the two types of company.

Where English statutory law lacked strictness in relation to regulating fiduciary duties of company directors, the courts have been quite stringent in this regard. Historically, English case law has been relentlessly opposing not only conflicts of interest between directors and their companies, but even the possibilities of such conflicts. Although the CA 2006 seemed to provide some relaxation to this approach, it is unclear whether the courts are still quick to change the general attitudes regarding treatment of directors' fiduciary duties³⁷.

1.5. Background: Saudi Arabia

Saudi Arabia is a unique country in many respects: cultural, political, religious, economic, and, eventually, legal. Consequently, the modern corporate governance framework that exists in the Kingdom can be considered as a product of the fusion of Islamic traditions and modern business trends. First and foremost, Saudi Arabia is a country where religion plays the most prominent role in all spheres and aspects of life. Islam, which originated in the lands of the modern Kingdom, is not only the official religion of the country: it is also the supreme law of the land³⁸. As such, any law issued in the Kingdom, without exception, has to be compliant with Islamic law principles (the *Shariah*) derived from the Holy Texts of the *Qur'an* and the *Sunnah*. Importantly, unlike the supreme laws in the majority of other countries, the *Shariah*

³⁶ Clear distinctions are made in section 154, which deals with the required number of directors, and sections 200-201, which prohibit the issue of loans, quasi-loans, and credit transactions for directors' benefits in public companies.

³⁷ Chapter 5 will provide details on this.

³⁸ Dennis Campbell and Christian Campbell (eds), *Legal Aspects Of Doing Business In The Middle East* (2nd edn, Yorkhill Law, 2007) 265.

cannot be changed or amended, because it is considered divine. However, government may issue additional laws in areas where the *Shariah* cannot provide sufficient guidance³⁹.

Corporate governance has been one of the areas where government-issued decrees have played a more significant role than traditional Islamic Law. The pressing need for the creation of the appropriate legal framework arose as a result of the rapid transition of the Kingdom from a poor country inhabited primarily by nomadic tribes into one of the wealthiest countries in the world, within just few decades. The rapid transformation of the country occurred after the discovery in the 1930s of oil, which would eventually become the major source of the country's revenues, provide economic prosperity, and ensure significant political and economic leverage for the Kingdom in the global arena⁴⁰. As oil revenue soared, the Saudi economy started attracting foreign capital in the Kingdom; however, the business entities popular in the West, such as limited liability corporations, were completely alien to the Saudi legal system, which traditionally only recognised various forms of partnerships⁴¹. Feeling the need to streamline legal governance of the new business entities and having virtually no experience in creating an appropriate framework on its own, the Saudi government chose to transplant the company law system from Egypt, which resulted in the issuance of the CL 1965.

Since its adoption, the CL 1965 has been amended numerous times; however, a fully updated, new statute to regulate company law in the Kingdom has yet to be introduced. The continued delay in the issuance of the much needed new statute can be explained by the rigidity of the Saudi government system. The Kingdom is an absolute monarchy, with all reins of political power vested in the hands of the King. The legislative bodies, the Council of Consultation and the Council of Ministers consist of individuals appointed by the King, and their main function is to assist him in carrying out the duties of ruling the Kingdom⁴². As such, the

³⁹ This is allowed under the principle of *almasalih almursalah* (public good): it allows the governing body of the country to establish new laws and regulations for which there are no clear answers in the Holy Texts, if these are dictated by the pressing needs of society, and if they are not in conflict with the *Shariah*. See Section 3.2.2 for more details.

⁴⁰ The Saudi Gazette, 'The story Of Oil In Saudi Arabia' (2008) <<http://www.saudigazette.com.sa/index.cfm?method=home.regcon&contentID=200805186773>> accessed 3 October 2011.

⁴¹ Foster (n 14) 28.

⁴² CIA World Fact Book, 'Saudi Arabia' (2010) <<https://www.cia.gov/library/publications/the-world-factbook/geos/sa.html>> accessed 3 October 2011.

legislative bodies have no powers or functions on their own and cannot engage in the creation of laws without the consent of the King. The judicial branch cannot contribute to the development of the new statute either, because the court decisions in the Saudi legal system create no judicial precedent.

However, to say that the development of company law in the Kingdom has not occurred would be a mistake. The government made a serious move towards the establishment of an independent Saudi stock market and, eventually, regulation of publicly listed companies with the creation of the Capital Market Authority (CMA) in 2003. The CMA, in turn, issued a number of groundbreaking policies such as the Listing Rules 2004 (LR 2004) which established provisions that have to be followed by all companies listed on the Saudi stock exchange (Tadawul). Still, the problems with regulating corporate governance framework in the Kingdom persisted, and resulted in the market crash of 2006, prompting the CMA to review the policies related to reporting and disclosure of the companies' actions⁴³. However, in relation to the treatment of fiduciary duties of company directors towards corporate property, Saudi law remains largely silent. The rules issued by the CMA do not mention fiduciary duties at all, although some provisions exist within the CL 1965 statutory framework. Nevertheless, these provisions are far from being either comprehensive or free from ambiguities and loopholes, as the analysis in this thesis will demonstrate.

1.6. Setting the Study Ground

At the heart of comparative methodology is the issue of comparability of the legal phenomenon in question⁴⁴. Consequently, a comparison can be considered meaningful when some common features are present in the objects of the comparison, upon which it can be based⁴⁵. These features, in turn, are commonly identified and analysed at the preliminary stage of the comparative process that establishes structure, purposes, and the environments of the legal institutions or rules subject to comparison⁴⁶. The general analysis of the economic,

⁴³ George Buchanan, 'The Saudi Capital Market', in Ramady M *The Saudi Arabian Economy* (New York, NY, Springer 2010) 145-177.

⁴⁴ Walter Kamba, 'Comparative Law: A Theoretical Framework' (1977) 23 *International And Comparative Law Quarterly* 485.

⁴⁵ George Mousourakis, 'Comparability, Functionalism, And The Scope Of Comparative Law' (2008) 41 (1) *Hosei Riron* 1.

⁴⁶ *ibid* 9.

political and legal environments of England and Saudi Arabia provides that both countries seek to regulate the same type of fiduciary duties within their major company law statutes. The purpose of such regulation converges in the sense that both countries need to effectively regulate corporate governance within their legal systems, while it diverges in the sense that English statutory provisions also aim to resolve the inconsistencies in case law decisions, whereas even though these might be present in Saudi courts, they are not available for public inquiry. The environments under which the regulation of fiduciary duties is applied are also different: the free market, democratic and secular system of England based on common law principles is very different from the deeply religious legal framework operating within the absolute monarchy rule in Saudi Arabia. Still, in the era of globalisation, the interactions between the two systems may provide a sufficient amount of legal diffusion to justify the comparison of regulations of directors' fiduciary duties towards property within these legal systems. Besides, the recent trends in Saudi company law indicate that it is more Western-oriented than one might think⁴⁷. On the other hand, the movement towards socially responsible corporations in England, such as recognition of the interests of the third parties in Section 172 of the CA 2006, which fits well within the *Shariah* principles, indicates that English law might have some points of legal convergence with Islamic law in this regard. For these reasons, the comparison of the two systems in terms of regulating fiduciary duties of company directors is fully justified.

1.7. Study Limitations and Difficulties

The major limitations and difficulties faced by the researcher were related to the scarcity of information on various aspects of regulating fiduciary duties of company directors towards property in Saudi Arabia. The most important aspect in this regard is the virtual absence of publicly available case law related to the matter, in the form of either original court publications or analysed case studies in secondary sources, such as books, journals, or reports. This makes it extremely difficult to determine how various statutory provisions and rules are treated by the judges and applied in practice. Where the publicly available decisions of English courts of all levels can be examined to see whether any problems of interpretation exist, the absence of readily available information about court decisions in Saudi Arabia sometimes left the writer with no choice but to speculate in this regard.

⁴⁷ Chapter 6 provides details on this.

The absence of case law reporting in the Kingdom can be traced to the principles of Islamic law and the origins of the transplanted company law that the country borrowed from Egypt. Islamic law, by nature, shows little consideration for judicial precedent, which plays a key role in common law systems. Whereas case law in England plays an important part in formulating the legal rules⁴⁸ and binding future court decisions, the judges in Saudi courts, which are heavily reliant on the *Shariah*, do not add to the existing jurisprudence: they may consult the existing legal texts to formulate the decisions, but the law itself is considered untouchable and immutable due to its divine nature. Second, by adopting the French-based, Egyptian company law code, Saudi Arabia also inherited attitudes towards law reporting that the French model engenders. In France, consistent case reporting only applies to the decisions of the Cours de Cassation – the highest appellate court in the country⁴⁹. The practice of limited case reporting, however, has been extended in Saudi Arabia to virtually avoid the publishing of court decisions at any level. In the opinion of the researcher, this is a serious omission in the Saudi legal system, as it prevents scholars from analysing the application of law in practice and suggesting improvements⁵⁰. No matter how comprehensive statutory provisions might be, they are not capable of covering every aspect of related law, thus there is always room for improvements. In the absence of public access to the court decisions in Saudi Arabia, the provisions of statutory law can be only meaningfully analysed within the *Shariah* framework, but not on the basis of how these provisions are interpreted and applied by the courts.

Another serious difficulty faced by the researcher has been the absence of codified *Shariah* rules and principles in the Saudi legal system in general and its company law in particular. Because the *Shariah* law a priori plays such a fundamental role in the Kingdom's legal system, it inevitably influences all matters within company law, including directors' duties and behaviour towards company property. However, the absence of a clear and comprehensible set of rules imposed by the *Shariah* hardly makes it readily applicable in all

⁴⁸ We will see, for example, that the previous court decisions heavily influenced the wording of some of the provisions in the CA 2006.

⁴⁹ Pascale Portier, 'Media Reporting Of Trials In France And Ireland' (2006) 6 (1) Judicial Studies Institute Journal 197; on the specifics and consequences of transplanting French civil law to middle eastern countries, see Ian Edge, 'Comparative Commercial Law Of Egypt And The Arabian Gulf' (1986) 34 Cleveland State Law Review 129.

⁵⁰ Since the codified company law in Saudi Arabia is not based on the *Shariah*, but only compatible with it, this allows the possibility of modifying it. The CL 1965 is a good example of this: the code has been amended several times since its adoption in the Kingdom.

situations, especially, in cases concerned with relatively new legal fields such as corporate governance. For these reasons, this study, apart from the main goal of investigating regulation of fiduciary duties of company directors toward corporate property, makes a strong case for introducing major codified *Shariah* principles for company law regulation in the Kingdom.

1.8. Structure of the Study

This study consists of seven chapters. The first chapter sets the basis for the research by providing the general background of the study, describing the study purpose, significance, and motivation behind it. It also reviews the major study limitations and difficulties of the research. The second chapter outlines the study methodology, which is comparative functionalism. The third chapter compares the main sources of law in England and Saudi Arabia, noting along the way the main similarities and differences between the two systems. The fourth chapter discusses the legal treatment of directorships in England and Saudi Arabia, with the focus on the legal definition of the term ‘director’, the types of directors recognised by law, and the legal position of a company director under both jurisdictions. The fifth and sixth chapters analyse how, respectively, the English and Saudi legal systems regulate the fiduciary duties of company directors towards property. Finally, the seventh chapter compares these regulations and, on the basis of comparison, provides suggestions for statutory amendments in both legal systems to ensure a higher degree of protection of company property from directors’ exploitation on the one hand while preserving a reasonable degree of flexibility in directors’ decision-making on the other.

Chapter Two: The Methodology of the Research

2.1. Introduction

Comparative research is a critical method of inquiry that is applicable in many fields of scientific knowledge. Comparative Law, like other sciences, ‘remains a science as long as it acquires knowledge and regardless of whether or not the knowledge is put to any further use’⁵¹. Zweigert observes that legal sciences in general are beset by methodological weaknesses that may be aptly remedied by Comparative Law⁵². In a similar context, Öricü asserts that the twenty-first century is the ‘age of the comparative law’ research⁵³. Further, Lord Goff argues that in the English legal system ‘comparative law may have been the hobby of yesterday, but it is destined to become the science of tomorrow; we must welcome rather than fear its influence’⁵⁴.

Recent years have witnessed an increased interest in comparative law research, which has been demonstrated in the significant growth in the volume of publications⁵⁵. Thus, the significance of comparative law research is nowadays less subject to dispute. Nonetheless, there is still ongoing debate over the meaning of comparative law research. Part of the debate relates to the outcomes of new emerging paths of research in Comparative Law⁵⁶. Most comparative legal scholars agree that the choice of the method depends on the primary aim of

⁵¹ Rodolfo Sacco, ‘Legal formants: A Dynamic Approach To Comparative Law (Part 1)’ (1991) 39 *American Journal of Comparative Law* 4.

⁵² Konrad Zweigert, ‘Methodological problems in comparative law’ (1972) 7 *Israel Law Review* 465, 466.

⁵³ Esin Öricü, *The Enigma Of Comparative Law: Variations On A Theme For The Twenty-First Century* (Boston, Martinus Nijhoff Publishers 2004) 7. Examining the history of comparative law is beyond the scope of this study; for more information on this, see Konrad Zweigert and Hein Kötz, *An Introduction To Comparative Law* (3rd edn., Oxford, Clarendon Press 1998) 48-62; see also Christopher Whytock, ‘Legal Origins, Functionalism, And The Future Of Comparative Law’ (2009) 6 *Brigham Young University Law Review* 1879.

⁵⁴ Lord Goff, ‘The Future of the Common Law’ (1977) 46 *International and Comparative Law Quarterly* 745, 748.

⁵⁵ For example, as will be discussed below, Öricü states that in the last ten years there has been a growing interest in using comparative research for different objects such as aiding law reform and policy developments. She observes that there is an increase in the number of journals relating to comparative law and the articles published on comparative research are numerous. She says ‘not only that but it has become indispensable for all doctoral research’. See Öricü (n 53) 8.

⁵⁶ Vernon Palmer, ‘From Lertholi to Lando: Some Examples Of Comparative Law Methodology’ (2005) 53 (1) *American Journal of Comparative Law* 261.

the comparison itself.⁵⁷ This chapter proceeds with a review of some contemporary approaches in comparative law with a deeper focus on the chosen methodology for the research.

2.2 Contemporary Approaches in Comparative Law

Comparative scholars have applied a range of different comparative methodologies in the literature. There are, for example, historical comparison, comparison of legal transplants, cultural comparison, critical comparison and functional comparison⁵⁸. While it is outside the scope of this study to conduct an in depth examination of these methods, an analysis will be undertaken of the most influential approaches in the recent literature on comparative legal methodologies: cultural and critical approaches and functionalism⁵⁹.

Contemporary approaches in comparative law are mainly derived from three influential schools: culturalism, criticism and functionalism. Pierre Legrand, a leading proponent of the cultural school, argues that the main aim of Comparative Law is to explain the deep cultural, moral and ideological dimensions of law⁶⁰. His main arguments orbit around the divergence and uniqueness of each legal culture which is ‘incommensurable and untranslatable except through a deep understanding of the surrounding social context’ and he argues that comparison must involve ‘the primary and fundamental investigation of difference’⁶¹. Further, he posits that when attempting to conduct a comparison with foreign law, the purpose of the

⁵⁷ Harold Gutteridge, *Comparative Law* (2nd edn., London, Cambridge University Press 1949), reprinted (London, Wildy & Sons 1974) 73; Zweigert and Kötz (n 53) 33; see also Kamba (n 44) 511; see Palmer (n 56) 290; Esin Örüçü, ‘Methodological Aspect Of Comparative Law’ (2006) 8 *European Journal Of Law Reform* 29. However, some comparative legal scholars claim that it is reductive to talk of a variety of comparative law methodologies while comparative law itself is a method: Hans Baade, Peter Herzog and Edward Wise, ‘The Comparative Method’ in Schlesinger R, *Comparative Law: Cases-text-materials* (6th edn., New York, Foundation Press 1998).

⁵⁸ See Ralf Michaels, ‘The functional Method Of Comparative Law’ in Reimann M and Zimmermann R (eds) *The Oxford Handbook of Comparative Law* (Oxford, Oxford University Press 2006) 339, 341. Other types of method are evolutionary, structural, thematic, empirical and statistical comparisons, see Palmer (n56) 263.

⁵⁹ Palmer (n56) 263.

⁶⁰ Pierre Legrand, ‘How To Compare Now’ (1996) 16 (2) *Legal Studies* 235.

⁶¹ Pierre Legrand, ‘The impossibility of legal transplants’ (1997) 4 *Maastricht Journal of European & Comparative Law* 123, 123-124.

comparison must be to criticise one's own law, not to propose a reform of the foreign law, as each legal culture is untranslatable and irreplaceable⁶².

Seemingly, this view suggests total incommensurability and thus incomparability between different legal cultures⁶³. It is derived from Legrand's observation that legal systems in Europe are not converging⁶⁴. Nonetheless, giving due attention to socio-cultural and traditional consideration of law, does not preclude comparisons between different legal systems⁶⁵. Moreover, the focus on differences rather than similarities appears to be non-neutral whereas a balanced comparison should examine both the difference and the sameness in the given jurisdictions. From a methodological point of view, cultural comparison has little to offer for the comparative researcher, given that it is mainly concerned with the differences and uniqueness of each legal culture.

Critical comparison, developed by Gunter Frankenberg, is another strict approach in comparative law. Frankenberg's theory is concerned with questioning why law should be studied comparatively⁶⁶, in addition to asking how the comparison should be made⁶⁷. Consequently, his approach dismisses the presumptions of the universality, necessity and functionality of law, and focuses on applying comparative law for the critique of law. The main weakness of the Critical School is that it diverts the attention of the comparative researcher from comparing laws of the given systems to comparing their cultures, history and politics⁶⁸. Frankenberg's view is that attempts to compare different systems are 'bound to fail'

⁶² *ibid.*

⁶³ See Anne Peters and Heiner Schwenke, 'Comparative Law Beyond Post Modernism' (2000) 49 (4) *International and Comparative Law Journal* 800, 802.

⁶⁴ See Pierre Legrand, 'European Legal Systems Are Not Converging' (1996) 45 *International & Comparative Law Quarterly* 52-58; Pierre Legrand, 'The Return Of The Repressed: Moving Comparative Legal Studies Beyond Pleasure' (2001) 75 *Tulane Law Review* 1033.

⁶⁵ Olivr Brand, 'Conceptual Comparisons: Towards A Coherent Methodology Of Comparative Legal Studies, (2006) 32 *Brooklyn Journal of International Law* 405, 431-432; see also Palmer V (n 56) 266.

⁶⁶ Gunter Frankenberg, 'Critical Comparison: Rethinking Comparative Law' (1985) 26 *Harvard Law Journal* 411, 416.

⁶⁷ Jaakko Husa, 'Farwell To Functionalism Or Methodological Tolerance?' (2003) 67 *Rabels Zeitschrift für ausländisches und internationales Privatrecht* 15 < <http://ssrn.com/abstract=1488669>>, accessed 3 October 2011.

⁶⁸ Gunter Frankenberg, 'Stranger Than Paradise: Identity And Politics In Comparative Law' (1997) 2 *Utah Law Review* 259; David Kennedy, 'New Approaches To Comparative Law: Comparativism And International Governance, (1997) 2 *Utah Law Review* 545.

unless the researcher is aware that each society is ‘shaped and dominated by a grid of concepts, research techniques, professional ethics, and politics, by which the prevailing culture imposes on the individual scholar its canons of how legal scholarship is conducted’⁶⁹. Importantly, while Frankenberg’s critical approach provides some useful guidelines in analysing conventional comparative studies, thus reducing their explanatory power, it fails to provide a viable alternative for solid comparative research. The three step analysis approach introduced by him cannot be considered a fully fledged framework, because it is grounded within the Critical Legal Studies approach, which lacks the theorising tools⁷⁰.

It is clear that the cultural and critical approaches are influenced by the assumption of ‘difference’ and ‘uniqueness’⁷¹. Both views exaggerate the examination of deep cultural-political and moral structures of the compared legal systems and oppose the idea of the convergence of law, and therefore come to the result of incommensurability of laws. Moreover, both of them lack a well developed theory that can be successfully applied within the comparative law framework. One may view such approaches as strict and odd, as they oppose the desirable and possible attempts at unification and development of laws. Peters and Schwenke argue that, according to postmodern approaches⁷², legal comparison is ‘trapped’ in ‘inescapable and incommensurable epistemic, linguistic, cultural and moral frameworks’ that determine language, reasoning, and judgment⁷³. Therefore, the irreducible differences lead to ‘*incommensurability*’ between different cultures⁷⁴. Thus, an approach which creates as many obstacles as possible to legal comparison and sees any comparative attempt as a futile⁷⁵, and

⁶⁹ *ibid* 270

⁷⁰ See Guyora Binder, ‘Critical Legal Studies’ in Patterson D (ed) *A Companion To Philosophy Of Law And Legal Theory* (Oxford: Blackwell Publishing 1999) 280–82, where the Critical Legal Studies approach is analysed and criticised.

⁷¹ Brand (n 65) 433.

⁷² In general, the post-modernist perspective welcomes the experience of plurality and difference as a basis of knowledge. It argues that there are many different forms of knowledge, behavioural patterns, and systems of morality, further noting that their discordance is inevitable and absolute. For more on post-modernism see Elizabeth Ermarth, ‘Postmodernism’ in Craig E (ed) *Routledge Encyclopedia Of Philosophy* (New York, NY, Routledge 1998) 587.

⁷³ Peters A and Schwenke H (n 63) 802.

⁷⁴ *ibid*.

⁷⁵ *ibid*.

which does not leave much hope for the comparative researcher⁷⁶, is unacceptable. If the researcher is driven by the ideas of the ‘convergence of law’ and the possibility of ‘transplants of legal solutions’, he or she would do better to explore alternative flexible approaches.

While not detracting from the validity of those two approaches for specific purposes, the researcher has chosen *Functionalism* as the methodology for this study. As will be shown below, the nature of the comparison being undertaken prompts the use of such a method, as it is apt for comparing between various legal jurisdictions at the micro-level. Furthermore, it is an appropriate methodological tool where the harmonisation and modernisation of private law is the purpose of the comparison⁷⁷. Recently, however, the critical comparative law literature has featured reservations about the functional approach. Some scholars have called for the creation of a new orientation to make the functional comparative approach more realistic and reliable⁷⁸. The primary issue of contention is that functionalist comparative researchers should look beyond law to consider non-legal factors affecting legal rules and institutions. Part of this concern is related to the postulate of functionalism that the practical results of the comparison must be similar in the given jurisdictions. It has, therefore, been recommended that to allow for more rigorous, broader and realistic comparisons through functional analysis, the inherent social, political and economic contexts of law must be taken into account. These issues will be discussed further in the following sections.

2.3. Functionalism in Comparative Law

The functional approach can be considered one of the most dominant approaches in comparative law⁷⁹. At the core of functionalism are the premises that: 1) countries face similar social problems; 2) countries make laws to resolve these problems; 3) despite differences in laws, they work towards a solution of the problems⁸⁰. According to Zweigert

⁷⁶ Husa (n 67) 15.

⁷⁷ Zweigert and Kötz (n 53) 45; Henry Hansmann and Ugo Mattie, ‘The Function Of Trust Law: A Comparative Legal And Economic Analysis’ (1998) 73 *New York University Law Review* 434; Reiner Kraakman, Paul Davis, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda and Edward Rock *The Anatomy Of Corporate Law: A Comparative And Functional Approach* (Oxford University Press 2004).

⁷⁸ Palmer (n 56), Michaels (n 58) and Husa (n 67).

⁷⁹ Mathias Reimann, ‘The Progress And Failure Of Comparative Law In The Second Half Of The Twentieth Century’ (2002) 50 *American Journal of Comparative Law* 671, 679; Michaels (n 58).

⁸⁰ Zweigert and Kötz (n 53) 48-62.

and Kötz, each comparative study starts from the question of whether a better solution to a concrete problem can be achieved than the one existing under the country's legal system⁸¹. This solution can be sought in other legal systems. This, in turn, requires the study of similarities and differences between the rules and institutions in these systems⁸². Consequently, three main elements are indispensable for functional comparison: the universality of the social problems in different societies; the similarity of function of legal rules and institutions to each problem; and the functional equivalence between the rules and institutions in given legal systems.

The significance of the functional approach can be witnessed in various comparative law projects. For example, it can be used to serve the purpose of harmonization and modernization of laws whether regionally or worldwide⁸³. If the comparative researcher aims to unify different legal rules of different jurisdictions, the functional method plays a decisive role in the harmonization and unification process. For unifying private law, for instance, it is helpful to use the functional approach when comparing different legal systems such as common law and civil law on topics related, for example, to trust law⁸⁴.

Functionalism is the most appropriate method to be adopted in this study for several reasons. First, functionalism presupposes the universality of social problems across different systems and therefore supports the idea of the 'convergence' of law⁸⁵. Second, it is an effective method if the purpose of the study is to primarily concentrate on law as rules (micro-level comparison)⁸⁶. Third, the functional approach suggests a frontier between legal norms, rules,

⁸¹ *ibid* 34.

⁸² *ibid*.

⁸³ Kraakman and others (n 77). By comparing the legal systems of five countries – France, Germany, Japan, the UK and the USA – the authors found that their legal systems addressed the same problem of the corporate conflicts of interest but in different ways.

⁸⁴ Hansmann and Mattie (n 77). In this regard, Michaels argues that a functionalist comparison between common law and civil law is possible for two reasons: first, it overcomes the 'epistemic/doctrinal difference' between both systems by declaring it functionally irrelevant. Second, the common law with its organic development should be particularly apt for functional understanding, and then one can see the influence of the functional method because it concentrates on legal institutions from the common law and their functional equivalence in the civil law. The same can be said about the functional comparison between socialist and capitalist legal systems. See Michaels (n 58).

⁸⁵ Zweigert and Kötz (n 53) 34.

⁸⁶ Michaels (n 58) 341; Örüçü emphasized that, 'When 'law' is regarded as a body of rules only and comparison at the micro-level is directed at these rules, then the functional approach is useful, since a body of rules is created for the purpose of solving human problems, most of which are shared' Esin Örüçü, 'Methodology Of

and principles on the one hand and a set of factual situations on the other⁸⁷. Fourth, it studies the similarities and differences between the compared rules and institutions⁸⁸. Fifth, it serves the purpose of the present research which aims at developing the law related to directors' duties towards company property in Saudi Arabia. Sixth, by adopting this approach comparability will be achieved, since the essence of functionalism is that foreign solutions are comparable if they deal with a common challenge⁸⁹. Accordingly, functional comparative analysis will be adopted as the method for this study. Nevertheless, some concerns about this method have been expressed by recent critical comparative scholarship.

2.3.1 Concerns Regarding Functionalism and Application of Other Theories

While functionalism is one of the most popular research tools in a Comparative Law context, a number of methodological limitations have created a strong wave of criticism regarding its approach⁹⁰. This criticism mainly comes from three directions: 1) the failure of this approach to extensively examine social, economic and political dimensions of law; 2) the assumption of the universality of social problems in different legal systems; and 3) the presumption of the similarity of legal solutions in the compared legal systems. The following sections examine each of the criticisms and discuss how they can be resolved by applying other relevant theories.

2.3.1.1 Functionalism and the Socio-Cultural Considerations of Law

The opponents of pure functionalism criticise the ignorance of this method when considering the social dimensions of law. They urge that comparative research must look beyond the mere

Comparative Law' in Smits J (ed), *Elgar Encyclopaedia Of Comparative Law* (Edward Elgar Publishing 2006) 447-449

⁸⁷ Geoffrey Samuel, 'Epistemology And Comparative Law: Contributions From The Sciences And Social Sciences' in Hoecke M (ed) *Epistemology And Methodology Of Comparative Law* (Oxford, Hart Publishing 2004) 41.

⁸⁸ Zweigert and Kötz (n 53) 43.

⁸⁹ Michael Graziadei, 'The Functionalist Heritage' in Legrand P and Munday R (eds), *Comparative Legal Studies: Traditions And Transitions* (Cambridge, Cambridge University Press 2003) 100.

⁹⁰ See Michaels R (n 58) 352-355: for certain prominent comparative law scholars, functionalism represents everything bad regarding mainstream comparative law, so there is a call for a more 'methodologically aware functionalism'. Also see Annelise Riles, 'Wigmore's Treasure Box: Comparative Law In The Era Of Information' (1999) 40 *Harvard International Law Journal* 221 for the discussion of the need for new methods in comparative law because functionalism has 'exhausted' itself as a viable approach.

examination of ‘black letter law of code and statute’, ‘judicial decisions’ and ‘doctrinal writings’⁹¹. Instead, they suggest that in order to build a comparative framework adequately and reliably, and therefore to achieve a successful comparison, one must realise that law involves much more than just studying rules and institutions⁹². Thus a researcher will be required to account for the socio-cultural framework ‘to avoid ethnocentricity and superficiality’ and to ‘reach into the ill-defined region of ‘deeper structures’ where the law perhaps meets philosophy, sociology and social culture’⁹³.

It is true that functional comparison’s main concentration is on the legal rules and institutions at micro-level, and it seeks to list similarities and differences between the compared rules and institutions. However, it must be borne in mind that this focus, in a functional sense, does not limit the comparative study to legislative rules or judicial decisions only. According to Zweigert and Kötz, in order to reach the comparability of legal rules and institutions, functionalist comparative researchers must study them as a part of the socio-legal context and place them in an external comparative framework⁹⁴. Hence, by taking other non-legal contexts into consideration it will be possible to construct the function of legal rules, and therefore the comparability of different laws can be achieved⁹⁵.

There is no doubt that the socio-cultural environment should be seriously considered by comparative legal scholars, including those who undertake studies from a functionalist perspective. Granted, no analysis can be an all-encompassing feat, which takes into account every contextual factor. According to Tushnet, such an approach is almost unrealistic. At the same time, *ceteris paribus*, the more context factors are introduced into the analysis the greater the depth that is achieved and the more certainty that is produced in the inferences regarding the legal rules existing in the compared countries. It is, perhaps, wrong to think that the application of legal rules developed in foreign countries will fail in contrast to those that

⁹¹ Palmer (n 56) 266.

⁹² Pierre Legrand, ‘Uniformity, Legal Traditions And Law’s Limits’ (1996-1997) 2 *Juridisk Tidskrift* 306. According to Legrand, every comparative research must involve the investigation of a deep cultural structure. Mere concentration on legislative rules and court decisions, as he observes, is superficial work and yields nothing about the deep structures of the compared legal systems; also see Frankenberg (n 66) 411, 438: ‘There is nothing outside legal texts and institutions for functionalists’.

⁹³ Palmer (n 56) 266.

⁹⁴ *ibid*, see also Husa (n 67) 5.

⁹⁵ Husa (n 67) 9.

are developed within the society in question⁹⁶. On the other hand, it is equally wrong to claim that there are legal institutions and rules that would be applicable in any society. It follows then, that the functionalist scholars have to consider the appropriateness of each legal institution and rule for each country in the context of its socio-cultural factors. In other words, a nuanced analysis of the law's interaction with economic, social and political factors is preferred instead of a deterministic one-size-fits-all approach.

2.3.1.2 Assumption of the Universality of Legal Problems

Another point of criticism is functionalism's assumption that 'the legal system of every society faces essentially the same problems'⁹⁷. Central among these criticisms is the already mentioned culturalist view, which implies that each society has historically conditioned, deeply rooted views on the nature of law and the appropriate structure and operation of a legal system⁹⁸. Based on this view, it is contended that the rules of every legal system are rooted in local unique cultures, which are different from each other. Consequently, it is argued that unique cultures cannot face problems which are similar in nature. Opponents of the universality of social problems⁹⁹ have, however, failed to recognise the reality of this assumption. The shared social problem between the jurisdictions being compared is the theoretical starting point for the comparative researcher to build his comparative framework. The functional comparatist has to ensure that the social problem in the jurisdictions under comparison is common in order to build his/her theoretical analysis. Otherwise, it would be difficult for her/him to find similar functions and therefore, comparability between the selected legal systems for comparison will be unattainable¹⁰⁰.

⁹⁶ Mark Tushnet, 'Returning With Interest: Observations On Some Putative Benefits Of Studying Comparative Constitutional Law' (1998) 1 (2) University Of Pennsylvania Journal Of Constitutional Law 325, 333. The claim that legal borrowings are bound to fail is especially prominent among organicist scholars.

⁹⁷ Zweigert and Kötz (n 53) 34.

⁹⁸ Henry Merryam and David Clark, *Comparative Law: Cases And Materials* (London: Bobbs-Merrill 1978) 28.

⁹⁹ Pierre Legrand Claims That Universalism Does Not Exist In Different Socio-Legal Systems: see Legrand (n 64) 52-58; Legrand (n 64) 1033; Legrand (n 61) 111, 113; see also Gunther Teubner, 'The King's Many Bodies: The Self-Deconstruction Of Law's Hierarchy' (1997) 31 (4) *Law & Society Review* 763; Gunther Teubner, 'Breaking Frames: The Global Interplay Of Legal And Social Systems' (1997) 45 *American Journal Of Comparative Law* 149.

¹⁰⁰ Husa (n 67) 10.

Comparative scholars who propose the idea of ‘universalism’ and ‘convergence’ and oppose the idea of ‘incommensurability’ and ‘divergence’ agree on the same basis. Markesinis and Glenn emphasise that human beings and their societies share similar or even identical social problems. The reason for the universality of problems, as they see it, lies in human nature and the common social demands in different societies¹⁰¹. Gordly argues that different legal systems in the world today may be consistent with the same legal principles. Hence, they seem to respond to the same common problem with quite similar circumstances and provide different solutions to this social problem¹⁰².

Therefore, there is at least a certain amount of universality of social problems in various societies. In this study and through the forthcoming discussion, it will be shown that English and Saudi systems respond to the same problem even if they reach different legal solutions. The common problem in England and Saudi corporate environments is the exploitation of company property by directors. Both jurisdictions deal with this particular problem in order to protect the interests of the company from the misconduct of its board of directors and also to protect the interests of its shareholders as well as investors as a whole. However, the two jurisdictions each have their own approach to this problem. They may reach the same or different legal solutions, but this, theoretically, is not an important element. The most important theoretical element in functionalism is to assume that different societies face the same social needs and to ensure the functional equivalence of the legal rules and institutions under comparison that meet these needs¹⁰³.

2.3.1.3 Presumption of the Similarity of Legal Systems

The notion of ‘functional equivalence’ means that the rule in one legal system has its equivalent function in another¹⁰⁴. To put it another way, comparative researchers should find

¹⁰¹ Basil Markesinis, ‘Learning from Europe and learning in Europe’, in Markesinis B (ed) *The Gradual Convergence: Foreign Ideas, Foreign Influences And European Law On The Eve Of The 21st Century*, (Oxford University Press 1999) 1, 30; Basil Markesinis, ‘Why A Code Is Not The Best Way To Advance The Cause Of European Unity’ (1997) 5 *European Review on Private Law* 519, 521; Patrick Glenn, *Legal Traditions Of The World: Sustainable Diversity In Law* (Oxford University Press 2000).

¹⁰² James Gordley, ‘Is Comparative Law A Distinct Discipline?’ (1998) 46 (4) *American Journal Of Comparative Law* 607; James Gordley, ‘The Universalist Heritage’ in Legrand P And Munday R (eds) *Comparative Legal Studies: Traditions And Transitions* (Cambridge: Cambridge University Press 2003) 31-45; see also Michaels (n 58) 346.

¹⁰³ Michaels (n 58) 368-369.

¹⁰⁴ *ibid.*

the legal rule that functionally responds to the same social problem in the given jurisdictions. However, this presumption of similarity has been severely criticised as it indicates the contrary. De Cruz, even though one of the proponents of functionalism, claims that ‘... it is too much of a generalisation to suggest that there should be a presumption that the practical result will invariably be the same in every, or even most, legal systems’¹⁰⁵. Quite the contrary, the hardcore of the functional approach in comparative law does not agree with the idea of similarity; instead, it supports the idea of both similarities and differences¹⁰⁶.

The universality of a legal problem prompts the similarity of function of the compared legal rules and institutions to solve this problem. However, this does not mean that the practical results will necessarily be similar¹⁰⁷. On the contrary, the existence of the common problem requires the existence of functional equivalence between rules and institutions in the compared jurisdictions. This means that if there is no common problem between the compared societies, there will be no functional equivalence of legal rules and institutions and consequently, the comparison will be invalid. Therefore, the legal rules may seem similar with regard to the functions they fulfil, not in the similarity of solutions that they may propose. The solutions proposed by the compared legal systems may be similar or different, which does not affect the comparability between different legal systems. However, what does really matter is the functional equivalence of legal rules to solve the problem in question. Therefore, functionalism without the strict approach of ‘*Praesumptio Similitudinis*’ seems better¹⁰⁸ and this is what has led Kötz recently to confirm that this presumption is ‘a rebuttable presumption, and rebutted it must be when there is evidence for doing so’¹⁰⁹.

2.3.1.4 A Balanced Approach: Application of Other Theories

As seen above, functionalism in its pure and strict form is not the best approach for comparing legal systems of different countries. Considering the most common criticisms of functionalism, a number of comparative law scholars have been seeking new directions for

¹⁰⁵ Peter De Cruz, *Comparative Law In A Changing World* (London, Routledge-Cavendish 2007) 230.

¹⁰⁶ Husa (n 67) 6.

¹⁰⁷ Michaels (n 58) 369-372.

¹⁰⁸ Husa (n 67) 6; Palmer (n 56) 284; Michaels (n 58) 369-372.

¹⁰⁹ Hein Kötz, ‘The Trento Project and its contribution to the Europeanization of private law’ in Bussani M and Mattie U (eds) *The Common Core Of European Private Law* (London, Kluwer Law International 2003) 212.

functional legal comparison. They argue that, when using other methods, the functionalist will better understand and enrich his/her own method and therefore, a successful comparison, epistemologically and methodologically, may be reached¹¹⁰. One of the fast developing areas of law in this regard is Socio-Legal Studies, which promotes an interdisciplinary approach to law.

Socio-legal theory is based on the idea that the 'law operates in a social context, that many factors interacted in the development of legal rules, and that law, therefore, needs to be studied and understood mainly as a social phenomenon'¹¹¹. According to Banakar¹¹², socio-legal studies should not be confused with legal sociology scholarship, which is popular in the West and is built upon much stronger disciplinary ties of law with social studies. Rather, socio-legal studies are regarded more as a subfield of social policy that focuses on resolving the issues in law and developing theories about the policy process¹¹³. Considering the work that has been conducted within socio-legal studies in the past years, it is possible to distinguish two major approaches. Banakar referred to them as 'Studies of Law in Context' and 'Policy Research'¹¹⁴. Studies of Law in Context are conducted within the setting of social theory to represent the context in which law exists¹¹⁵. Policy Research, on the other hand, focuses on the way that law influences social conditions and behaviours¹¹⁶.

Importantly, socio-legal studies often focus on the gaps that exist between the intention of legislatures behind the laws and the reality of the application of such laws, as interpreted by the courts and legal officials. Fredman showed this in an example of ethnic discrimination,

¹¹⁰ Michaels (n 58) 342; also Palmer says 'a multiplicity of methods has been a source of enrichment in the best comparative law': see Palmer (n 56) 266.

¹¹¹ Werner Menski, *Comparative law in a global context: The legal systems of Asia and Africa* (Cambridge University Press, 2006) 163.

¹¹² Reza Banakar, 'Law Through Sociology's Looking Glass: Conflict And Competition In Sociological Studies Of Law' in Denis A and Kalekin-Fishman D (eds) *The New ISA Handbook In Contemporary International Sociology: Conflict, Competition, And Cooperation* (London, Sage 2009) 58-73.

¹¹³ Max Travers, 'Sociology Of Law In Britain' (2001) 32 *American Sociologist* 26-40.

¹¹⁴ Banakar (n 112) 69.

¹¹⁵ Sally Wheeler and Peter Thomas, 'Socio-Legal Studies' in Hayton D (ed) *Law's Future(s)* (Oxford: Hart Publishing 2002) 271.

¹¹⁶ Travers (n 113).

where the intent of the law did not match its real life applications¹¹⁷. Within the context of socio-legal studies, the law that is not applied in accordance with its original purpose is technically flawed¹¹⁸. Consequently, the notions of who interprets the law become as important as the law itself.

The focus of the current research was on the examination of legal rules and institutions while not neglecting the influence of socio-cultural factors on them. It comparatively analysed legal rules as enacted by the legislator, case law as created by the judiciary and scholarly writings as produced by scholars. It also took into account the plurality of legal rules and institutions prevailing in the legal systems of England and Saudi Arabia. It also attempted to uncover patterns of convergence and similarities as opposed to divergence and differences between the compared jurisdictions. The functionalism approach, combined with the Socio-Legal Studies, in this sense represents the most realistic and applicable methodological tool for Comparative Law research¹¹⁹.

2.3.1.5 The Study Process

The process of comparison proceeded in accordance with the process of functional comparative law as developed by Zweigert and Kötz while considering some helpful methodological means from Socio-Legal Studies. Specifically, the following steps were applied:

- 1) Justification of the comparative research by analysing the two legal systems under investigation with the goal of determining the points of convergence and divergence;¹²⁰
- 2) Introduction of the problem that both systems face;
- 3) Presentation of the systems' approaches to solving the problem in question;¹²¹

¹¹⁷ Sandra Fredman, *Discrimination And Human Rights: The Case Of Racism* (Oxford University Press 2002).

¹¹⁸ Banakar (n 112) 69.

¹¹⁹ See also Husa (n 67) 24.

¹²⁰ 'If we find that different countries meet the same need in different ways, we must ask why' Zweigert and Kötz (n 53) 44.

¹²¹ '...this may be sufficient where each of the jurisdictions gives a clear and easily comprehensible solution to the problem in question' Zweigert and Kötz (n 53) 43.

- 4) Conducting an inquiry into the similarities and differences between the legal systems as a pathway to solving the problem;
- 5) At the final stage, ‘the comparatist must proceed to a critical evaluation of what he has discovered’¹²².

These steps were applied in the current research. The first step involved the review of the English and Saudi Arabian legal systems and determined how the systems are similar and how they are different. Socio-cultural environment was considered in this step, due to its tremendous impact on the way that the law operates in both countries. Further, justification for the comparison of the two systems was provided. The second step involved the introduction of the common problem that the systems in both countries have to address by legal means: directors’ exploitation of corporate property. The third step in the research process presented the ways in which the English and Saudi legal systems regulated the duties of company directors towards corporate property. The fourth step introduced a comparative analysis of the approaches that both systems used for regulating the fiduciary duties of directors towards corporate property, and an assessment of their effectiveness. The final step in the analysis was the critical evaluation of the discovery and subsequent proposals for improving the regulations of the issue at hand in both legal systems. Table 1 provides an overview of the research process used in this research. The steps in the functional analysis in the table are matched with the corresponding chapters of the thesis, and the use of the Socio-Legal approach is indicated where it was applied.

¹²² *ibid* 46.

Table 1*The Research Process*

| Step in Functional Analysis | Corresponding Chapter of the Thesis | Application of Socio-Legal Studies Approach |
|--|-------------------------------------|---|
| Justification of the comparative research | Chapter 3 | Applied |
| Introduction of the common issue | Chapter 4 | Applied |
| Presentation of the legal approaches used to resolve the issue | Chapter 5, Chapter 6 | Applied |
| Analysis of the approaches used to resolve the issue | Chapter 7 | Applied |
| Discovery of the ways to improve the legal approaches | Chapter 7 | Applied |

2.4 Data Collection and Analysis

This research was based on legal materials from English and Saudi law, in general, and on the company law of England and Saudi Arabia, in particular. The data collection was conducted by using library-based resources and electronic sources. The library resources used in the thesis can be divided into two types: printed collections and online databases resources. The printed resources included primary and secondary materials. The primary sources included codes of law, written constitutions, and law reports. The secondary sources included textbooks, scholarly legal and non-legal journals, and other relevant published works.

The library of the School of Oriental and African Studies (SOAS) and the library of the Institute of Advanced Legal Studies (IALS) at the University of London as well as the official sites of Saudi Arabian Ministries were used to gather information about the legal and socio-cultural environment in Saudi Arabia. Due to the recent accession of the Kingdom to the World Trade Organisation (WTO), many official regulations and statutes are available on these sites in English. Consulting the relevant government departments in Saudi Arabia was conducted in cases where the documents in question lacked translation.

The analysis of the collected data was conducted using the deductive method: first the socio-cultural environments of both countries were reviewed to determine the major factors that influenced the applications of law. After that, the study looked into the specific sources of law regulating the fiduciary duties of corporate directors towards company property. The codified company law was the major focus of the analysis at this level, because of the possibility of introducing changes into it and its influence on company law in both countries in general.

This chapter reviewed the methodological approach to be applied in this study and introduced the sequential steps of the inquiry method. Following the introduced method, the next chapter accordingly presents the legal systems of England and Saudi Arabia and makes the case for their comparison.

Chapter Three: The Legal System of Saudi Arabia – Sources of Law, Authorities and Judiciary in A Comparative Perspective

3.1. Introduction

Comparative lawyers have always given special attention to the classification of the legal systems under comparison. They are particularly concerned with examining the sources of law of the chosen jurisdictions, before comparing the relevant rules and institutions or concepts¹²³. However, any comparison involving the sources of law presents special difficulties which are compounded if the compared systems have fundamental differences¹²⁴. Nevertheless, Zweigert and Kötz argue that in any comparison ‘...the comparatist must treat as a source of law whatever moulds or affects the living law in his chosen system, whatever the lawyers there would treat as a source of law, and he must accord those sources the same relative weight and value as they do...’¹²⁵.

The received wisdom is that every attempt to compare different legal systems, legal cultures or legal traditions should accord due cognisance to the relevant sources of law and legal institutions or concepts, otherwise such comparative studies may run into methodological quandaries¹²⁶. Examining sources of law within the chosen legal systems is beneficial from both theoretical and practical perspectives¹²⁷. Theoretically, the sources of law are a critical criterion to be applied when classifying the world’s legal systems into distinct legal families¹²⁸. In practical terms, knowing the sources of law helps the comparatist to understand which types of legal sources constitute the law under comparison, and therefore to

¹²³ Stefan Vogenauer, ‘Sources of law and legal method’ in Reimann M and Zimmermann R (eds) *The Oxford Handbook Of Comparative Law* (Oxford, Oxford University Press 2006) 871-876.

¹²⁴ Gutteridge (n 57) 73; Legrand (n 92) 306-318.

¹²⁵ Zweigert and Kötz (n 53) 35-36.

¹²⁶ John Merryman, *The Civil Law Tradition: An Introduction To The Legal Systems Of Western Europe And Latin America* (2nd edn., California, Stanford University Press 1985) ch IV-X; Peter Glenn, *Legal Tradition Of The World* (2nd edn., Oxford, Oxford University Press 2004) 61-176.

¹²⁷ Vogenauer (n 123) 871-876.

¹²⁸ As examined in the previous chapter, Zweigert and Kötz emphasise that the type of legal sources is an important factor to distinguish the given legal system, in addition to other important factors such as the historical development, a distinctive mode of legal thinking, and distinctive legal institutions. See Zweigert and Kötz (n 53) 68-73; see also Vogenauer (n 123) 872-874.

be able to find a solution to the challenges at hand, whether in case-law, codes or other types of sources¹²⁹.

According to the methodological approach chosen for this study¹³⁰, the second step in the inquiry is to prepare a report on the legal systems under comparison. The report is often divided into three main parts: the sources of law, legal methodology, and the legal concepts or institutions of each legal system. According to the classification of legal families, English law is classified under Common law, while Saudi law belongs to Islamic law. Taking into consideration that the English legal system is well-researched and understood, this chapter focuses on the sources of law, legal authorities, and judiciary in Saudi Arabia with references to English law, where appropriate, to demonstrate similar features or differences between the legal systems of the two countries.

3.2. The Legal System in The Kingdom of Saudi Arabia

For the majority of western societies, the legal system of Saudi Arabia is quite enigmatic. Some would argue that the nature of law in this country seems inconsistent and reflects the conflict between traditions and modernity¹³¹. The same difficulty is seen also in understanding the legal system of most Islamic countries, as it is seen as a complex family of laws rather than one single legal system¹³². However, others claim that Islamic law is capable of meeting the demands of societies in different aspects of life whether social, political, economic or legal, and therefore is amenable to modernity and globalization¹³³. Glenn, for instance, opines that ‘while globalization has been going on above, Islamic law has been expanding on the ground’¹³⁴. In any case, Islamic Law should represent a genuine interest for

¹²⁹Vogenauer (n 123) 872.

¹³⁰ See Chapter 2 for discussion on functional comparison and socio-legal studies.

¹³¹ Carolyn Ruis, ‘Legal Practice Shaped By Loyalty To Tradition: The Case Of Saudi Arabia’ (1985) 7 *Michigan Year Book of International Legal Studies* 107.

¹³²Menski (n 111) 279-283; Hossein Esmaeili, ‘On A Slow Boat Towards The Rule Of Law: The Nature Of Law In The Saudi Legal System’ (2009) 26 (1) *Arizona Journal of International and Comparative Law*, 26.

¹³³ Anderson JND, ‘The Significance Of Islamic Law In The World Today’ (1960) 9 *American Journal Of Comparative Law* 187-198; Glenn (n 126) 51; Sam Souryal, ‘The Religionization Of Society: The Continuing Application Of *Shariah* Law In Saudi Arabia’ (1987) 26 *Journal For The Scientific Study Of Religion* 429; Howard Stovall, ‘Arab Commercial Law: Into The Future’ (2000) 34 *International Law* 839; Ben Abderrahman, ‘A Contribution To The Study Of The Qur’anic Sources Of Saudi Arabian Business Law’ (1988) 3 *Arab Law Quarterly* 132.

¹³⁴ Glenn (n 126) 51.

a comparative lawyer due to its unique nature, distinct sources of law, different structure and legal methodology.

Islamic law, or *Shariah*¹³⁵, is based on rules and provisions embodied primarily in the *Qur'an* and the customary traditions of the Prophet Muhammad, the *Sunnah*. There are also supplementary sources of law, such as the *Ijma* and *Qiyas*. Finally, due to evolving developments in the laws of the Kingdom, government-issued laws have been gaining ground in the areas where the primary and supplementary religious sources fail to provide clear explanations. This chapter proceeds by examining the primary and secondary sources of *Shariah* law first. Further, it examines the modern sources of law that have an influence on the contemporary Saudi legal system. Then it moves on to shed some light on the authorities of the state and illustrates the most recent developments. The entire discussion is conducted with the elements of a comparative analysis: where appropriate, parallels with the English legal system are drawn.

3.2.1 The Sources of Law

The sources of law in Saudi Arabia can be classified into three categories: primary, secondary and ancillary:

- 1) Primary sources are the main binding sources in Saudi law which comprise:
 - a) The *Qur'an*: the book of God; and
 - b) The *Sunnah*: the tradition of His Prophet
- 2) Secondary sources are those which are seen as supplementary to the primary sources and have varying degrees of applicability. They consist of:
 - a) *Ijma* (the consensus of Muslim jurists)
 - b) *Qiyas* (judgement upon juristic analogy)
- 3) Ancillary sources comprise:
 - a) Regulations: enacted by government;

¹³⁵ The general term for law in Arabic is *Shariah*, which means 'the path or way which God wishes for men to follow'. See Glenn P (n 126) 173.

- b) Borrowed laws: the laws that have been developed by other countries, usually developed ones, and adopted by Saudi law.

3.2.1.1 The Primary Sources of Law: the *Qur'an* and the *Sunnah*

As Saudi Arabia is an Islamic state, in fact the birth place of Islam, the Islamic tradition is the basis for its social, political and legal systems. Its legal system is *Shariah* which is primarily based on two sources: the *Qur'an* and the *Sunnah*. Article 1 of the Basic Law of Governance 1992, states that 'the religion of the kingdom of Saudi Arabia is Islam; its constitution is the Book of God Most High and the *Sunnah* of His Prophet, May God bless him and give him peace'¹³⁶. Article 7 of the same regulations lays down that the rule in the kingdom of Saudi Arabia draws its authorities from the Book of God Most High and the *Sunnah* of his Prophet. These two are sovereign over this regulation and all regulations of the state¹³⁷.

The *Quran*¹³⁸, the speech of God revealed to the Prophet Mohammed fourteen centuries ago, is considered as the first and the most important source of law in the Islamic legal system. It contains more than 6,200 verses organized in 30 chapters that cover every aspect of life. Approximately eight hundred of the verses concern a range of issues, such as moral, ethical, criminal, social, political and economic matters. The most relevant to this study are the regulation verses related to financial matters, business activities, commerce and trust¹³⁹.

For Muslims, the law of God is the supreme legislation, and the *Quran* is 'the real law'¹⁴⁰. Allah says in the *Qur'an*: 'obey God and obey His Prophet'¹⁴¹ and also 'take what the

¹³⁶ The Basic Law of Governance of Saudi Arabia, 1 March 1992. In fact, prior to the passing of this law, Saudi Arabia had no written constitution, the same as in England. Since 1 March 1992, however, the kingdom can be characterised as one of the countries which have a written constitution in a recognisable modern form, such as in France and Germany. For further information, see Ali Almehaimeed, 'The Constitutional System Of Saudi Arabia: A Conspectus' (1993) 8 Arab Law Quarterly 30.

¹³⁷ *ibid.*

¹³⁸ The meaning of '*Qur'an*' is 'reading' and the first revealed verse of the *Qur'an* starts with the word (*eqra'a beism rabik*) which means 'Read in the name of your Lord', the *Qur'an* (96:1).

¹³⁹ These verses contain provisions that regulate different legal aspects. Some of them are related to civil and commercial transactions such as civil and commercial contracts, sales, loans, leases and mortgages. Some were revealed to deal with criminal issues and punishments such as murder, robbery, adultery, highway robbery and false accusation. Some others concern marriage, divorce, revocation, maintenance, dowry, custody of children, fosterage, paternity, inheritance and bequests. Additionally, some were revealed to repeal objectionable customs, such as gambling, usury, infanticide and unlimited polygamy. For further information, see Mohamed Kamaly, *Principles Of Islamic Jurisprudence* (The Islamic Texts Society 2003) 26.

¹⁴⁰ Menski (n 111) 283.

Messenger assigns to you, and deny yourselves that which he withholds from you'¹⁴². It is explicit, therefore, in the *Qur'an*, that the word of God is to be treated in the same way as the word of the Prophet, which is described in the *Sunnah*.

The *Sunnah* literally means the traditions and the spoken words of the Prophet Mohammed received through his companions and then transmitted from generation to generation¹⁴³. This source includes approximately thirty thousand *Hadiths* (Narrations) from the anecdotes, acts and sayings of the Prophet during his lifetime¹⁴⁴. The prophetic *Sunnah* plays an important role in Islamic jurisdiction as it is considered as the main interpreter of the passages of the *Qur'an* and elaborates or explains other verses of it. The Prophet, as a recipient of the divine law and as Head of the early Islamic community, acted as a guide and an interpreter of the *Qur'anic* concepts and textual principles. In addition to this interpretative role, the significance of the *Sunnah* lies in playing a legislative role where the *Qur'an* provides no clear provision regarding a particular case. This authority was given by God to His Prophet, as the Prophet was the legislator, ruler, judge and leader of the early Islamic community¹⁴⁵. Amongst all Muslims, including Saudis, the Prophet's practices, actions and way of life are seen as a model to be followed in all ways of life.

The *Qur'an* and the *Sunnah* are divine legal rulings and the primary sources of legal rights and duties. The *Qur'an* is seen by Muslims as much more than human-made law in codes such as the case of *Napoleonic* code of law or in case law developed by the notion of *stare decisis*¹⁴⁶. It is, rather, revealed as a comprehensive guidance for a Muslim's life, and as an

¹⁴¹ The *Qur'an* (5:92)

¹⁴² The *Qur'an* (59:7)

¹⁴³ It should be noticed that the transmission of the *Sunnah* must be followed by very strict criteria and requirements that have been set by leading Muslim jurists (*Ulama*).

¹⁴⁴ The prophet's sayings and actions (the *Sunnah*) have been edited and published in a number of publications and several volumes called books of *Hadith* (Narration). The most important of these books are: *Sahih Bukhary* and *Sahih Muslim*, and each book is named after the jurist who compiled it. There are other famous books of *Hadith*, such as *Almusnad*, *Tirmidi* and *Abu Dawod*.

¹⁴⁵ Menski (n 111) 284.

¹⁴⁶ Menski (n 111) 284; Nicholas Foster, 'Islamic Commercial Law: An Overview (I)' (2006) 3, <<http://www.raco.cat/index.php/InDret/article/viewFile/122208/169328>>, accessed 3 October 2011.

ethical, moral and legal code that ‘covers every aspect of life and every field of law: international, constitutional, criminal, civil, family, personal, and religious’¹⁴⁷.

It has been observed that the main difference between the primary sources of Western law and *Shariah* law is as follows. The Western view of the content of law holds that the law is made by ‘legislators, judges and other social forces’, and hence secular, and considered as a response to the needs for regulating different social, political and legal issues in a particular society¹⁴⁸. *Shariah* law, however, is considered divine in nature and, therefore, *immutable*¹⁴⁹. This view starts from a proposition that this law was given by God, and it reflects His intention rather than the intention of any earthly law-maker¹⁵⁰. It was revealed to regulate every single issue in society; and, therefore, society must adapt itself to it rather than creating its own laws. From a conservative Islamic view, rulers, leaders and judges must apply this law and never resort to any human source of law where Islamic rules exist. However, if no definite guidance or clear provision about a particular legal matter is found within the *Qur’an* and the *Sunnah*, supplementary sources of law, namely the *Ijma* and *Qiyas*, can be used.

3.2.1.2 The Secondary Sources of Law: the *Ijma* and the *Qiyas* ¹⁵¹

Although it is believed that divine revelation covers the totality of human life, its full content needs to be extracted, understood and interpreted clearly and correctly by human effort. The Prophet was the only man who had the privilege to understand the intention of God directly and to act primarily as an interpreter of the words of God on one hand, and as the legislator for the Islamic community where the *Qur’an* remains silent, on the other¹⁵². While the Prophet faithfully fulfilled this role during his life, since his death Islamic scholars have had to continue ascertaining legal rules and interpreting the intention of the divine law and

¹⁴⁷ JND Anderson, ‘Law As A Social Force In Islamic Culture And History’ (1957) 20 Bulletin of the School of Oriental and African Studies 14.

¹⁴⁸ Harold Berman and Samir Saliba, *The Nature And Function Of Law* (New York, NY, Foundation Press 1972) 6-7; see also Zweigert and Kötz (n 53) 304.

¹⁴⁹ Zweigert and Kötz (n 53) 304.

¹⁵⁰ *ibid.*

¹⁵¹ There are other additional sources of law that can be referred to as Subsidiary sources, such as; *Qawl Alsahabi* (decision of a companion), *Istihsan* (equity in Islamic law), *Istishab* (legal presumption) and *Urf* (local custom). On secondary sources of the Islamic legal system, see generally Mohamad Kamil, *The Beginning Of Islamic Legislation* (Amman, Dar Althaqafah, 1989) 45-130.

¹⁵² Menski (n 111) 294.

turning it into ‘living law’. The primary sources of law may not be very clear or may not answer all legal questions directly and in detail. Instead, they give a broadly guiding legal framework. Hence, Islamic jurists have to find the answer within the primary sources of guidance. However, they do not attempt to create new rules but rather to discover, understand and interpret ‘the law which already exists’¹⁵³. This effort can be practised through the principles of either *Ijma* or *Qiyas*.

The *Ijma* means the ‘unanimous agreement of Muslim jurists’ on a particular matter, in any period following the death of the Prophet Mohammed¹⁵⁴. During the Prophet’s lifetime there was no place for any human-made endeavour as the only applicable sources were the *Qur’an* and *Sunnah*, while the Prophet was the community leader and the administrator of justice who applied, decided and interpreted legal rules. However, since his passing, it is clear that the *Qur’an* and the *Sunnah* do not always directly address certain aspects of human life. In this case, the consensus of Islamic scholars over a given issue became another important source of law. The *Ijma* is not available in resolving a potential problem, but rather for those that have arisen at a particular time¹⁵⁵.

The contributors to the *Ijma* are usually scholars who have knowledge of *Shariah* law and are expected to understand the provisions of the *Qur’an* and the *Sunnah* and, therefore, be able to reach a decision or solution for the problem in question. The validity of the *Ijma* is determined by strict and rigorous requirements. First, the *Ijma* must be in strict accordance with the principles of the primary sources of law. Second, the decision must be approved by the majority of the relevant scholars at the time of deciding the legal issue¹⁵⁶.

In contemporary Saudi Arabia, the *Ijma* can be witnessed in the role shared by the members of the Council of Ministers and the Consultative Council¹⁵⁷. Among other powers, these two

¹⁵³ Zweigert and Kötz (n 53) 304.

¹⁵⁴ Kamaly (n 139) 169; see also Umar Moghul, ‘Approximating Certainty In Ratiocination: How To Ascertain The *Illah* (Effective Cause) In The Islamic Legal System And How To Determine The *Ratio Decidendi* In The Anglo-American Common Law’ (1999) 4 *Journal of Islamic Law* 137.

¹⁵⁵ Carol Childress, ‘Saudi Arabian Contact Law: A Comparative Perspective’ (1990) 2 *Saint Thomas Legal Forum* 69, 73.

¹⁵⁶ James Brand, ‘Aspects Of Saudi Arabian Law And Practice’ (1986) 9 (1) *Boston College International & Comparative Law Review* 1, 4.

¹⁵⁷ The legislative authority in Saudi Arabia will be examined below.

councils have the authority for regulating and reforming the laws in the Kingdom. Hence, any decision or any regulation to emerge from these councils should be treated as an *Ijma* of scholars and therefore as binding. The role of the *Ijma* can be understood from the perspective of Western law-making as well. For example, Parliament, as a legislative body in England, has to provide consent to a given law or decision before it is approved and comes into force as law. This is simply the *Ijma* as applied in *Shariah* law.

Qiyas (analogical reasoning) is another supplementary source of law in Saudi Arabia. *Qiyas* may be best defined as ‘equivalence between a novel case and a principal case in respect to a rule-occasioning factor [illah] gleaned from a rule governing the principal case’¹⁵⁸. This principle holds that where there is no clear indication about a legal issue within the primary sources, the judge, by using analogical reasoning may look to the entire law, applying the most appropriate rule to the case at hand. *Qiyas* can be practised by the method of ascertaining the *Illah* (effective cause) of any given legal rule or case and applying it to the new case. The *Illah* may be defined as the reason for which a particular rule is believed to have been established by a law-giver¹⁵⁹.

Interestingly, *Qiyas*, through ascertaining the *Illah* or effective cause, is almost identical to the legal reasoning in common law, through determining the *ratio decidendi* of a case; although there may be differences between them in respect of the pillars and criteria of the decision making process¹⁶⁰. In both jurisdictions, the judge has a practical role in promulgating legal determinations more than in other legal systems in the world. The common law judge applies the law to the case before him by examining the relevant previous case law, determining its *ratio decidendi* and applying the *ratio* analogically to reach his decision. Likewise, the *Shariah* judge in Saudi Arabia has a similar practical role which arises in situations where he is not able to find a clear answer in *Shariah* law for the matter at

¹⁵⁸ For more discussion on the definition and elements of *Qiyas*, see Hassan A, ‘Analogical reasoning in Islamic jurisprudence: A study of the judicial principle of *Qiyas*’ (1986) 169 *Journal of Islamic Law* 94-121.

¹⁵⁹ Sherman Jackson, *Islamic Law And The State: The Constitutional Jurisprudence Of Shihab Al-Din Al-Qarafi* (New York, NY, Brill 1996).

¹⁶⁰ Moghul (n 154) 198.

hand. The law permits the judge to look beyond the primary sources and reach a determination by using *Qiyas*¹⁶¹.

The *Qiyas*, much like *ratio decidendi*, has a significant practical role as it gives the judge or Islamic scholar the right, in fact the obligation, to extract, interpret and apply legal provisions. This can be performed through the implementation of the doctrine of *Ijtihad* (personal reasoning or endeavour). This doctrine can be defined as ‘the method of seeking to establish a proper legal opinion by Islamic jurists, based on the interpretation of the *Qur’an* and the *Sunnah*’¹⁶². While some scholars see *Ijtihad* as a source of law added to the secondary sources of *Shariah* law, most Islamic scholars consider it as a legal method or technique in ascertaining and interpreting the law rather than an acknowledged source of law¹⁶³. As is the case in English jurisdiction, in *Sharia* law the purpose of interpretation is to discover the main intention of the legislator in respect of what has not been expressed clearly, as a matter of necessary inference from the surrounding circumstances¹⁶⁴.

The above are seen as mechanisms used by scholars to interpret and derive law from the primary sources. It is therefore significant to note that the *Ijma* and *Qiyas* must be reached in accordance with the Islamic principles contained in the main two sources; otherwise they will not be accepted as valid sources. In addition, to interpret and ascertain legal rules it is necessary for the interpreter to obtain the necessary knowledge in order to be qualified to

¹⁶¹It is also interesting to note that, while reviewing the historical link between common law and Islamic law, Makdisi (1999) finds another relationship between common law and Islamic law. He maintains that several legal institutions in English common law may have been adapted from legal institutions and jurisprudence of medieval Islamic law. He argues that these legal institutions and principles of Islamic jurisprudence were introduced into England after the Norman Conquest, in the twelfth century, and are inherited from the then applied Islamic legal administration in the Emirate of Sicily. He continues: ‘The study of the characteristics of the function and structure of Islamic law demonstrate its remarkable kinship with the common law in contrast to the civil law.... one cannot forget the opportunity for the transplant of these mechanisms for Islam through Sicily to Norman England in the twelfth century. Motive, method, and opportunity existed for King Henry II to adopt an Islamic approach to legal and administrative procedures’. Makdisi observes that there are certain legal principles shared between common and Islamic law traditions, particularly in the area of contract law and property law. These principles still apply in modern English and Islamic law. He concludes that these principles have no precedent in any Western legal system prior to the twelfth century and it seems inconceivable that this rule should have appeared suddenly in England without any precedent. John Makdisi, ‘The Islamic Origin Of The Common Law’ (1999) 77 North Carolina Law Review 1638. See Also, Aron Zysow, ‘The Problem Of Offer And Acceptance: A Study Of Implied-In-Fact Islamic Law And The Common Law’ (1985) 34 Cleveland State Law Review 69.

¹⁶² Ibrahim Almarzouqi, *Human Rights In Islamic Law* (Abu Dhabi, Dian 2000) 44.

¹⁶³ Childress (n 115) 72.

¹⁶⁴ Kamaly (n 139) 17.

clearly understand the legal texts provided in both of them. In the Kingdom, the interpretation of the divine sources is done through the ‘Supreme Council of Senior Ulama¹⁶⁵ (a government body of religious scholars), those who possess a knowledge of Islamic jurisprudence (*Fiqh*)¹⁶⁶. These scholars are responsible for maintaining *Shariah* law in its pure form by deducing and interpreting the law according to the *Hanbali* school, the school of interpretation in the kingdom¹⁶⁷.

3.2.2 The Legislative Authorities in Saudi Arabia

3.2.2.1 The Role and Treatment of Secular Law

From the Islamic perspective, *Shariah* is an applicable and a comprehensive law that covers all aspects of human life in all times and all places¹⁶⁸. Hence, in this law there is significant restriction on innovation, which is to be rejected if it is not based on a traditional textual source of Islamic principles. However, as a result of globalisation and the pressing need for legal development, the *Shariah* legal system has had the flexibility to consult and even ‘import’ any legal rule complementary to it which deals with any legal matter where the Islamic sources of law provide no answer. This follows the fact that, while conforming to the primary sources and the principles contained in *Shariah*, Saudi Arabia is attempting to harmonise the principles of *Shariah* law with social, economic and legal development by evolving a form of legal system capable of meeting the needs of modern demands¹⁶⁹. Similar to England and other nations in the globalised world, Saudi Arabia has had, and continues to face, the challenge of social, economic and political realities. It is, therefore, attempting to develop the law and to move forward to meet these challenges by passing regulations or

¹⁶⁵ This council was established by Royal Order no. A/137 in 1971

¹⁶⁶ Abdullah Ansary, ‘A Brief Overview Of The Saudi Arabian Legal System’, (*GlobaLex*, 2008), available at http://www.nyulawglobal.org/globalex/Saudi_Arabia.htm, accessed 11 October 2011.

¹⁶⁷ In Islamic law, there are four (Orthodox) schools of jurisprudence: *Hanafi*, *Shafie*, *Maliki* and *Hanbali*. Each of these schools is named after the founding jurist who lived during the first few centuries after the Prophet’s death. The *Hanbali* school is found in Qatar and Saudi Arabia. It follows a fundamental interpretation of the primary Islamic sources of law, while restricting the role of the *Ijma* and *Qiyas*. Nevertheless, the *Hanbali* school accepts consulting with other schools of Islamic thought on the issues that cannot be clearly interpreted by consulting *Qur’an* and *Sunnah* by themselves. See Hanson M (n 15) 274; also see Ansary (n 166); Joseph Schacht, *An Introduction To Islamic Law* (Oxford, Oxford University Press 1964) 60; Ahmed Al-Ghadayan, ‘The Judiciary In Saudi Arabia’ (1998) 13 (3) Arab Law Quarterly 235.

¹⁶⁸ Frank Vogel, ‘Islamic Governance In The Gulf: A Framework For Analysis, Comparison And Prediction’ in Sick G and Potter L (eds) *The Persian Gulf At The Millennium* (London, McMillan Press Ltd 1997) 249.

¹⁶⁹ Hanson (n 15) 272.

adopting foreign law rules which can supplement and be consistent with *Shariah* principles. The Saudi government has followed two principles in developing and applying secular law in the Kingdom: *al-siyasah al-sharyiah* (public policy) and *almasalih almursalah* (public interests).

The doctrine of *al-siyasah al-sharyiah* is defined as ‘the administration of the affairs of subjects, executed by caring for their well-being and needs, their property and honor, and the dispatch of justice between and amongst them’¹⁷⁰. Under this principle the ruler (the king) is given the legitimate authority to enact regulations in the best interests of the society and its people¹⁷¹. In addition, it allows him to borrow, adopt and adapt foreign law in order to solve any legal issue for which no applicable rule is found in *Shariah* law.

The dualism of traditional and borrowed law in contemporary Saudi Arabia is a product of two factors, historical and economic. From a historical perspective, Saudi Arabia underwent certain legal changes at the end of the eighteenth century and the first decades of the nineteenth century, when legal reforms took place and several laws from Western countries were introduced¹⁷². It has been argued that this time is considered as the most decisive moment in bringing legal reform to most Islamic countries and introducing the notion of the codification of laws¹⁷³. Furthermore, most of the countries neighbouring the current Kingdom of Saudi Arabia were either previous British or French colonies, and thus were influenced by common law and civil law traditions¹⁷⁴. Consequently, some parts of French codes of private law in Saudi Arabia came through Egypt, which began its relationship with the French legal system more than a century before any other countries in the region¹⁷⁵. A prime example of this influence, as will be discussed later, is seen in the Saudi CL 1965 which was directly

¹⁷⁰ Ibn Khaldun, *Muqadimmat Ibn Khaldun* (Alexandria, Dar Ibn Khaldun 1982) 213, Quoting from Al-Atawneh M, ‘Is Saudi Arabia a theocracy? Religion and governance in contemporary Saudi Arabia’ (2009) 45 (5) Middle Eastern Studies 721, 722.

¹⁷¹ Hanson M (n 15) 274.

¹⁷² Oussama Arabi, *Studies In Modern Islamic Law And Jurisprudence* (Kluwer Law International 2001) 1.

¹⁷³ *ibid.*

¹⁷⁴ For example, countries like Oman, the United Arab Emirates, Qatar, Bahrain, Kuwait and Jordan were British colonial territories during the first half of the nineteenth century and Syria was one of the French colonies during the same period of time. For more insight into this, see Al-Suwaidi A, ‘Developments of the legal systems of the Gulf Arab states’ (1993) 15 Arab Law Quarterly 289-301.

¹⁷⁵ Ruud Peters, ‘Divine Law Or Man-Made Law? Egypt And The Application Of *Shariah*’ (1988) 3 (3) Arab Law Quarterly 231.

copied by the Egyptians from French company law before the amendments of July 1966 and also adopted by the Saudis¹⁷⁶.

Another reason for the existence of modern legal rules within current Saudi law is the fact that the Kingdom is driven by pressures to create laws which are capable of meeting the modern legal and economic challenges, globally and regionally. At the global level, one of these pressures is being one of the most important crude oil exporting countries. This makes the Kingdom an influential nation in the global economy¹⁷⁷. A further reason is its accession to the WTO and the legal process following this accession. These factors impelled the government to create modern laws which can meet international requirements by regulating foreign investment rules, promoting transparency, and ensuring a free market. At the regional level, the same requirement is derived from the Gulf Cooperation Council (GCC) and its initiatives¹⁷⁸. The GCC requires the Member States, such as the Kingdom, to cooperate in the harmonization process of certain areas of law¹⁷⁹. This has consequently led the government to promulgate laws which are consistent with *Shariah* principles on the one hand and capable of meeting all of these demands on the other.

The blending of foreign law rules, particularly those of developed nations, with Islamic legal principles can be seen as an inevitable outcome of the Kingdom's historical development and contemporary economic realities¹⁸⁰. However, Western law, from an Islamic perspective, is secular in nature. *Shariah*, on the other hand, is divine and, therefore superior to it. This results in the requirement that all man-made laws conform to the rules of *Shariah*. More importantly, statutory rules enacted by government, or adopted from other jurisdictions, contribute as gap-filling and reformatory instruments within non-codified *Shariah* law¹⁸¹.

¹⁷⁶Hanson (n 15) 66.

¹⁷⁷ Saudi Arabia is one of the most powerful countries in the global economy; it is one of the G20 Members among such countries as the USA, China, UK, Japan and India: see BBC News, 'G20: Economic Summit Snapshot' (2010) <http://news.bbc.co.uk/2/hi/in_depth/business/2009/g20/7897719.stm>, accessed 11 October 2011.

¹⁷⁸ The members of the GCC are the Arabian Gulf countries: Kuwait, Bahrain, Qatar, United Arab Emirates, Oman and Saudi Arabia.

¹⁷⁹ Stovall (n 133) 842.

¹⁸⁰ *ibid* 840.

¹⁸¹ In this regard, see Frank Vogel, *Islamic Law And Legal System: Studies Of Saudi Arabia* (Brill, Boston 2000) 322: 'In most Islamic states other than Saudi Arabia, the legal system is bifurcated: one part is based on man-made, positive law; the other part is Islamic law. The first part usually exists in the form of comprehensive

This is in sharp contrast with Western countries, including England, where secular law plays the primary role in governing human affairs. Unlike England, where the laws are issued to regulate all aspects of human life, only *Shariah* is granted such privilege in Saudi Arabia: secular law only carries a role of ‘patching the holes’ in Islamic law.

3.2.2.2 The Legal Authorities

Article 44 of the Basic Law of Governance 1992 (BLG) confirms that ‘the authorities of the state consist of the following: the legislative authority, the executive authority and the judicial authority. These authorities cooperate in carrying out their functions, in accordance with the provisions of this and other regulations; the king shall be the point of reference for all these authorities’. The ‘authorities’ are similar to what are called the ‘Arms of Government’ in other countries.

Since Saudi Arabia acknowledges that only God has the real authority to legislate¹⁸², it is particularly true that there is no real legislative body which has the authority to enact laws in the Kingdom, as the English Parliament has. However, as mentioned earlier, the legislative process can be performed through the Islamic principles of public policy (*alsiyasah alshar'iyah*) and public interest (*almaslahah almursalah*)¹⁸³. Under these two doctrines numerous regulations have been promulgated to aid the administrative and legal developments in the Kingdom over the past decades. The King has the power to enact, approve and amend regulations by a Royal Decree or Royal Order. Royal Orders can be issued by the King to regulate most fundamental laws such as the Basic Law of Governance 1992 (BLG)¹⁸⁴; the Council of Ministers Law (1993)¹⁸⁵ and the Law of the Consultative

codes similar to those of the European civil law systems, and the second in the form of Islamic law, usually codified as well. ...Saudi Arabia has also a dual legal system, but the relative roles for the two sides are reversed. The Islamic component of the legal system is fundamental and dominant. The positive law, on the other hand, is subordinate constitutionally and in scope’.

¹⁸² Abdulaziz Al-Fahad, ‘Ornamental Constitutionalism: The Saudi Basic Law Of Governance’ (2005) 30 (2) Yale Journal of International Law 376, 386.

¹⁸³ BLG 1992, article 55

¹⁸⁴ Established by Royal Order No A/90, March 1st 1992.

¹⁸⁵ Royal Order No A/13, Aug 21st 1993.

Council (1992)¹⁸⁶. A Royal Order comes into force as soon as it is established, without other legislative institutions being consulted.

The legislative authority in the kingdom is shared by the King, the Council of Ministers and the Consultative Council¹⁸⁷. The Council of Ministers has regulatory, administrative and executive authority and the power to decide the country's policy. With regard to regulatory authority, the council shares this function with the king where any of its members can propose a law concerning his or her Ministry's affairs. Then, after considering the proposed law, the council reaches its decision by the approval of two-thirds of its members. The council then will be responsible for sending its decision to the king to have his final approval and to issue the Royal Decree. The Consultative Council also shares a regulatory role through consulting its members regarding the proposed law. The decision of this council is subject to amendment by the king, and once he ratifies it the final Royal Decree can be created and the new law announced¹⁸⁸.

Arguably, Article 44 of the BLG 1992 has confirmed the separation of powers between the legislative, executive and judicial authorities for the first time in the history of the Kingdom. Yet there is no clear separation of powers in its true meaning and therefore two important points should be made¹⁸⁹. On the one hand, while this Article confirms clearly the separation of powers between legislative and executive authorities, the Council of Ministers enjoys both of these. Hence, according to the principle of separation of powers, when more than one authority rests solely in one single branch of government this could create less accountability and therefore abuse of power may occur¹⁹⁰. On the other hand, Article 67 of the same law laid down that the Council of Ministers and the Consultative Council could share the legislative function while in fact the role of the Consultative Council is seemingly of an advisory nature rather than a legislative one¹⁹¹. In any event, whether the Consultative

¹⁸⁶ Issued by Royal Order No. A/91, March 1st 1992.

¹⁸⁷ BLG 1992, article 67.

¹⁸⁸ Once the Royal Decree is approved by the king, it should be published in the official gazette (*Um Alqura*).

¹⁸⁹ For more examination on the doctrine of Separation of Powers, see Torsten Persson, Gerard Roland and Guido Tabellini, 'Separation Of Power And Political Accountability' (1997) 112 (4) Quarterly Journal of Economics 1162.

¹⁹⁰ *ibid.*

¹⁹¹ See also Almeahimed (n 136) 35; Ayoub Al-Jarbou, 'Judicial Independence: Case Study Of Saudi Arabia' (2004) 19 (1/4) Arab Law Quarterly 5, 18.

Council plays the legislative or consultative role, the total and ultimate approval of the proposed law resides with the King, and hence laws cannot be issued without his consent.

The King also heads the Council of Ministers, which plays an essential role in conducting and directing the Kingdom's internal and external policies and affairs. As the Prime Minister, the King is the final authority in deciding state policy and has legislative, executive and administrative authority¹⁹². These include control of the financial, economic, educational and defence policies. In addition to its legislative role, the council is the direct executive authority, and once it establishes regulations it has the power to monitor the enforcement of these laws¹⁹³. In doing so, the council is given the authority to create committees and councils such as the Higher Committee for Administrative Reform, the Supreme Council of Higher Education, the Supreme Council of Islamic Affairs and the National Security Council. The main task of these committees and councils is to review the conduct of the ministries to ensure proper implementation of the laws and to improve the administrative function¹⁹⁴. The only concern in this regard, however, is that both legislative and executive powers are concentrated in a single arm of the government, which may be seen as a contradiction to the notion of separation of powers which are typical for Western democracies including England.

As is seen, the king is the ultimate authority in deciding state policies and approving regulations. Since the foundation of the Kingdom in 1932, King Abdul-Aziz and his successors have played a significant role in influencing the legal infrastructure of the Kingdom. The government, in all these reigns, has set five-year development plans that resulted in various regulations, most notably commerce-related enactments. The CL 1965¹⁹⁵, for instance, is the largest piece of legislation that the government introduced in the era of King Faisal (1964-1975). Furthermore, during the reign of King Fahad (1982-2005) significant steps were taken to improve the Kingdom's laws when the king approved three significant written laws. He established fundamental commercial regulations such as the Arbitration Law (AL1993)¹⁹⁶, the Foreign Investment Law (FIL2000)¹⁹⁷ and the Capital

¹⁹² Article 1 of the Council of Ministers' Law, issued by Royal Decree No A/13, Aug 21st 1993.

¹⁹³ Council of Ministers' Law, article 19 and 29.

¹⁹⁴ Ansary (n 166).

¹⁹⁵ Royal Decree No M/6, 1965.

¹⁹⁶ Issued by Royal Decree No M/46, 1993.

Market Law (CML2003)¹⁹⁸. Further, the long awaited law of Corporate Governance Regulations (CGRs 2006),¹⁹⁹ when approved by King Abdullah (the current king), was lauded by judges as well as the business community²⁰⁰.

It is therefore evident that since the late twentieth century and continuing into the first decade of this century, there have been feverish and largely government-promoted legislative activities with the aim of codification. Yet the codification of laws is a contemporary challenge that has both proponents and opponents in the Kingdom. The opponents maintain that codification denies the fact that ‘Islamic law being a doctrine and a method rather than a code.....is by its nature incompatible with being codified, and every codification must subtly distort it’²⁰¹. The proponents of codification, however, observe that the purpose of codification is to overcome ‘unwieldiness and ambiguity of classical Islamic law by reducing the multitude of authoritative legal interpretation to a single standardized code’²⁰². The government in turn tries to reconcile the views of traditionalists and modernists towards the codification of laws.

The current judicial system of Saudi Arabia is based on the Judiciary Statute of 2007²⁰³. This law classifies courts in the kingdom into a three-tiered system composed of the *Shariah* courts system, the administrative courts system, and the civil and commercial tribunals. According to Article 7 of the Judiciary Act 2007, the Supreme Judicial Council is the main supervisor of the judicial system in the Kingdom and has several functions over all courts including administrative and consultative responsibilities²⁰⁴. The administrative function is to

¹⁹⁷ Royal Decree No M/1, April 2000.

¹⁹⁸ Established by Royal Decree No M/30, 2003.

¹⁹⁹ Established in 2006 by the Board of Capital Market Authority (CMA), Resolution No 1/212/2006.

²⁰⁰ Further examination of these regulations will be carried out in the next chapter.

²⁰¹ Joseph Schacht, ‘Problem Of Modern Islamic Legislation’ (1960) 12 *Studia Islamica* 99, 108.

²⁰² Jackson S, quoted from *Moghul* (n 154) 196.

²⁰³ The old Judiciary Statute was enacted in 1975 and has been subject to many amendments to meet new needs and challenges. The new law was established by a Royal Decree, issued by King Abdullah on October 1st 2007. It is aimed at reforming the judicial system in the kingdom. A budget of 7 billion Saudi Riyals (approx £1200 million) has been allocated to this project. It is seen as a serious and the most extensive attempt to shape the Saudi Judiciary to meet the highest standards of the judicial system. This came about as a result of pressing social and economic demands to improve the whole legal system of the kingdom.

²⁰⁴ Judiciary Statute 2007, article 7 states that ‘the Supreme Judicial Council has a supervisory role over the courts in as much as is designated by this Act’.

supervise the internal system of the courts, the judges and their employment-related affairs and to appoint and dismiss them²⁰⁵. The consultative role is where the King or the Minister of Justice requires consultation on a particular legal matter; the council's role is to provide legal advice regarding the issue. In addition, the council has the power to resolve issues of jurisdictional conflict between the *Shariah* courts.

Shariah courts have general jurisdiction over a wide range of cases including criminal, civil, commercial, labour and personal status cases²⁰⁶. The *Shariah* court system consists of three levels established as follows: the High Court, the Court of Appeal and the First Degree Courts²⁰⁷. The First Degree Courts consist of five types: General Courts, Criminal Courts, Personal Status Courts, Commercial Courts and Labour Courts. The Court of Appeal has the same structure of several panels, and its main function is to review rulings issued by the lower courts and to monitor the implementation of *Shariah* law. The High Court is the highest authority in the *Shariah* court system. Its main judicial role is to review judgments and decisions made by the Court of Appeal on important cases.

Modern developments in the economic and social life of the Kingdom have brought many new aspects that have to be covered by law. Sometimes *Shariah* is not able to provide succinct answers to regulation of these aspects, and therefore additional legal institutions have been introduced for these matters. The Board of Grievances, *Diwan Almadalim*, which is known as *Conseil d'Etat* in France and *Majlis alDawla* in Egypt, was established to settle administrative and commercial disputes²⁰⁸. It has a similar hierarchical structure to that of the *Shariah* courts: High Administrative Court, Administrative Court of Appeal, and Administrative Courts. In addition, the Judiciary Act 2007 has set down specialised committees to settle other civil and commercial disputes that fall outside the jurisdiction of the *Shariah* courts and the Board of Grievances: the Committee of Customs, the Committee

²⁰⁵ Judiciary Statute 2007, article 7.

²⁰⁶ Judiciary Statute 2007, article 26 indicates that 'the *Shariah* courts shall have a jurisdiction over all types of disputes and crimes except those excluded by law'. Article 49 of the Basic System of Governance 1992 declares that 'Observing what is stated in Article 53 of this law, the courts shall arbitrate in all disputes and crimes'.

²⁰⁷ Article 2-25 of the Judiciary Statute.

²⁰⁸ Board of Grievances Statute 1982, article 8. The following types of cases are decided by *Diwan Almadalim*: cases related to the rights of employees; compensation cases; objections to administrative decisions; contract related issues; disciplinary cases filed by the Bureau of Control and Investigation; penal cases regarding bribery and forgery; and requests for implementation of foreign judgments.

of Settlement of Labour Disputes, the Committee of Settlement of Banking Disputes and the Committee of Commercial Disputes Settlement²⁰⁹.

Importantly, however, none of these institutes and boards function independently. The Board of Grievances is responsible directly to the King²¹⁰, while the Committees are considered as parts of the executive authority, the Council of Ministers²¹¹. This is a further indication of the fact that, in reality, there is no separation of powers in the Kingdom: while Article 46 confirms the independence of the judiciary from other authorities in the state, the entire judicial system is subordinate to the King²¹². Further, each board and committee has auditors, who observe the compliance with *Shariah*. Article 48 of the Basic Law of Governance lays down that all courts in the kingdom are obliged to apply *Shariah* law to cases brought before them, and the regulations issued by the king if they do not contradict the principles of *Shariah* law.

The reason for the absence of independence of judicial authority in Saudi Arabia can be explained by the fact that most Islamic scholars are in consensus that the head of the state also has authority over the judiciary²¹³. Therefore, the king in Saudi Arabia is the ultimate source for all of the state's authorities including the judiciary²¹⁴. He exercises authority over the judiciary by appointing and dismissing judges according to recommendations made by the Supreme Judicial Council²¹⁵. He also can intervene in any court judgment to ensure the implementation of *Shariah* law and has the right to intervene in any major judicial decision related to certain serious crimes²¹⁶. One can conclude therefore that in Saudi Arabia, and

²⁰⁹ The decisions of these committees do not have finality and should be reviewed by the Board of Grievances in order to reach finality. Al-Jarbou (n 191) 34.

²¹⁰ Board of Grievances Statute 1982, article 1 establishes the Board's full subordination to the King.

²¹¹ These committees are established under the authority of one of the ministers. Al-Jarbou (n 191) 29.

²¹² It should be noted that in recent years and due to the increase in the number of civil and commercial disputes, there has been a tendency to assign the boards and committees full judicial authority. This may be an indication that the Saudi government is considering establishing more specialised courts with qualified judges to handle these different civil and commercial matters. These developments can be seen as the beginning of an improvement in the Judiciary System of Saudi Arabia.

²¹³ Al-Jarbou (n 191) 15.

²¹⁴ BLG 1992, article 44

²¹⁵ BLG 1992, article 52 states that the appointment and dismissal of judges is carried out by royal orders.

²¹⁶ In serious criminal cases such as brigandage (*Hiraba*) or other criminal acts which threaten the safety of the state and its people such as terrorist acts, the court's authority is to identify the type of the crime and to propose

despite the fact that the separation of powers has been recognised in the Basic Law of Governance, the king has the ‘supreme power’ and he is the final resort of the authorities of the state.

3.2.2.3 The Authorities of the Courts

As was demonstrated above, the Saudi Judicial system is not independent in a sense that is understood in the West. Consequently, the authorities of Saudi courts are also quite different from, for example, English courts. In England, even though there is a tendency to give the acts of Parliament supremacy over case law, important bodies of law are almost entirely judge-made, which is the main characteristic of this type of law. In Saudi Arabia by contrast, the law is governed by the *Qur'an* and the *Sunnah* as primary sources and the *Ijma* and *Qiyas* as secondary sources, and these four have always been held as the uppermost sources of law. Consequently, the courts do not make or adjust the law: they only interpret it.

Second, English law applies the principle of ‘*stare decisis*,’ which requires the judge, when deciding a new case, to look at the facts of prior case law and compare them with the facts of the case at hand, then decide accordingly. Saudi law, however, does not bind the judge in this way: *Shariah* law, especially the primary sources, formulates the law. This means that Saudi judges do not look at precedents; rather, they treat each case on a separate basis based on the applicable rules of secular law and in compliance with *Shariah*. This puts Saudi courts closer to their counterparts in civil law systems.

At the same time, judges in both jurisdictions have a practical role in promulgating legal determinations. The common law judge applies the law to the case before him by examining the relevant previous case law, determining its *ratio decidendi* and applying the *ratio* analogically to reach his decision. Likewise, the *Shariah* judge in Saudi Arabia has a similar practical role which arises in situations where he is not able to find a clear answer in *Shariah* law for the matter at hand. The law permits the judge to look beyond the primary sources and reach a determination by using *Qiyas* (analogical reasoning). In the view of the researcher therefore, this feature is one of the key motivations driving the rejection of codification as it would deprive the judges, in both legal systems, of their legislative role.

the appropriate punishment. The final decision is within the King’s authority as he may ratify the decision or reject it as he deems fit. See Ibrahim Zafir, *Criminal Procedures* (Riyadh, King Fahad National Library 1999) 393.

3.3 Codification of Law: Present Situation and Future Prospects

The codification of laws has been a challenge for both English and Saudi law. However, while English law has overcome this challenge²¹⁷, in Saudi Arabia there is still strong resistance to the codification of *Shariah* law. In fact, there is a huge ongoing debate among the legal authorities and the religious scholars about the possibility of codifying *Shariah* law. On the one hand, opponents of codification argue that codification means legislation and this is un-Islamic and will erode the key distinguishing feature of *Shariah* law. Consequently people will rely on other codified laws rather than the *Shariah* and this in turn challenges the supremacy of the divine law²¹⁸. On the other hand, proponents of codification of the *Shariah* principles maintain that the lack of codification has contributed to a certain degree to the inconsistency and uncertainty in court judgments in the Kingdom²¹⁹. Safeir contends that the codification of *Shariah* law is the overarching theme for the development of law which will bring about an effective legal reform for the legal system of Saudi Arabia²²⁰. Codification also helps practitioners in understanding the law, as it is not easy to understand, especially for a foreign lawyer who needs to acquire the related rules from different sources of *Shariah* law. These sources are generally included in large numbers of volumes available only to the experts of *Shariah* law and are seen by other practitioners as a sophisticated art²²¹.

The option of codifying *Shariah* law overcomes the ‘unwieldiness’ of classical *Shariah* principles to be provided in an accessible and single code of law. Even in England, a common law country, where the law is not based on legal codes, enormous numbers of codifications

²¹⁷ Up to the second half of the twentieth century, codification of law was not welcomed in England. See, for example, Harlan Stone, ‘Some Aspects Of The Problem Of Law Simplification’ (1923) 23 *Columbia Law Review* 319 (quoted from Cappalli R *The American Common Law Method* (Transnational Publishing 1997) 62. However, today codes and statutes comprise the primary source of law in the country. The importance of parliamentary Acts is particularly noteworthy with legislation relating to commerce. For example, The CA 2006, The Directors’ Disqualification Act 1986, and the Insolvency Act 1986 are the key regulations in the area of corporate affairs.

²¹⁸ Frank Vogel, ‘Prospects For A Restatement: The Codification Of Commercial And Contract Law In Saudi Arabia’ in Ruttley H and Mallat C (eds) *Commercial Law In The Middle East* (London, Kluwer Law International Incorporates 1995) 34.

²¹⁹ This evidence is provided by a *Shariah* court judge who is calling for the codification of the *Shariah* law in particular in civil and commercial issues. Nasser Bin Dawood, ‘The Codification Between Acceptance And Resistance’. (2006) (Arabic) <<http://www.cojss.com/article.php?a=68>>, accessed 20 September 2010.

²²⁰ George Sfeir, ‘The Saudi Approach To Law Reform’ (1988) 36 *The American Journal of Comparative Law* 729, 757-758; Esmaili (n 132) 30-31.

²²¹ David Karl, ‘Law In Saudi Arabia: What Foreign Attorneys Should Know’ (1992) 25 *George Washington Journal of International Law and Economics* 131.

have been passed by Parliament as a means to help people to understand the law and to enable judges to be less variable in their judgments. Although the English judiciary has played a great part in developing the law in the country, codification is also recommended as promoting legal certainty. The prime example, as will be seen later on in this research, is in the new codified duties of directors under the English Companies Act 2006. Moreover, the attempts taken by some Islamic countries, such as Egypt in codifying its civil law in 1949, Lebanon in codifying commercial rules in 1965, and Kuwait in codifying its civil law in 1980 and commercial law in 1981, are seen as successful examples in codifying *Shariah* law in these particular areas of law²²². These codes adopt and adapt Islamic legal principles that are compatible with modern law²²³.

Codification is therefore an important step to be taken to improve the legal system in Saudi Arabia, and it is recommended that the government accords this project top priority status and moves towards the codification of *Shariah* law. It is suggested that the codes should include the relevant *Shariah* rules in each specific area of law and where there is no clear provision in *Shariah*, the gap should be filled by legal rules established by royal decrees and orders or borrowed from other countries' legal systems. This will render the legitimacy of the rules indicated in the codes certain, as they combine *Shariah* rules with human-made law and therefore should be applicable in the country. This consequently obliges the judges of *Shariah* courts to be more accurate in their judgement and to gradually accept the idea of codification on the one hand, and to help other courts' judges to assimilate the viable *Shariah* rules and apply them in a proper way, on the other. The interpretation of the codes, as well as decisions that the codes do not provide, will be left to the Ulama (religious scholars)²²⁴.

Second, the current legal scholars in the Kingdom are usually criticized for lack of familiarity with the changing styles of the modern legal demands, in that they cannot relate the principles of *Shariah* law to contemporary jurisdictions and judicial practice. This criticism may be attached to the lack of effort by the Ulama (religious scholars) to ascertain legal rules from *Shariah* law that are more responsive to the demands of the modern economy. The issue,

²²² Prior to these codifications there was the Ottoman *Majalla*, which constituted the first modern codification of certain areas of *Shariah* law concerning the law of contract, obligation and some other commercial and civil rules. It was promulgated in 1877 by the Ottoman government and remained in force until the dismantling of the empire in 1918.

²²³ Sfeir (n 220) 757.

²²⁴ Esmaeili (n 132) 30.

perhaps, lies in a failure to use available Islamic legal methodologies to extract the relevant rules to specific legal issues from the sources of Islamic law. Certain areas of law such as family law, inheritance, criminal and other different areas of law such as public law have been developed by Islamic scholars over time, from the medieval ages until recent times. However, other particular subjects such as that of private law need to be developed further, in order to meet the current legal challenges. Although Islamic law has gradually become established as a source of reference in Banking law (Islamic Banking) for instance,²²⁵ it is not so developed in the area of company law²²⁶. While *Shariah* law is a comprehensive code that leaves nothing uncovered, ascertaining the legal rules related to this area is the main task of *Shariah* scholars.

As has been seen, effective codification of law is of the utmost importance for Saudi Arabia. First, it follows from the fact that judges are not capable of making law or changing it. Second, it is dictated by the constantly evolving socio-economic sphere of life. Third, and this is also applicable to England, effective codification of law should resolve inconsistencies between legal decisions. Therefore, this study focuses on the codified law in both countries in an attempt to distinguish the best areas of legislative practice and to identify the areas that require a better formulation of law.

²²⁵ Ashraf Kazi and Abdel Halabi, 'The Influence Of Qur'an And Islamic Financial Transactions And Banking' (2006) 20 (3) Arab Law Quarterly 321.

²²⁶ Timur Kuran, 'The Absence Of The Corporation In Islamic Law: Origin And Persistence' (2005) 53 The American Journal of Comparative Law 785.

Chapter Four: The Board of Directors in English and Saudi Jurisdictions: A Comparative Analysis

4.1 Introduction

The previous chapter reviewed the legal system of Saudi Arabia with comparative references to England. It was shown that while the legal systems in these countries belong to different legal families (Islamic and common law respectively) and exist in different socio-cultural environments, they still can be usefully compared from the functionalist perspective due to their existing strong similarities in terms of legal institutions regulating the corporate governance framework and statutory provisions that create the major laws of governance. Following the functional approach introduced by Zweigert and Kötz as the research method of this study, the next step presents the common issue that these legal systems face.

This chapter begins by arguing that both Saudi and English legal systems face the common problem of effective law codification to regulate the fiduciary duties of company directors towards company property. Prior to conducting the analysis itself, however, it is important to understand exactly what (and whom) the corresponding provisions in the statutory law are created to regulate, as well as why and how. By answering these questions, it will be possible to analyse the effectiveness of statutory codes in relation to their main tasks and functions. Accordingly, the rest of the chapter is structured to provide a discussion about those who are targeted by the statutory provisions in question: the company directors and their positions, roles, and interaction with other parties in the corporate governance framework. Remaining with the comparative nature of the research, the discussion is conducted in relation to both England and Saudi Arabia, noting any similarities and differences between the systems as the discussion moves along.

The second section of the chapter analyses the structure and types of ownership of companies in England and Saudi Arabia to present the environments in which regulation of the fiduciary duties of company directors takes place. The third section discusses the legal concept of a director in each legal system and reviews various forms of directorship that exist within them. Since the thesis concentrates on statutory law in both countries, only the types of directors recognised in the company law statutes of each country will be considered (bearing in mind that neither in England nor in Saudi Arabia is a comprehensive definition of the term ‘director’ provided). The fourth section analyses the legal position of a company director in England and Saudi Arabia, and the chapter concludes with a brief summary.

4.2 The Issue Faced by the Legal Systems

One of the current and most pressing demands in both the English and Saudi legal systems is the notion of law codification. This legal challenge is seen as a result of the pressing domestic needs for a healthier legal climate. Although there are different reasons that have led to this demand (and these will be demonstrated in this chapter), the importance of it has not diminished in either country.

As was examined previously, although English law, being a common law system, does not depend much on legal codification, there has recently been a considerable interest in taking this approach seriously. For instance, company law is seen as an excellent example of legal codification in this area. In the mid-nineteenth century, the provisions related to companies in England were included in a short statute that was combined with certain existing concepts from case law and further developed to create a basis of modern company law: the Joint Stock Companies Act 1844 (7 & 8 Vict.c.110) expanded access to incorporation of joint-stock companies, while the later Limited Liability Act 1855 created limited liability companies, and the Joint Stock Companies Act 1856 created a basic legal system of company law. Over decades, the legal developments have continued and caused a significant increase in the scope of statutory codification resulting in the CA 2006: the longest statute in English legal history²²⁷. This series of Acts has long guided legal development in corporate regulations in England and even beyond²²⁸. By contrast, in Saudi Arabia, where the accelerating economic growth meets socio-political developments, there is a public ‘thirst’ for legal reform and, consequently, an increase in the scope of codifications. Despite the lack of support for codification from religious scholars in the kingdom, this notion has found somewhat greater favour from Saudi lawyers in the area of commercial and company law. Under the pressure of legal reform demands, the Saudi legislators deferred and employed the

²²⁷ John Armour, ‘Codification And UK Company Law’ In Association Du Bicentenaire Du Code De Commerce (ed) *Bicentenaire du Code de Commerce 1807-2007: Les Actes des Colloques* (Paris, Dalloz 2008) 287-310. <<http://www1.fee.uva.nl/fm/conference/legal/2008%20Company%20Law%20Codification%20Dalloz.pdf>>, accessed 11 January 2011.

²²⁸ Mohammad Salim, ‘Legal Transplantation And Local Knowledge: Corporate Governance In Malaysia’ (2006) 20 (1) *Australian Journal of Corporate Law* 55. While the CA 2006 has been in force for only five years, the series of Companies Acts, starting from the Joint Stock Companies Act of 1844, have essentially retained the same fundamental features which have influenced corporate governance in England.

codification technique, which is considered the most important and effective tool for improving corporate legal environment in the Kingdom²²⁹.

As far as company law is concerned, England is generally regarded as having one of the most comprehensive legal systems today. After the long history of legal developments, the 1300 sections and 16 schedules of the CA 2006 include provisions related to the formation of companies, their businesses and the rights and duties of a company's shareholders and directors. One of the main changes introduced by the Act to company law was related to the codification of the directors' fiduciary duties and the common law duty of care and skill. This is important, considering that prior to the Act; directors' duties were regulated in a disorganised manner by certain statutory requirements, equitable principles, and pieces of common law²³⁰. The Act and the later introduced CGC 2010 had the goal of codifying and simplifying directors' fiduciary duties by listing and explaining them in one place. It is, however, by no means clear that all the duties have been codified and whether or not there is potential to expand the range of duties. In addition, as will be seen from the following chapters, even the CA 2006 has been incapable of resolving many of the issues that remain present in the country's company law. This rests in particular with the traditional approaches that English courts have taken in resolving the problems related to regulation of the fiduciary duties of company directors. Many of the historic decisions regarding various matters in this regard have been controversial and even contradictory, as the courts took different approaches to similar matters. The CA 2006 is the first attempt by the English legislature to regulate the fiduciary duties of company directors; therefore, it is not free from certain omissions and ambiguities.

In Saudi Arabia, the major law regulating business practices is the 1965 Companies Law. Unlike the CA 2006, the CL 1965 was not developed in its entirety by Saudi legislators, since

²²⁹ See Thabet Korateym, 'The Islamic Nature Of The Saudi Regulations For Companies' (2000) 15 (1) Arab Law Quarterly 63, 64-65. While *Shariah* Law, which is the Supreme Law in the Kingdom, has been considered the most competent in regulating unchanging aspects of human relations, such as family law, criminal law, or property relations, it has not been found such for the ever-changing aspects of business governance. At the same time, the booming Saudi economy after the oil discovery demanded solutions in law codification for the good of society. This resulted in the Companies Act being signed into law in 1965. Until recently, the Act has remained the only legal tool for governing the corporate legal environment in the Kingdom.

²³⁰ See Lee Roach, 'The Legal Model Of The Company And The Company Law Review' (2005) 26 The Company Lawyer 98 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1754679>, accessed 11 January 2011. In order to obtain a picture of the nature and scope of directors' duties, one had to review 'a confusing and compendious mass of case law and the occasional statutory measure;' also see Ron Harris, *Industrialising English Law: Entrepreneurship And Business Organisation, 1720-1844* (Cambridge, Cambridge University Press 2000).

its major provisions have been borrowed from Egyptian-French company law. The CL 1965, however, also lays out the legal framework regulating the board of directors, and their rights, duties and responsibilities in conducting the business of the company. In 2006, the Saudi government introduced its own version of a company soft law²³¹: the CGR 2006, which contains a comprehensive list of the best governance practices for listed companies. As the main company law document in Saudi Arabia, the CL 1965 has supremacy over other statutes and legal provisions except for its subservience to *Shariah* law²³². Nevertheless, despite numerous amendments, the CL 1965 itself has never been revised as a whole. To many legal scholars and practitioners of company law, the CL 1965 represents an outdated mechanism of corporate governance, which does not effectively match the realities of modern times. The analysis of the CL 1965 provided later in this thesis, in relation to the fiduciary duties of directors towards corporate property, reveals numerous unresolved issues and loopholes that make the effective application of the law quite difficult. Therefore, the issue of effective codification of law is present in Saudi Arabia as well.

Both laws, the CL 1965 and the CA 2006, have imposed certain provisions concerning a company's board of directors, its functions, legal status, structure, and composition, and they outline the duties and responsibilities of the board and individual directors. While the focus of this study is to deal with the duties of directors in respect of company property that arise from their fiduciary relationship,²³³ the nature of this relationship is worth identifying and explaining before moving on to examine these duties. Even more importantly, the majority of large companies face two main obstacles to the proper implementation of the fiduciary duties of directors: one arising from the ownership structure and the powers of controlling shareholders, and the other dealing with the legal identification of a company director who can be considered as a fiduciary. Therefore, before analysing the duties of directors in the compared jurisdictions it is pertinent to consider the theories and approaches related to the ownership structure and the classification of companies under both legal systems.

²³¹ The term 'soft law' is generally applied to the quasi-legal instruments that do not have the binding status of laws and regulations. Although pieces of soft law play an important role in improving corporate governance standards, they are generally of an advisory nature, providing guidance on best practice. See, for example, Jean Du Plessis, Anil Hargovan and Mirko Bagaric, *Principles Of Contemporary Corporate Governance* (Cambridge University Press 2010) 170; also see Jonathan Charkham and Helen Poix, *Keeping Better Company: Corporate Governance Ten Years On* (Oxford University Press 2005) 298-299.

²³² As noted in Chapter 3, every human-made law in the Kingdom has to be *Shariah* compliant in order to become active.

²³³ This will be dealt with extensively in the following two chapters.

4.3 Ownership Structure and the Classification of Companies

Most corporate governance regulations in the world agree that there are two primary institutions within a corporation: the board of directors, or managers, and shareholders²³⁴. In addition, these regulations are always concerned with how the corporation is managed and the interrelationship between these institutions²³⁵. However, the ownership structure of a company, as well as the different countries' jurisdictions, creates a diversity of patterns governing these interrelations. For example, in civil law jurisdictions, the concentrated ownership is prevalent. It is characterised by a small number of investors who have an influence on the company's management. In contrast, in common law jurisdictions the dispersed ownership is more popular. It is characterised by the presence of a large number of shareholders, none of whom has too much controlling influence. As will be shown below, England and Saudi Arabia differ from each other in terms of corporate ownership to a large degree, and this fact creates different patterns of corporate governance in each country.

4.3.1 Theories of Corporate Ownership and Control

It is an acknowledged fact today that the modern corporate world is divided into two systems of ownership: dispersed and concentrated²³⁶. Consequently, why ownership structures in some countries fall into a dispersed category and in others into a concentrated one, largely depends on the quality of law, the protection of property rights, and the effectiveness of legal institutions²³⁷. The groundbreaking work in this matter is widely considered Adolf Berle's

²³⁴ Jeswald Salacuse, 'Corporate Governance In The UNECE Region' (United Nations Economic Commission for Europe 2002) 76-78 <<http://www.unece.org/ead/misc/Salacuse.pdf>>, accessed 15 January 2011. However, the case in other legal systems is different. German company law, for instance, adopts a two-tier management structure, composed of a managerial board and supervisory board. The former exercises the day-to-day management, with the latter being responsible for exercising a supervisory function over the executive management. This in turn creates a third type in the hierarchy of corporate management, contrary to what is common in most legal systems in the world. See Len Sealy and Sarah Worthington, *Sealy's Cases And Materials In Company Law* (9th edn., Oxford, Oxford University Press 2010) 179.

²³⁵ Charlotte Villiers, 'Corporate Governance' in Birds J, Boyle A, Clark B, MacNeil I, McGormack G, Twigg-Flesner C and Villiers C (eds) *Boyle & Birds' Company Law* (6th edn., Bristol, Jordans Publishing Limited 2007) 381.

²³⁶ See John Armour, Brian Cheffins and David Skeel, 'Corporate Ownership Structure And The Evolution Of Bankruptcy Law' (2002) 55 *Vanderbilt Law Review* 1699; John Coffee, 'Privatization And Corporate Governance: The Lessons From Securities Market Failure' (1999) 25 (1) *Journal of Corporation Law* 9; Salim (n 228).

²³⁷ Rafael La Porta, Florencia Lopez-de-Silanes and Andrei Shliefer, 'Corporate Ownership Around The World' (1999) 54 (2) *Journal of Finance* 471; Curtis Milhaupt, 'Property Rights In Firms' (1998) 84 *Vanderbilt Law*

and Gardiner Means' *The Modern Corporation and Private Property*, written in 1932. From an empiric investigation of two hundred of the largest non-financial public companies in the United States, the authors argued that their capital needs could only be fulfilled by the presence of a large number of investors with a small number of shares, which does not give anyone significant control over the company²³⁸. This, in turn, created a gap in corporate control, which was filled by the corporate executives. In the end, according to Berle and Means, the executives had a small share in the company, but full functional control, while shareholders had neither means nor incentives to control the executives²³⁹.

The two primary concerns raised by Berle and Means were that corporate management might not have the same objectives as directors and that it might not be accountable to shareholders. As a result, the authors argued that the main purpose of corporate governance regulation was to align the interests of corporate managers, directors and the owners²⁴⁰. Berle and Means' book generated a vast amount of literature on 'managerialism', which addressed the objectives of corporate managers within a publicly held corporation²⁴¹. The general assumption of the 'managerialism' theory was that shareholders were the lawful owners of the company because they provide capital²⁴². Therefore, the 'managerialism' theory posited that corporations should be managed so as to advance shareholders' interests. At the same time, since corporate managers hold functional powers, it becomes necessary to establish incentive structures to converge the interests of shareholders and managers.

Review 1145, 1154; and Katharina Pistor, 'Patterns Of Legal Change: Shareholder And Creditor Rights In Transition Economies' (2000) 1 *European Business Organisation Law Review* 57.

238 Adolf Berle and Gardiner Means, *The Modern Corporation And Private Property* (New York, NY, Harcourt, Brace & World Inc 1932), Transaction Publishers edn (New Brunswick/London 1991).

²³⁹ *ibid.*

²⁴⁰ *ibid.*

²⁴¹ William Baumol, *Business Behavior, Value And Growth* (New York, NY, MacMillan 1959); Robin Marris, *The Economic Theory Of Managerial Capitalism* (Glencoe, Illinois, Free Press 1964); Edith Penrose, *The Theory Of The Growth Of The Firm* (Oxford, Basil Blackwell 1959); later contributions to agency cost theory were provided by Michael Jensen and William Meckling, 'Theory Of The Firm: Managerial Behavior, Agency Costs, And Ownership Structure' (1976) 3 *Journal of Financial Economics* 305; and Sanford Grossman and Oliver Hart, 'The Costs And Benefits Of Ownership: A Theory Of Vertical And Lateral Integration' (1980) 94 *Journal of Political Economy* 691.

²⁴² See Murry Weidenbaum and Michael Jensen, 'Introduction To The Transaction Edition' In Berle And Means' (2001) ix–xviii; William Bratton, 'Berle And Means Reconsidered At The Century's Turn' (2001) 26 *Iowa Journal of Corporate Law* 737; Mark Mizruchi, 'Berle And Means Revisited: The Corporate Governance And Power Of Large US Corporations' (2004) 33 *Theory and Society* 579.

‘Managerialism’ still remains an important theory on corporate governance in some countries (including the USA and Britain)²⁴³, as governance reform programmes are generally concentrated on the role of boards of directors, and takeovers and derivative actions are common ways to discipline managers²⁴⁴. However, since the 1970s, researchers have begun to question the empirical validity of Berle and Means’ conclusions. A number of studies have showed that concentration of ownership is present even in the largest American companies²⁴⁵. Studies also found significant ownership concentration in other developed countries like Germany²⁴⁶, Japan²⁴⁷, Italy²⁴⁸, and a number of OECD countries²⁴⁹. Further, heavy concentration of ownership was discovered in many developing countries²⁵⁰. Therefore, the concentrated form of corporate ownership became considered a norm in the modern corporate world²⁵¹.

Whether a country has a concentrated or dispersed type of shareholding as the dominant one can be explained by the prevailing legal system. This thesis was developed following the

²⁴³ Salim (n 228) 8.

²⁴⁴ For a good discussion on governance reform programmes, see Stephen Bainbridge, ‘Independent Directors And ALI Corporate Governance Project’ (1993) 61 *The George Washington Law Review*, 1034. Also, see discussion on the use of takeovers and derivative mechanisms in the United States and England in Geoffrey Miller, ‘Political Structure And Corporate Governance: Some Points Of Contrast Between The United States And England’ (1998) 51 (1) *Columbia Business Law Review* 629.

²⁴⁵ Harold Demsetz and Kenneth Lehn, ‘The Structure Of Corporate Ownership: Causes And Consequences’ (1985) 93 *Journal of Political Economy* 1155; Melvin Eisenberg, *The Structure Of The Corporation: A Legal Analysis* (Boston, MA, Little, Brown and Co. 1976); Randall Morck, Andrei Shleifer and Robert Vishny, ‘Management Ownership And Market Valuation: An Empirical Analysis’ (1988) 20 *Journal of Financial Economics* 293; Andrei Shleifer and Robert Vishny, ‘Large Shareholders And Corporate Control’ (1986) 94 *Journal Of Political Economy* 461.

²⁴⁶ Jeremy Edwards and Marcus Nibler, ‘Corporate Governance In Germany: The Role Of Banks In Ownership Concentration’ (2000) 15 (31) *Economic Policy* 239.

²⁴⁷ Erik Berglof And Enrico Perotti, ‘The Governance Structure Of The Japanese Financial Keiretsu’ (1994) 36 *Journal Of Financial Economics* 259; Stephen Prowse, ‘The Structure Of Corporate Ownership In Japan’ (1992) 47 *Journal Of Finance* 1121.

²⁴⁸ Magda Bianco and Paola Casavola, ‘Italian Corporate Governance: Effects On Financial Structure And Firm Performance’ (1999) 43 *European Economic Review* 1057.

²⁴⁹ Organization for Economic Co-operation and Development, ‘Corporate governance: A survey of OECD countries’ (2004), <<http://www.oecd.org/dataoecd/58/27/21755678.pdf>>, accessed on 1 February 2011.

²⁵⁰ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, ‘Law and Finance’ (1998) 106 *Journal of Political Economy* 1113; Stijn Claessens, Simeon Djankov and Larry Lang, ‘The Separation Of Ownership And Control In East Asian Corporations’ (2000) 58 *Journal of Financial Economics* 81.

²⁵¹ La Porta and others (n 250); Claessens and others (n 250).

Berle-Means study, as researchers attempted to answer the question as to whether dispersed ownership in the United States was a product of legal evolution or simply a historical accident²⁵². Numerous studies in the late 1990s seemed to confirm the former²⁵³. This brought up an important concept, that a country's legal system was integral to its ownership structure²⁵⁴. Empirical investigations by La Porta et al. gave the 'law matter' theory a considerable boost. In their comprehensive analysis of dominant ownership types around the world, the authors classified countries as being of either common law or civil law origins. While dispersed ownership was more typical in the countries with the common law family origins, the countries with civil law origins were more likely to have a concentrated form of ownership²⁵⁵.

Whether companies have a dispersed or concentrated type of ownership greatly influences their governance. As a result, the roles of directors and managers vary as well. When concentrated ownership is present, large block holders of shares are believed to have enough incentive and the power to influence managerial decisions, when these would go against their interests²⁵⁶. These incentives and the perceived 'ownership' rights stemming from dominant shareholding mean that the shareholders retain a powerful right: to appoint and dismiss directors, and this becomes a form of indirect control over the corporation²⁵⁷. However, practical application of these powers in companies with dispersed ownership is problematic. The dispersed shareholding structure creates a collective action problem, coupled with management's agenda control, proxy voting machineries, and controlling pyramids, all of

²⁵² See Mark Roe, 'Political And Legal Restraints On Ownership And Control For Public Companies' (1990) 27 *Journal of Financial Economics* 7; Mark Roe, *Strong Managers, Weak Owners: The Political Roots Of American Corporate Finance* (Princeton, NJ, Princeton University Press 1994).

²⁵³ Abrahams P, 'A Sudden Increase In Demand Has Caught Everyone By Surprise', *Financial Times*, (2000 May 8) 2; Coffee (n 19).

²⁵⁴ This is also widely known as the 'Law matters' thesis, which received strong support among the researchers studying differences in corporate ownership patterns across the globe. See, for example, Brian Cheffins, 'Does Law Matter?: The Separation Of Ownership And Control In The United Kingdom' (ESRC Centre for Business Research, working paper N 172 2000); Coffee (n 236); John Coffee, 'Rise Of Dispersed Ownership: The Roles Of Law And The State In The Separation Of Ownership And Control' (2001) 111(1) *Yale Law Journal* 1; Andrei Shleifer and Robert Vishny, 'A Survey Of Corporate Governance' (1997) 52 *Journal of Finance* 737.

²⁵⁵ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'Legal Determinants Of External Finance' (1997) 52 (3) *Journal of Finance* 1131; La Porta and others (n 250).

²⁵⁶ This idea is thoroughly discussed in Shleifer and Vishny (n 254) 737.

²⁵⁷ Salim (n 228) 10.

which lead to an even stronger separation of corporate assets from shareholders²⁵⁸. On the other hand, if powers are concentrated in the hands of the directors, there is a need for a legal regime that focuses on making them accountable and redressing possible director-shareholder conflicts.

4.3.2 Comparison of Ownership and Control in England and Saudi Arabia

Understanding the structure of ownership and control is crucial to defining the roles of directors that are present in different countries. In essence, corporate governance answers the two fundamental questions: who ultimately controls the company and who derives the main benefits from it. The analysis conducted in this section showed that England and Saudi Arabia seem to offer different answers to these questions. Significant differences exist in the dominant types of ownership, prevailing company structures, and the ways that laws defining corporate governance are followed.

England's present form of corporate governance has been developed within the common law legal system, which prompted the creation of dispersed shareholding and the emergence of the Berle-Means company as the dominant corporate form²⁵⁹. In the past few years, the system of corporate governance in English companies has been characterized as an 'outsider arms-length', which can be defined as one with a highly dispersed share ownership and run by professional managers who collectively own a small percentage of shares, insufficient to influence the outcome of shareholders' votes²⁶⁰. In his most recent comprehensive review of corporate ownership in England, Cheffins claimed that such a structure is likely to be a durable arrangement for English companies in the near future²⁶¹.

²⁵⁸ Melvin Eisenberg, 'Megasubsidiaries: The Effect Of Corporate Structure On Corporate Control' (1971) 84 (7) *Harvard Law Review* 1577.

²⁵⁹ The divorce of ownership and control in English publicly traded companies became a norm in the second half of the twentieth century. See Brian Cheffins, *Corporate Ownership And Control: British Business Transformed* (Oxford University Press 2008).

²⁶⁰ *ibid*; also see Brian Cheffins, 'Minority Shareholders And Corporate Governance' (2000) 21 *The Company Lawyer* 41.

²⁶¹ *ibid*.

Dispersed shareholding in the majority of large public corporations in England created an agency problem, which has been well documented in the literature²⁶². In order to curb excessive powers of directors, the protection of shareholders has been emphasised in the creation of the list of directors' duties. As a counterbalance measure, directors are given significant powers in English law to perform business on behalf of the company, and shareholders have limited powers to 'supervise' them. This separation of ownership and control in England has been emphasised in both legislation and the courts' decisions. The courts recognised two core powers in English companies as being the shareholders in general meeting and the board of directors²⁶³. In *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunningham*²⁶⁴ and *Quin & Arxtens Ltd v Salmon*²⁶⁵ the powers of the board were described as being given by provisions in the corporate articles, and the members were not to interfere in directors' actions, nor could they direct the way that the board operates. Subsequently, the courts established that it is acceptable for the board to have powers free from interference by the company shareholders. As such, the courts may refuse to allow shareholders to take the power of conducting the business out of the directors' hands²⁶⁶, force the directors to pursue certain actions such as company property sale or ceasing legal proceedings in the name of the company²⁶⁷, and interfere in the directors' appointment of executives²⁶⁸. At the same time, in cases where directors are unable or unwilling to use powers conferred upon them by the articles of association, the general meeting is allowed to perform the duties which directors fail to perform²⁶⁹. Further, the courts established that the general meeting has wide powers to

²⁶² Jensen and Meckling (n 241); Eugene Fama and Michael Jensen, 'Agency Problems And Residual Claims' (1983) 26 *Journal of Law & Economics* 327; Cheffins (n 260).

²⁶³ *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113.

²⁶⁴ [1906] 12 Ch 34.

²⁶⁵ [1909] AC 442.

²⁶⁶ *Gramophone and Typewriter v Stanley* [1908] 2 KB 89 at 105.

²⁶⁷ *Scott v Scott* [1943] 1 All ER 582 (Companies Act); *Marshall's Valve Gear Co v Manning, Wardle & Co* [1909] 1 Ch 267, which may be explained as authorising the shareholders to commence proceedings when the board refuses to do so.

²⁶⁸ *Thomas Logan v Davis* [1911] 104 LT 914, 105 LT 419.

²⁶⁹ *Barron v Potter* [1914] 1 Ch 895; *Foster v Foster* [1916] 1 Ch 532.

sanction directors' acts beyond the authority vested by the articles, as well as act in cases of breach of duty, to cure an abuse of power by directors²⁷⁰.

Contrary to the position in England, corporate ownership in Saudi Arabia is regarded as highly concentrated²⁷¹. The evolution of the existing system has been shaped by three sets of factors: political, financial and legal. From the political perspective, small private investors have never been favoured by Saudi authorities²⁷². In terms of finances, concentrated ownership in Saudi companies can be explained by the way that the Saudi Arabian stock market emerged and progressed: the initial high trading costs have turned many small investors away, while wealthy family blockholdings have become very common in the investment landscape of the Kingdom²⁷³. Finally, Saudi Arabia's move towards a market economy and modern company law has been taking place within the French tradition of civil law²⁷⁴. This tradition is commonly characterised by a concentrated form of ownership in contrast to that of common law systems.

With large blockholdings by the government and wealthy families in the overwhelming majority of Saudi companies, the influence of these types of shareholders is not only financial, but managerial as well: the government tends to appoint executives by royal decree, while families typically give their members a seat on corporate boards and put them into top

²⁷⁰ *Hely Hutchinson v Brayhead Ltd.* [1968] 1 Q.B. 549, Companies Act; *Hunter v Senate Support Services, Ltd.* [2004] EWHC, 1085 Ch; [2005] 1 B.C.L.C. 175; *Peskin v Anderson* [2001] 1 B.C.L.C. 372. CA 2006, s 239 also introduced the statutory ability of shareholders to ratify any conduct of the directors previously regulated by common law principles only. Further, under the Act, directors who are also shareholders, or persons connected with them, are not entitled to vote in relation to any ratification resolution concerning their actions.

²⁷¹ Mohsen Al-Hajji, 'The Determinants Of Bank Profitability Of A Petroleum Economy: The Case Of Saudi Arabia' (2003) 22 Petroleum Accounting and Financial Management Journal 69; Ahmad Al-Harkan, 'An Investigation Into The Emerging Corporate Governance Framework In Saudi Arabia' (DPhil thesis, Cardiff Business School 2005); Randall Morck R (ed) *Concentrated Corporate Ownership* (Chicago, IL, University of Chicago Press 2000); Mohammed Soliman, *Ownership Concentration And Firm's Financial Performance: Evidence From Saudi Arabia* (Arab Academy Of Science Working Paper 2009).

²⁷² The Saudi government's hostility towards private investors' decision making process, as well as its control proclivity, and its bureaucracy, are discussed in Paul Aarts and Gerd Nonneman (eds) *Saudi Arabia In The Balance: Political Economy, Society, Foreign Affairs* (London, C. Hurst & Co. Publishers 2005); Ramady (n 43); Jill Solomon (ed) *Corporate Governance And Accountability* (Hoboken, NJ, John Wiley & Sons 2007).

²⁷³ The significance of financial market development in shaping different ownership structures has been extensively discussed by Coffee (n 236) 7-9.

²⁷⁴ Korateym (n 229) 64-65. Importing foreign statutes for company regulation was justified by the Islamic principle of public interest and increasing overall welfare of the society. It should be noted, however, that each piece of legislation governing corporate affairs has to be fully in conformance with *Shariah*, which makes the process of adopting new regulations rather slow and cautious.

management positions²⁷⁵. The concentration of control is furthered by the use of interlocking directorates and interlocked share ownership. The fact that controlling functions over Saudi corporations is exercised by blockholders and not directors simply makes the theory of separation of ownership and control misplaced in the context of Saudi Arabia. Indeed, the primary focus of researchers has been not the conflict between directors and shareholders, but the issue of the minority shareholders' rights²⁷⁶.

Legal regimes in England and Saudi Arabia have also determined the dominant company types in these countries. Here, again, significant differences are present. In England, companies are either private or public²⁷⁷, with large public companies playing a significant role in the country's economy. In Saudi Arabia, public limited companies, with similar, dispersed ownership represent only a very small part of all corporations²⁷⁸. These are also small companies, which are considered less safe than highly profitable and well-financed companies with significant government stakes²⁷⁹. Ironically, the structure and governance of the largest companies in Saudi Arabia can be paralleled to private limited companies in England, where large blockholding by the company founders is common. Due to capitalisation requirements, however, such companies in England are rarely large.

It has not been conclusively pinpointed in literature whether companies with concentrated forms of ownership have a higher incidence of corporate abuse. There is an important distinction between the company types in terms of the distribution of powers between directors and shareholders. In companies with a concentrated ownership, blockholders have

²⁷⁵ Fahad Almajid, *A Conceptual Framework For Reforming The Corporate Governance Of Saudi Publically Held Companies: A Comparative And Analytical Study From A Legal Perspective* (DPhil thesis, University of Manchester 2008) 244-249. Consider the examples of SABIC, where the CEO was appointed by Royal decree, or the Al Rajhi Bank, where the CEO and more than half the board members belong to the family controlling over 44% of the company.

²⁷⁶ See Al-Harkan (n 271) 118.

²⁷⁷ CA 2006, s 4. Within these categories, the Act distinguishes three liability categories: limited by shares, limited by guarantee, and unlimited.

²⁷⁸ This is due to the fact that the government and wealthy families usually own large blocks of shares, being uninterested in small investments.

²⁷⁹ For a good discussion on this, see Mike Burkart and Samuel Lee, 'The One Share – One Vote Debate: A Theoretical Perspective' (ECGI, Finance Working Paper N176 2007) 34; see also Saleh Awwad, *Legal Regulation Of The Saudi Stock Market: Evaluation And Prospect For Reforms* (DPhil thesis, University of Warwick 2000) 151-152.

significant financial interest and perceived ‘ownership’,²⁸⁰ and they are more likely to exercise the ultimate power of appointing and removing directors. At the same time, it is more likely for these companies to have directors with substantial shareholding power, which brings the issue of conflict of interest. On the other hand, in companies where dispersed shareholding is common, these powers are difficult to achieve and exercise in practice. The dispersed shareholding structure brings the problem of collective action, which is added to by likely directors’ control over meeting agendas, proxy machineries, and, sometimes, usage of pyramids to further detach shareholders from corporate assets²⁸¹.

Nevertheless, directors’ powers have to be regulated in either case. Whether controlling shareholders or not, there is always a possibility that directors might have little concern about maximising the interests of all shareholders. There is also the risk that directors may use company resources or information or their position to promote their own interests. In general, the absence of concrete mechanisms to enforce appropriate directors’ behaviour and punish them for misconduct leads to the corporate governance system.

Attempts to effectively regulate directors’ behaviour in both England and Saudi Arabia have included the creation of legal authorities and implementing legal statutes. In England, there is a clear indication of the legislator’s intent to apply various rules of governance for different types of companies. With regard to directors’ duties, this has resulted in different applications of certain duties for directors of companies, in the CA 2006²⁸², depending on whether the company is public or private. The same cannot be said about Saudi Arabia. The major regulation, the CL 1965, does not distinguish between private and public companies. A relatively new set of regulations issued by the Capital Market Authority – the CGR 2006 and

²⁸⁰ It is questionable that shareholders are considered the ultimate owners of the company in England. The issue has been extensively discussed in literature with many researchers denying this fact. See, for example, Martin Lipton and Steve Rosenblum, ‘A New System Of Corporate Governance: The Quinquennial Election Of Directors’ (1991) 58(1) *University of Chicago Law Review* 187, 195; Paddy Ireland, ‘Capitalism Without The Capitalist: The Joint Stock Company Share And The Emergence Of The Modern Doctrine Of Separate Corporate Personality’ (1996) 17 (1) *Legal History* 41; Melvin Eisenberg, ‘The Conception That The Corporation Is A Nexus Of Contracts, And The Dual Nature Of The Firm’ (1999) 24 *Journal of Corporate Law* 819; Sarah Worthington, ‘Shares And Shareholders: Property, Power And Entitlement (Part 1)’ (2001) 22 (9) *The Company Lawyer* 258 and (Part 2) 22 (10) *The Company Lawyer* 307. In *Short v Treasury Commissioners* [1948] 1 KB 116 at 122 Judge Evershed explicitly stated that shareholders were not the owners of a company.

²⁸¹ See Eisenberg (n 258) 1577.

²⁸² For example, authorisation for breaches of duties is provided differently depending on whether the company is private or public: CA 2006, s 175(5). Clear distinctions are also made in section 154, which deals with the required number of directors and sections 200-201, which prohibit issue of loans, quasi-loans, and credit transactions for directors’ benefits in public companies. Still, the majority of duties are considered universal.

the Listing Rules 2004 – are targeting only public companies, and even here practical implementation of the principles declared in the CGR 2006 has been problematic in Saudi Arabia due to its soft law nature, many generalizations, and the absence of a clear distinction of powers in the companies.

With the clear lines drawn between ownership and control in English and Saudi companies, it is time to look in-depth into the meaning of directorship according to the legal systems in both countries and determine the key differences in terms of duties and roles outlined there.

4.4 Board of Directors

A company, as an artificial entity, operates through natural persons who have the authority to exercise the day-to-day management on its behalf²⁸³. Those persons are known as the directors of the company who have the power to manage its affairs and represent it to a third party. The representatives of the company cannot possess such recognition unless they are legally appointed to the company's board of directors²⁸⁴. The board of directors is the ultimate decision making entity on behalf of the company, which exercises important powers in conducting its business. However, the members of the board are obliged by law to conduct business in a good faith and for the best interest of their company.

From a comparative perspective, various jurisdictions have different regulations controlling the board of directors, its structure and composition, and different rules concerning their legal meaning, roles and positions. In their settings, both English and Saudi legislators have recognised the powers and roles of the board of directors and imposed a number of statutory duties upon the persons who fall within the ambit of the legal definition of 'director'.

Identifying the meaning of the term 'director' as well as distinguishing between the types of directors is vital for several reasons. First, it can help establish the role and the managerial activities that each director is obliged to perform. Second, it is crucial in differentiating

²⁸³ Although it is possible for a company to run the business of another company, at least one director of every company must be a natural person: CA 2006, s 155 (1)

²⁸⁴ The provision relating to the appointment of directors is usually made by a company's articles of association. The CA 2006 requires the first directors to be appointed by a statement made by or on behalf of subscribers to the memorandum (the company's first members). This statement, amongst other requirements, must be included in the application for registration of the company, (s 9/4/c). The statement must include consent from the appointed director to act on behalf of the company, (s12/3). At the first general meeting of the company, the directors who have been appointed must retire and none of them can stay in office any longer after this meeting unless they are reappointed by the company's shareholders, (article 21/1 of the draft model articles for a public company).

between the roles, legal position and duties of insider and outsider directors. Third, it enables a third party who deals with the company in good faith to recognise the person(s) who has the authority to bind the company. Fourth, it helps the court recognise the nature and scope of the duties of each director in order to establish his/her liability in the case of wrongful acts. Fifth, it helps in identifying the fiduciary relationship that a director owes towards his or her company in addition to other general duties.

Given the strategic importance of directors in the management of the company, their legal definition, legal position and role must be identified in order to establish the scope of their duties towards the company, as these are seen in English and Saudi legislations. Therefore, the following part of this chapter examines the legal definition of the term ‘director’, and the composition and the structure of the boards in English and Saudi jurisdictions.

4.4.1 English law

4.4.1.1 Composition of the Board of Directors

Traditionally, English company law has adopted a one-tier board system, which is typical for most common law jurisdictions. As mentioned, the CA 2006 requires a private company to have at least one director and public companies to have at least two directors. Adopting the notion of ‘one size does not fit all,’ the number of directors in the boardroom differs from company to company according to its size and businesses. An English company board is composed of different types of directors with a variety of functions and experiences. Some of these types of directors are recognised in the CA 2006 (such as shadow directors), and some of them are recognised in the CGC 2010 (such as executive and non-executive directors). De jure and de facto directors are not recognised by statute, although they have been well recognised and developed by case law. The following sub-sections examine the concept of each type of director in order to provide a clear distinction between them and to identify the nature of each type’s relationship with the company management.

4.4.1.2 Legal Concept of Company Director

The CA 2006 in section 154 requires every company to have directors: a public company must have at least two directors, and a private company must have at least one director. The CA 2006 broadly defines a company director as ‘any person occupying the position of director by whatever name called’²⁸⁵. The same definition is adopted by the Insolvency Act

²⁸⁵ CA 2006, s 250

(IA) 2000, s 251; the Company Director Disqualification Act (CDDA) 1989, s 22 (94); and the Financial Services and Markets Act (FSAMA) 2000, s 417 (1). Through this brief definition, the English legislator seems to follow a wide and flexible approach in defining a company director. However, such an approach is hardly helpful in identifying those who can be considered directors and, hence, the scope of their roles and duties with the company. By its nature, the statutory definition of ‘director’ is not exclusive; therefore, its interpretation is not intended to stand on specific formalities when considering who is a director of a company.

This lack of formality in the statutory definition of ‘director’ in English law is important. It is as if the English legislator’s intention is to leave it to the company and its articles of association to generally determine the identities of those who are going to sit in the boardroom and occupy the position of directorship. By providing a much broader definition of those who ‘occupy’ the position of a director, the CA 2006 leaves room for consideration of other persons, not formally registered by the company articles but allowed by the company to act in the role of or as directors. As such, it follows that for statutory purposes, it is more important for someone to occupy the position of a director than to be registered as a director, in order to be recognised as one. While this seems to provide the courts with some room for identifying special cases of directorship, the meaning and the scope of the phrase ‘occupying the position of a director’ is not delivered either. This does not assist either in identifying the true meaning of a director or the role that a director plays in the company’s management²⁸⁶.

While formally English case law has recognised a variety of directorship forms in practice²⁸⁷, the CA 2006 only recognises shadow directors as a distinct category from de jure directors. This secondary type of directorship is clearly distinguished from a ‘director’ per se by the fact that this director would most likely not be registered by the company articles and would remain unseen by the third parties dealing with the company. Implicit in this fact is the notion that directors are those who direct the company and participate in the decision making process at the top level, not necessarily those who are registered as a director. However,

²⁸⁶ In *Re Lo-Line Electric Motors Ltd*, Sir Nicholas Brown-Wilkinson pointed out that this definition ‘does not purport to define the meaning of director but merely provides that certain persons are to be included in the definition’. [1988] 4 B.C.C. 477

²⁸⁷ As well as the types of directors mentioned, the courts have acknowledged the existence of de facto, nominee and non-executive directors, and also alternate directors. See, for example, Alan Dignam and John Lowry, *Company Law* (5th edn., Oxford University Press 2008) 269.

whether de jure and shadow directors can be viewed as being within the same legal concept of directorship needs to be seen. The next section addresses this issue.

4.4.1.2.1 De Jure Directors

The case law recognises a de jure director as a person who is properly appointed as a director of the company and is freely accepted to be in this position²⁸⁸. This person takes his or her authority from the office and has the ability to act on behalf of the company. Once a de jure director has consented to becoming a director, s/he will be considered as a fiduciary and subject to the fiduciaries' obligations²⁸⁹. From that point on, until his or her appointment ends, the director is accountable at law for all actions and inactions. English courts have rejected such defences as forgetting having been appointed a director²⁹⁰, believing oneself to have resigned, although that was not the case²⁹¹, doing nothing as a director²⁹², and following other's orders²⁹³, if there was a reasonable expectation that the director could or should have acted to prevent such occurrence.

It should be noted here that the de jure director must meet all the legal requirements to be eligible to act as a director; otherwise the appointment will be void. Although the CA 2006 does not clearly indicate these requirements, except for the minimum age of the director²⁹⁴ and holding a specific number of shares²⁹⁵, the CDDA 1986, further amended by the IA

²⁸⁸ *CEM Connections Ltd, Re* [2000] B.C.C. 917.

²⁸⁹ '.... It is of greatest importance that any individual who undertakes the statutory and fiduciary obligations of being a company director should realise that these are inescapable personal responsibilities'. *Westmid Packing Services Ltd, Re* [1998] 2 All E.R. 124 at 130a-b, 131e.

²⁹⁰ *Kaytech International Plc, Re* [1999] B.C.C. 390 403H: the director held many directorship positions in different companies.

²⁹¹ *Promwalk Services Ltd, Re* [2002] EWHC 2688.

²⁹² *Simon Box (Diamonds) Ltd, Re* [2000] B.C.C. 275.

²⁹³ *Bishopsgate Investment Management Ltd v Maxwell (No.2)* [1994] 1 All E.R. 261.

²⁹⁴ CA t 2006, s 157. There is an exception from the minimum age requirement as indicated in s 158 of the same Act as follows: 1) The Secretary of State may make provision by regulation for cases in which a person who has not attained the age of 16 years may be appointed a director of a company. 2) The regulation must specify the circumstances in which, and any condition subject to which, the appointment may be made.; 3) If the specified circumstances cease to obtain, or any specified conditions cease to be met, a person who was appointed by virtue of the regulations and who has not since attained the age of 16 years ceases to hold the office. Otherwise the appointment of a person under the age of 16 is void.

²⁹⁵ This is an important requirement which must be met by the person who wishes to be appointed as a de jure director, otherwise this person cannot be appointed as such. For instance, in the case of *Canadian Land*

2000, laid down the required qualifications for the person who wishes to be appointed as a director. One of the requirements is that the person must not be held insolvent or have a disqualification order by the court to act as a director²⁹⁶. Another requirement is that the appointee must not be a director or shadow director of an insolvent company²⁹⁷.

The de jure directors can be easily recognised by their status as full time directors involved in day-to-day management of the company and by the records of the company held by the companies' registrar. The identification of de jure directors does not raise any concern in respect of their legal relationship with the company as they are recognised as fiduciaries and have duties of a fiduciary nature towards the company. However, the concern is with regard to the types of directorship that have not been recognised at law but are considered sometimes as one type of de jure directorship such as nominee directors and alternative directors. A nominee director is a person appointed by internal or external shareholders to represent them on the company board and to make decisions that serve the interests of the appointer/s. Nominee directors are a common feature of the English corporate landscape in both private and public companies²⁹⁸, especially in cases where the smooth running of interlocked businesses is necessary or when large shareholders have little or no expertise in running the business themselves. In fact, this type of director has not been given due attention legally or judicially, but it has been recognised in commercial practice, as will be shown below²⁹⁹.

The statutory law in England makes no reference regarding the concept of nominee directors. As the legislature has not grappled with the matter, it has been left to the courts to outline the boundaries of nominee directors' duties and responsibilities. Here, the two sides of the matter have to be considered. On the one hand, as the appointed directors of the company, nominees

Reclaiming & Colonizing Co, Re, [1880] L.R 14 Ch. D. 660, two appointees were accepted as de jure directors and appointed as such. The company's articles stated that each person should hold at least 100 shares whereas in fact they never held any shares. The court then held that both appointments were invalid and the two persons could not act as de jure directors but they could serve as de facto directors.

²⁹⁶ CDDA 1986, s 1 and s 11.

²⁹⁷ IA 1986, s 216/1.

²⁹⁸ See *Boulting v Association of Cinematograph, Television and Allied Technicians* [1963] 2 Q.B. 606 at 626, where Lord Denning, M.R., acknowledged that nominee directors were 'appointed every day' and there 'is nothing wrong in it' 741(1). Also see *Promwalk Services Ltd, Re* [2002] EWHC 2688.

²⁹⁹ Dan Prentice, 'Duties Of Directors', in Hannigan B and Prentice D (eds) *The Companies Act 2006: A Commentary* (London, LexisNexis Butterworths 2007) 34.

have to act in promoting the success of the company pursuant to section 172 of the CA 2006 and, hence, they have the same duties and liabilities as the formally appointed directors³⁰⁰. On the other hand, being appointed by other natural or artificial persons, nominee directors may find themselves under pressure of being expected or even obliged to act in the best interests of their appointors. This consequently raises confusion as to whether the nominee director has a distinct legal status and duties towards the appointor to the same degree as to the company.

Although English courts have acknowledged the legality of nominee directors, they have also pointed out that the nature of the director's office does not differ based on the source of their appointment. In this regard, Lord Denning explained:

‘... [T]ake a nominee director, that is, a director of a company who is nominated by a large shareholder to represent his interests. There is nothing wrong in it. It is done every day. Nothing wrong, that is, so long as the director is left free to exercise his best judgment in the interests of the company which he serves. But if he is put upon terms that he is bound to act in the affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful, or if he agrees to subordinate the interests of the company to the interests of his patron...’³⁰¹

The notion of exercising the best judgment is especially important to note in cases where the conflict of interests exists between the nominee directors' company and his/her appointor. In essence, for a nominee, the question of how to act in such cases is no mean feat. While the commercial and social expectation would be for such a person to act in the interests of the appointor party, the question remains whether such latitude can be given to a nominee as a matter of legal principle. In the context of English law, the general principle is to act in the company's interest, and this, as demonstrated above, is quite clear. At the same time, in the absence of direct statutory provisions pointing clearly to the duties of nominee directors, the recent court decisions have somewhat pragmatically recognised the dual role that nominee directors play.

Two recent cases considered the duties of nominee directors in the light of the conflict of interests existing between the company and the appointor(s). In *Hawkes v Cuddy*, the court held that:

³⁰⁰ See also Deirdre Ahern, ‘Irish Legislative Proposals For Clarification Of Nominee Directors’ Best Interests Duties’ (2010) 31 (9) *Company Lawyer* 291.

³⁰¹ See *Boulting* (n 298) 626-627.

‘an appointed director, without being in breach of his duties to the company, may take the interests of his nominator into account, provided that his decisions as a director are in what he genuinely considers to be in the best interests of the company; but that is a very different thing from his being under a duty to his nominator by reason of his appointment by it’.³⁰²

This view basically reiterates the existing legal position toward nominee duties in England, which entitles them to consider the appointor’s interests only to the extent that these do not become incompatible with the general duty to act in the interests of the company. It is important to note, however, that the court recognised that the nominee director may owe certain duties to the appointor by reason of the terms of the appointment, but this fact does not create a duty as a director of a company. This can be seen as a useful clarification in relation to the duties owed and is consistent with the view that some duties can be owed to the appointor.

In another recent case, *Cobden Investments v RWM*, the court, among other things, specifically addressed the issue of independent judgment exercised by a nominee director. The court acknowledged that a company is entitled to expect the best independent judgment from a nominee director, but, in some matters of specific interest, the latter can be released from this duty in the case of unanimous agreement by all shareholders³⁰³. Whereas the applications of the *Cobden Investments* decision in terms of modification of nominee directors’ duties are hard to anticipate in the public company settings due to dispersed ownership, such a possibility can be borne in mind for smaller companies with few shareholders. Of course, nominees’ duties cannot be completely overridden, but the possibility of modifying their duties, even though only in certain matters and to a narrow extent, seems real. The rulings in *Hawkes* and *Cobden Investments*, however, clearly represent some recognition of circumstances where nominee directors should be distinguished from de jure directors in terms of duties owed. This notion will be discussed in details in the chapter dealing with the fiduciary duties of the directors.

Another special case of de jure directorship is an alternative director. This is the director who replaces a company’s director at the latter’s discretion. Alternative directors, however, have

³⁰² [2009] EWCA Civ 291 (Para. 33).

³⁰³ [2008] EWHC 2810 (Ch) [67].

to be authorised to act as directors by the company's articles³⁰⁴. Once appointed, an alternative director is warranted to perform all director's duties in the absence of his appointor³⁰⁵. In essence, alternative directors substitute their appointors, but the law recognises them as independent directors in their own right, not as the agents of their appointors. At the same time, an alternative director's tenure in terms of time completely depends upon the appointor: as soon as the appointor notifies the board of the end of the tenure³⁰⁶, or if the appointor, for whatever reason, ceases to be the director³⁰⁷, the alternative director loses his or her office.

4.4.1.2.2 Shadow Directors

The CA 2006 in section 251 clearly identifies the term 'shadow director': a person in accordance with whose directions or instructions the directors of a company are accustomed to act³⁰⁸. Shadow directors often maintain that they are not directors at all: they tend to act behind the de jure directors, thus making their actions less obvious than those of de facto directors³⁰⁹. Typically, when defining whether a person is a shadow director, English courts consider the communications between the person and the company board and determine whether it can be regarded as being of a directive or an instructive nature. This was clearly outlined in *Secretary of State for Trade and Industry v Deverell*: it is not required to show that the provider of instructions to the board expects them to be followed, but if the board is subservient to these orders, the fact of shadow directorship is present³¹⁰. The courts have also

³⁰⁴ See *Kaytech International Plc, Re* [1999] B.C.C. 390, at 401H. It is quite common for English companies to regulate alternative directorship within their articles as they deem fit, in relation to their interests. In general, provisions for the appointment of alternative directors by the acting directors are embedded in the articles.

³⁰⁵ See *Richborough Furniture Ltd, Re* [1996] 1 B.C.L.C. 507 524.

³⁰⁶ *Secretary of State for Trade v Tjolle* [1998] B.C.C. 282 290D.

³⁰⁷ *Secretary of State for Trade v Jones* [1999] B.C.C. 336.

³⁰⁸ CA 2006, s 251.

³⁰⁹ See *Re Hydrodan (Corby) Ltd* [1994] BCC 16 163. Also see *Re PFTZM Ltd* [1995] BCC 280 (Baker) 292.

³¹⁰ [2001] Ch 340; [2000] 2 WLR 907; [2000] 2 BCC 133. It is worth pointing out that the actual behaviour of both accused directors in the case was closer to de facto directorship, considering their active participation in the matters of the company. However, the initial allegation by the Secretary was based on the 'shadow director' definition, not the de facto one. Further attempts by the plaintiff to add de facto directorship were dismissed by the court in the light of prejudice toward the defendants and the case process, which was based on the shadow directorship platform [22].

ruled that it has to be shown that the directors acted on such orders more than once³¹¹ and were ‘accustomed’ to act under the instructions of the alleged shadow director³¹². In *Re Unisoft Group Ltd (No3)*, the court stated that the company directors’ acts based on instructions of the alleged shadow director are a matter of regular practice³¹³. In fact, the courts admitted that the very use of the term ‘shadow director’ was just a way to convey the fact that a person was acting through the medium of real directors to govern the company³¹⁴.

Section 251 of the CA 2006 was established to distinguish those who govern the company from professional advisers. Specifically, according to the Act, ‘A person is not to be regarded as a shadow director by reason only that the directors act on advice given by him in a professional capacity’. As such, people such as legal consultants, auditors or accountants, and representatives of other professional services, have to be excluded as shadow directors. What seems to be critical here is the professional nature of advice as a service provided by an expert. The advice is offered not as a mandatory order, but as a suggestion to act, which can be freely accepted or rejected by the company directors. However, statutory law does not mention this fact. Therefore, the interpretation of the word ‘advice’ is apparently left to case law to consider. An important aspect here is to distinguish genuine professional advice from manipulating the board while veiling this as advisory services. A hypothetical situation arising from the wording of section 251 is that of giving directors orders to act while covering this as consulting. Based on the wording of section 251 only, such behaviour may free the manipulator from responsibilities under shadow directorship. Therefore, each particular case

³¹¹ *Secretary of State for Trade and Industry v Becker* [2003] 1 BCLC 555. The court admitted that it did not matter whether following the instructions by the board lasted over the course of the company lifetime or just during a substantial period of time.

³¹² *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340; [2000] 2 WLR 907; [2000] 2 BCLC 133. The courts also held that a shadow directorship is established only when the majority of the board follow the instructions of the alleged shadow director.

³¹³ [1994] 1 BCLC 609 620.

³¹⁴ See *Lo-Line Electric Motors Ltd* [1988] Ch 477 (Morrit) 421-422. Morrit LJ specifically stated that the use of epithets such as ‘shadow’ could be misleading when applied to different cases, and that it was not the factor that the courts should explicitly rely upon. Rather, evidence of instructions and accustomed acting on them was important.

of consulting should be subject to scrutiny by the courts, although distinguishing consulting from manipulating may be extremely hard sometimes³¹⁵.

The courts have also held that a company can be a shadow director, as long as it issues directions to the board of another company and those directions are customarily followed³¹⁶. However, the courts do not readily associate a membership of the shadow company board as being a shadow director³¹⁷. Rather, it can be observed that each relevant case would be based on its own merits and the degree of involvement of the individual concerned with the directors of a subject company. For example, where a company was in financial crisis, the bank was able to be a shadow director and the board of directors had no option but to follow the financial policy of the bank that was imposed upon it³¹⁸. However, in *Re PFTZM Ltd*, the court held that laying down the terms for further crediting does not make the bank a shadow director³¹⁹. This is an important distinction to make, since companies often pursue different interests when entering into contractual relationships. As such, does it mean that pursuing its own interests at the expense of another company creates a shadow directorship? Apparently, English case law says it does not, as long as the offers made to another company are of such a nature that they can be easily accepted or rejected.

There is still much uncertainty in the English legal system as to whether shadow directors owe the same duties as directors in general. Section 170(5) of the CA 2006 indicates that the shadow directors owe the general duties where, and to the extent that, corresponding common law rules and equitable principles so apply. It has been contended that the Act treats shadow

³¹⁵ Some cases have managed to distinguish instructing from consulting. See, for example, *Deverell* (n 312); also see *Re Tasbian Ltd (No.3)* [1992] BCC 358. *Akai Pty Ltd v Ho* [2006] FCA 511. Still, the issue will most likely remain unresolved until further clarified by statutory law.

³¹⁶ See *Hydrodan*, (n 309); also see *Official Receiver v Brady* [1999] B.C.C. 258.

³¹⁷ *Salomon v Salomon & Co Ltd* [1897] A.C. 22 [51]; also see *Rainham Chemical Works Ltd v Belvedere Fish Guano Co Ltd* [1921] 2 A.C. 465 475. In *Hydrodan*, (n 309), Millet J. explained: 'It is possible ... that the directors [of Company A] as a collective body gave directions to the directors of ... [Company B] and that the directors of ... [Company B] were accustomed to act in accordance with such directions. But if they did give such directions as directors of [Company A], acting as the board of [Company A] (or more accurately as the appropriate organ of [Company A]) and the result is to constitute [Company A], but not themselves, shadow directors of ... [Company B]'.

³¹⁸ *A company (No. 005009 of 1987)*[1988] 4 BBC 424.

³¹⁹ [1995] BCC 280 292. The court stated that the company had the liberty to decide whether to accept the bank's terms in order to obtain another credit line. See also the recent *Buzzle Operations Pty Ltd (In Liquidation) v Apple Computer Australia Pty Ltd* [2010] NSWSC 233, where the creditor's financial power based on a loan policy was not considered sufficient for a shadow directorship.

directors as validly appointed directors, and they are subject to the same obligations as those which apply to the latter. Accordingly, they may also be subject to wrongful trading provisions, according to the IA 1986 and therefore could be disqualified under the CDDA 1986 for their ‘unfit conduct’³²⁰. A case in point is the decision in *Yukong Line Ltd of Korea v Rendsburg Investment Corp of Liberia, the Rialto*³²¹, where the court held that the shadow director was considered as a real director and held liable for the breach of his duties toward the company.

However, in the case of *Ultraframe (England) Ltd v Fielding*³²² it was held that the shadow director owes only the duty of care and skill and he is not liable as a constructive trustee to owe fiduciary duties to his company. Lewison J stated that shadow directors are only indirectly involved in the acts concerning the company’s assets, and that was the reason to not impose fiduciary duties upon them³²³. However, there is no reason not to treat a shadow director as an accountable person and subject to the same fiduciary duties as properly appointed directors. In some cases, English courts treat directors other than de jure as constructive trustees although not formally appointed³²⁴. It also seems logical to apply the same duties to shadow directors as to the company directors through whom they govern. On the other hand, it could also be argued that the acting directors have the choice of whether to be directed or not. Following the decision outlined in *Ultraframe*, it is now accepted in English law that the general scope of duties of shadow directors is the following: 1) the duties do not apply retrospectively to the time when real directors began to follow the instructions; 2) a shadow director does not owe any fiduciary duties if he or she does not deal with the assets of a company; 3) a shadow director still has to declare his or her interest in any contract with the board of directors; 4) a shadow director has to disclose the interest in shares or debentures of the company if any; 5) any transaction by a shadow director equal to

³²⁰ Martha Bruce, *Rights And Duties Of Directors* (9th edn., West Sussex, Tottel Publishing 2009) 6.

³²¹ [1998] 2 BCLC 485. The decision was linked to Insolvency Act 1986, s 212, and the actions of the defendants were classified as ‘misfeasance’.

³²² [2005] EWHC 16389 (Ch).

³²³ *ibid* 1289.

³²⁴ John Birds ‘The Duties Of Directors, General’ in Birds J, Boyle A, Clark B, MacNeil I, McGormack G, Twigg-Flesner C and Villiers C (eds) *Boyle & Birds’ Company Law* (6th edn., Bristol, Jordans 2007) 607.

£100,000 or 10% of the company value has to be approved by the shareholders' meeting first³²⁵.

4.4.1.2.3 Executive and Non-Executive Directors

Although the CA 2006 does not mention executive and non-executive directors, the two terms are distinguished in practice and mentioned in self-regulatory documentation and the CGC 2010. English courts have also readily accepted the terms and the differences between the two. Executive directors are those directors who are involved in company activities on a full-time basis; they could have been appointed to their posts and they perform specific governance tasks for the company on a daily basis. These directors are likely to have contracts with the company and be granted extensive managerial powers³²⁶. Typically, one of the executive directors is appointed as a Chief Executive Officer (CEO), with general responsibility to manage the company's business. In contrast to this, the non-executive directors (NEDs) are rarely engaged in the company's business on a full-time basis; nor are they commissioned with the task of managing the company's operations³²⁷. NEDs are normally appointed to attract lenders or customers, or add to the reputation of the company's business³²⁸. Quite often, former executives are appointed as NEDs due to their skills and expertise.

While the importance of executive directors is easily observed due to their full participation in company's activities, the role of NEDs should not be underestimated. The various corporate governance reports (including the CGC 2010) and codes have emphasised the importance of NEDs to the process of corporate governance. There is an extensive amount of literature that suggests that the corporate board should have a substantial number of NEDs for effective governance process. Some studies have emphasised the beneficial role of NEDs due

³²⁵ *ibid* 559; see *Paragon Finance v D B Thakerar & Co* [1999] 1 All ER 400; *Dubai Aluminium Co Ltd v Salaam*, [2002] England HL 48; also, see CA 2006, s. 191.

³²⁶ John De Lacy, 'The Concept Of A Company Director: Time For A New Expanded And Unified Statutory Concept' (2006) 3 *Journal of Business Law* 267, 270.

³²⁷ Executive and non-executive directors are defined and their roles are outlined extensively in literature. See, for example Solomon (n 272) 84-85; also see David Campbell and Tom Craig, *Organizations And The Business Environment* (2nd ed., Oxford, Elsevier Butterworth-Hannemann 2005) 73-74; Patrick Dunn and Glynis Morris, *Non-Executive Director's Handbook* (2nd edn., Oxford, Elsevier 2008); Mark Goergen, Christine Malline, Eve Mitleton-Kelly, Ahmed Al-Hawamdeh and Hse-Yu Chiu, *Corporate Governance And Complexity Theory* (Cheltenham, Edward Elgar 2010) 33-34

³²⁸ See *Daniels v Anderson* [1995] 13 ACC 614 662.

to their significant expertise as well as their firm specific and market specific information³²⁹, while others have stressed their role in making the board act in the shareholders' interests³³⁰.

The two primary roles of the NED in corporate governance have been identified as monitoring the acts of executive directors and supervising the executive directors in developing the overall company strategy³³¹. As a result, companies should look to NEDs for their presumed independence of judgement and relationship with the shareholders. In *Equitable Life Assurance Society v Bowley*, the court specifically recognised these roles of the NED³³². The NED's independence was also emphasised in the Cadbury, Hampel, and Higgs Reports, which defined it as 'independent from management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement'.

However, the view that NED in English companies really achieve independence of judgement has been widely challenged. Substantial amount of empirical data shows a large number of 'insider' NEDs, who are appointed by or have strong relationships with executive directors³³³. There are several arguments as to why the independence of NEDs and their effective supervision of executive directors are not fully achieved in the UK. NEDs have been reported as lacking incentives and time to be active in managing the company; being specifically chosen for potential inactivity; or being controlled by the executive board or the

³²⁹ Charu Raheja, 'The Interaction Of Insiders And Outsiders In Monitoring: A Theory Of Corporate Boards' (2005) 40 *Journal of Financial and Quantitative Analysis* 283.

³³⁰ Kenneth Borokhovich, Robert Parrino and Teresa Trapani, 'Outside Directors And CEO Selection' (1996) 31 (3) *Journal of Financial and Quantitative Analysis* 337; Benjamin Hermalin and Michael Weisbach, 'Endogenously Chosen Boards Of Directors And Their Monitoring Of The CEO' (1998) 88 (1) *The American Economic Review* 96; James Brickley, Jeffrey Coles and Rory Terry, 'Outside Directors And The Adoption Of Poison Pills' (1994) 34 *Journal of Financial Economics* 371.

³³¹ Cadbury Report 1992 was the first to emphasise the monitoring role of the NED. This function was also emphasised in the Hampel Report 1998, which stressed the importance of NED independence. More recently, the Higgs Review 2003 and the Tyson Report 2003 focused specifically on the role of the NED in the corporate governance process. The Corporate Governance Regulations 2010 emphasised both the monitoring and strategic management functions of the NED.

³³² [2003] EWHC 2263 (Comm); [2004] 1 BCLC 180 [41].

³³³ Andy Cosh and Alan Hughes, 'The Changing Anatomy Of Corporate Control And The Market For Executives In The United Kingdom' (1997) 24 *Journal of Law and Society* 104, 111 and 121. See also Victor Brudney, 'The Independent Director - Heavenly City Or Potemkin Village?' (1982) 95 *Harvard Law Review* 597; John Lowry, 'Directorial Self-Dealing: Constructing A Regime Of Accountability' (1997) 48 *North Ireland Law Quarterly* 211, 234-235; Solomon (n 272) 93-95; Roberto Mura, 'Firm Performance: Do Non-Executive Directors Have A Mind Of Their Own? Evidence From UK Panel Data' (2007) 36 (3) *Financial Management* 81-112.

CEO³³⁴. In addition, it has been a common practice to appoint NEDs based on friendship, business connections, or relationships. Even with the recent attempts to clarify the roles and functions of NEDs in reports and corporate governance codes, it still remains doubtful that NEDs are effective in monitoring and supervising the executives.

While NEDs are not actively engaged in company affairs like executive directors, English legislation does not distinguish between these two types of directors in terms of duties and obligations, although the courts have separated these in practice³³⁵. The court has also ruled that inactivity by NEDs does not exempt them from the duties that directors owe to shareholders³³⁶. However, in terms of duties, different levels of engagement are expected from executive and non-executive directors due to the different levels of involvement in company affairs³³⁷. In recent cases, the courts have taken into account this fact and the limited responsibilities of NEDs. For instance, in the case of *Re Stephenson Cobbold Ltd*³³⁸ the court ruled that although the non-executive director was a cheque signatory, he was not responsible for deciding which creditors were paid where preferential treatment had been given. Further, in *Daniels v AWA*, Rogers CJ stated that NEDs would normally rely on the executives who manage the company and trust them to do so in a competent manner, thus lowering the bar for the monitoring duty of NEDs³³⁹.

³³⁴ Goergen and others (n 327) 34; see also Laura Lin, 'The Effectiveness Of Outside Directors As A Corporate Governance Mechanism: Theories And Evidence' (1996) 90 *Northwestern University Law Review* 898, 898-903 and 914-917

³³⁵ This was referenced in *Equitable Life Assurance Society v Bowley* [2003] EWHC 2263 (Comm) at [35]; [2004] 1 BCLC 180.

³³⁶ *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 444; *Francis v United Jersey Bank* [1981] 432 A 2d 814; *Statewide Tobacco Services Ltd v Morley* [1990] 2 ACSR 405; 8 ACLC 827.

³³⁷ *Equitable Life* (n 335); [2004] 1 BCLC 180 188-189: 'There is a considerable measure of agreement about the duty owed in law by a non-executive director to a company. In expression it does not differ from the duty owed by an executive director but in application it may and usually will do so'; see also *Re Continental Assurance Co. of London Plc*, [2001] B.P.I.R. 733, 850 (Ch.), 'I accept that the managing director of a company. . .has a general responsibility to oversee the activities of the company, which presumably includes its accounting operations. But I do not think that those responsibilities go as far as to require the non-executive directors to overrule the specialist directors, like the finance director, in their specialist fields'.

³³⁸ [2001] BCC38, It is also important to mention that the court admitted the NED's high reliance on the information coming from auditors in terms of money distribution. Also see *Re Peppermint Park* [1998].

³³⁹ *Daniels v AWA Ltd* (1995) 37 NSWLR 438; (1995) 16 ACSR 607; (1995) 13 ACLC 614 (NSWCA). See also *Dorchester Finance Co Ltd v Stebbings* [1989] BCLC 498

To date, the role of NEDs and their liability still remains unclear³⁴⁰. On the one hand, legislation requires non-executive directors to show the same duty of care and fiduciary duties to a company as an executive director. On the other hand, the courts have remained unconvinced that non-executive directors have the same, full-scale responsibility as executive directors. This could become an issue, however, in the cases of competing directorships. If we consider, for example, looser fiduciary duties being imposed on NEDs, such as duties of loyalty and the duty of promoting the company's interests, there is a possibility in the latter situation of NEDs serving as directors of two or more competing companies³⁴¹.

Following the recent cases, it is clear, however, that it is important to ensure that non-executive directors have the same access to information within the company as other directors. The development in the area of responsibility by NEDs is yet to be seen; however, at this point, it is likely that the courts would consider executive directors to be under stricter duties, meaning that they are more likely to be involved in legal proceedings. There are several reasons for this. First, the CA 2006 in s.1157 (2) (b) provides that the court may relieve directors from a breach of duty if they find that the directors acted reasonably and in good faith. There is a much higher likelihood (and this was confirmed in *Stephenson Cobbold Re* and *Daniels*) that the courts would consider NEDs acting in such manner, based on information provided by the executives. Second, NEDs may benefit from the indemnity provision of the CA 2006 (s. 234 and 239), which covers fines and penalties incurred by directors in cases of a breach of duty. Section 239 requires a more detailed investigation due to its possible ambiguous interpretation.

Following the *Equitable Life* case, the amendments to the English legislation now allow companies to ratify such actions as negligence, breach of duty of trust, and default, which are subject to liability:³⁴². The Act mentions that an appropriate resolution has to be issued by the 'members of the company' to ratify such acts. At the same time, the act does not specify the number (or percentage) of the required signatories. Therefore, there is still uncertainty about how many of these 'members' would be deemed appropriate for this purpose. It also remains

³⁴⁰ Lee Roach, 'Equitable Life And Director Liability' (2006) 17 *International Company and Commercial Law Review* 225, 227. The *Higgs Report* stated that the role of non-executive directors in the UK remains poorly developed and understood. Little, however, has changed since publication of the report in 2003.

³⁴¹ See the extensive discussion on competing directorships in section 4.4.3.3. and chapter 5, section 5.3.2.2.2.4.

³⁴² CA 2006, s 239 (1).

unclear whether the acts of shadow directors should be excluded from liability. On the one hand, shadow directors, who are unlikely to have direct relationships with the company, should be reasonably excluded from the duties of loyalty and acting in the company's best interests. On the other hand, their control over the company members may be strong enough to use the members' votes under Section 239(1) to exclude themselves from any duty at all. Arguably, Section 239(3) prevents the involved directors from voting on such matters either on their own or through "connected persons." However, the definition of the "connected persons" as provided in Section 252 does not include the members that might be controlled by outside parties, such as shadow directors. Therefore, if the breaches of shadow directors may be subject to ratification by members' voting, shadow directors might be able to exclude themselves from almost any kind of liability by means of controlling the members and, therefore, the voting process.

4.4.2 Saudi Law

In Saudi Arabia, the board of directors is considered the main body governing a company's business and responsible for meeting the company's financial, social and business objectives. Consequently, Saudi legislation delegates broad authority to the board in terms of corporate governance³⁴³. At the same time, the primary Saudi company legislation does not clearly define the rights and obligations of the board³⁴⁴. In practice, however, the CL 1965 serves as the primary source outlining the duties of the board. The CL 1965 grants companies the right to make certain provisions related to the fiduciary duties of the directors within the company's by-laws; however, the supremacy of the CL 1965 is evident: where its provisions are violated, the company directors are held liable.

4.4.2.1 The Board Structure and Composition

The board structure in Saudi Arabia resembles the one typically applied in the common law countries. Specifically, all companies listed on Saudi Arabia's stock exchange have unitary boards, although the CL 1965 does not constrain companies in their choice of board structure. The widespread adoption of the unitary board structure in Saudi Arabia, however, can be

³⁴³ CL 1965, article 73.

³⁴⁴ Even though the CL 1965 grants a 'wide range of responsibilities' to the board, what these responsibilities consist of is nowhere mentioned in the Law. It has been left to the recently introduced pieces of legislation such as the LR 2004 and the CGR 2006 to define in detail the responsibilities of the company boards. However, the LR 2004 only apply to public companies, and the CGR 2006 carry a recommending, non-binding character. Therefore, even the introduction of these acts has not managed to fully deal with the issue.

explained by the main role given to the board, which is overseeing management of the company and ensuring their loyalty³⁴⁵. In the Saudi context, the board members are considered representatives of the issuer (company)³⁴⁶. In other words, board members do not represent other entities, like company employees for example, and have to care only about the welfare of the company³⁴⁷.

While the CL 1965 states the minimum number of the board members (three), there is no indication of the maximum number. This means that the legislation again leaves it to the company articles to determine the number of directors that it considers appropriate for the nature and size of the business³⁴⁸. It has been argued that such a system promotes more flexibility, as it is based on the principle ‘one size does not fit all,’ largely because companies vary significantly in their size and type of activities, which requires the number of corporate directors to be adjusted accordingly³⁴⁹. Yet, given the nature of publicly traded companies in Saudi Arabia, the absence of an upper limit on the number of corporate directors may further exacerbate the degree of the blockholders’ control, as they may use this to appoint their nominees. In England, for example, this issue is less acute, because of dispersed ownership, which is dominant in public companies. Therefore, the recently introduced CGR 2006 suggested limiting the number of board directors to eleven³⁵⁰. The boards of currently listed companies on Tadawul (the Saudi stock exchange) vary from two to twelve members, with an average board size of 8.4³⁵¹, which shows that CGR recommendations regarding this

³⁴⁵ Mohammed Al-Jeber, *The Saudi Commercial Law* (King Fahad National Library 1996) 325.

³⁴⁶ LR 2004, article 28. CGR 2006, article 11(d), however, establishes that directors represent company shareholders, thus establishing an apparent conflict of laws. In view of the fact that the CGR 2006 is a soft law, LR 2004, article 28 is expected to prevail, although interests of shareholders are likely to be considered before the interests of any other group. A more detailed discussion is provided in Section 6.4.1. of this thesis.

³⁴⁷ This is a common approach for the unitary board structure. See Christine Mallin (ed), *Corporate Governance* (2nd edn., Oxford, Ashford Colour Press 2007) 122; Solomon (n 272) 78; Cornelis de Groot, *Corporate Governance As A Limited Legal Concept* (Bedfordshire, Turbin Distributions 2009) 48.

³⁴⁸ CL 1965, article 66.

³⁴⁹ Almajid (n 275) 247.

³⁵⁰ CGR, article 12(a).

³⁵¹ The National Investor Survey 2008, as reported in Chris Pierce, *Corporate Governance In The Middle East And North Africa* (Global Market Briefings 2008).

matter are generally followed. This also demonstrates that Saudi companies tend to follow the American-England compositions of the boards with relatively few members³⁵².

A distinctive feature of corporate board composition in many large companies in Saudi Arabia is domination by government representatives, which stems from the fact that the state holds the largest number of shares in these companies. In general, the government influences the selection process not only by having the majority of votes, but also by dictating its will to smaller shareholders³⁵³. Such influence should not be a surprise though, considering the state's dominating position in both the economy and politics of the Kingdom. In many cases, the government's selection of the board members is seen as an act of the state, not as another shareholder, which leaves little room for questioning or opposition³⁵⁴.

While the government controls the largest corporations in the Kingdom, the majority of smaller businesses are controlled by wealthy families, as discussed above. In these companies, appointment to the board of directors is commonly based on family connections and/or business relationships³⁵⁵. Moreover, it is typical for the family-controlled companies to have what is called cross-directorship: where members of related families sit on the boards of each other's companies. As a result, many companies listed on Tadawul have the same representatives on their boards, appointed by either the state or wealthy families. In the end, there is a limited number of board members controlled by the limited number of large blockholders (families and government).

Another particular feature of the Saudi company boards is the absence of other entities besides shareholders. Saudi legislation does not require any type of company to appoint employee representatives, clients, suppliers or creditors to the board (although it does not prohibit it either). This is one of the instances where Saudi company law diverges from the

³⁵² Compare with France, for example, where an average board consists of fifteen members. See Yixi Ning, Wallace Davidson and Jifu Wang, *Does Optimal Corporate Board Size Exist? An Empirical Analysis* (2010) 20 *Journal of Applied Finance* 57-69; Du Plessis J, McConvill J and Bagaric M, *Principles Of Contemporary Corporate Governance* (Cambridge University Press, 2005) 307; Charkham and Ploix (n 231) 197.

³⁵³ Sometimes, the state appoints its representatives without following the procedures of the corporate articles.

³⁵⁴ See Almajid (n 275) 249.

³⁵⁵ Waleed Al-Ajlan, *Corporate Governance In Saudi Arabia: The Roles And Responsibilities Of The Board Of Directors In The Banking Industry* (DPhil thesis, University of Nottingham 2005) 363-366. The author posited that a few large blockholders in Saudi companies normally select the boards, because they have the ultimate voting power. According to The National Investor Survey 2008 (n 351), 33% of the companies in Saudi Arabia have at least two directors from the same family.

civil law principles: this practice, which means the absence of co-determination for the board, is also a common feature for the common law countries, including England³⁵⁶. This reflects the dedication of Saudi legislation to focus on one goal of the company directors: to increase shareholders' wealth³⁵⁷. As well as the legal factors contributing to this, researchers point to political and traditional reasons. Historically, the political structure of the Kingdom impeded the appearance of equally strong institutional and private entities to the official structures, which makes it hard to challenge their decisions. As a result, private and institutional activism in the country is virtually absent, which explains, when linked specifically to corporate governance, why there is little or no challenge of the appointed directors³⁵⁸.

4.4.2.2 Legal Concept of Company Director

The only place in the company law statutes of Saudi Arabia where directors are defined is the Glossary of Defined Terms Used in the Regulations and Rules of the Capital Market Authority. It states that a director 'in relation to a joint stock company, includes a member of the board of directors and in relation to any other company includes any manager or other senior executive who makes and implements the company's strategic decisions'³⁵⁹. Two points call for immediate attention here. From the definition, it is clear that the Capital Market Authority (CMA) distinguishes between the legal concepts of director as applied to joint stock companies and other forms of business. This is different from the English approach to the legal concept of director, where the same definition is applied to all types of companies. In contrast, the CMA seems to assume that the type of company would allocate different functions to directors for the purposes of law.

³⁵⁶ See Andrew Hicks and SH Goo, *Cases And Materials On Company Law* (Oxford University Press 2008) 22; also see Michael Lower, *Employee Participation In Governance: A Legal And Ethical Analysis* (Cambridge University Press, 2010) 136: 'The shareholder value approach characterises British company law. It can be seen, for example, in the Companies Act provisions concerning the appointment and removal of board members, the duties of directors and the disclosure and accountability mechanisms provided for. In each of these respects, it is clear that the CA 2006 focuses on the needs of the shareholders'.

³⁵⁷ Unlike, for example, many European civil law countries, Saudi Arabia's corporate governance does not have the term 'stakeholder', which applies to all parties potentially affected by the company's actions. The only party which is consistently mentioned throughout the Kingdom's major pieces of corporate legislation is 'shareholders'. This is in clear parallel to the legislation of the common law countries, including England.

³⁵⁸ Almajid (n 275) 251.

³⁵⁹ Capital Market Authority, 'The Glossary of Defined Terms Used in the Regulations and Rules of the Capital Market Authority' (2004) 10.

In the absence of any other definition of director in Saudi law, establishing clear guidelines regarding the legal concept of director may seem like a positive step. However, the CMA has been created to govern the listed joint stock companies only: it does not cover privately held business entities. For this reason, distinguishing between directors on the basis of company type may be logical only for contrasting purposes. Indeed, the definition of directors of publicly held companies is quite narrow: it includes only those individuals who are members of the board. As such, all other individuals, including those who may influence the decision making process in the company, but who are not officially considered members of the board of directors, are not directors for the purposes of law.

In sharp contrast with this is the wide definition of directors of other forms of business, where individuals making ‘strategic decisions’ for the company are included. To some extent, this definition is closer to the legal concept of director recognised in England. In both cases, the directors are not limited to only the persons serving in board positions, but include those who may influence the decision making process in the company. However, in the same manner, this definition provided by the CMA is not completely clear. It is unclear how far the definition extends since nowhere is it clarified what ‘strategic decisions’ may mean. Consequently, the role and position of the director in non-public companies remain uncertain.

4.4.2.3 Types of Directors in Saudi Arabia

The CL 1965 does not distinguish between different types of directors in the same manner as the CL 2006 does. However, when considering companies listed on the Saudi stock exchange, the recent trend has been to recognise the non-executive type of directorship and distinguish it from the executive directorship. The role of the NEDs has been extensively covered in the CGR 2006, and the dominant number of companies in the Kingdom has them present on their corporate boards today³⁶⁰. With the recent legislation openly recognising NEDs and their roles in corporate governance, there is a clear trend in Saudi Arabia for increasing NEDs influence in the actions of the board. However, while this trend has been

³⁶⁰ See Al-Ajlan (n 355). According to him, the majority of banks in Saudi Arabia are required to have NEDs as their board members. CGR 2006, article 12(c) also specifically points out that the majority of board members in companies have to be NEDs.

evident in government-controlled enterprises, companies owned by families have not been so fast in increasing NED membership on their boards³⁶¹.

While the presence of non-executive directors has been on the rise in many Saudi companies recently, the real question remains whether their presence adheres to the roles and responsibilities outlined in the recent legislation. Indeed, the fact that Saudi companies are putting more NEDs on their boards does not alone mean that such boards will function successfully. From this point of view, the real contribution of NEDs in governing Saudi companies has yet to be confirmed. As Almajid mentioned, frankness in Saudi boardrooms is largely diminished by the intention of expressing politeness and courtesy, which often prevents NEDs from expressing their alternative opinion regarding different matters³⁶². Further, as mentioned, due to the high level of blockholding control in Saudi corporations and cross-directorship the presence of independent judgement from the side of NEDs is unlikely.

In terms of governance policies in Saudi companies, information is virtually unavailable for researchers, and the CL 1965 exclusively grants the right for the companies not to disclose this kind of information³⁶³. Therefore, all assumptions regarding NEDs' role in corporate affairs in Saudi companies remain only assumptions. It is clear, however, that until monitoring and disciplining functions of NEDs in Saudi companies are fully established, and their independence from executive directors is instituted, there will be little effect from including NEDs in the corporate boards. Therefore, the current legislative activities oriented at including NEDs in corporate governance processes in the Kingdom should be coupled with the legislating activities aimed at ensuring the positive differences in strategic decision making processes that the NEDs may bring to the companies. The fact that Saudi company legislation does not recognise shadow directors has some important consequences in terms of the determination and application of directors' duties, as will be demonstrated below.

4.5 The Legal Position of a Company Director

In order to determine whether directors hold fiduciary duties toward their companies, it is necessary to identify the type of relationship existing between the directors, the company and

³⁶¹ Almajid (n 275) 256. The author also notes that in many cases, when NEDs are appointed, there is a high likelihood of the appointments being based on cross-directorship principles. However, no particular evidence is presented in this regard.

³⁶² *ibid* 257.

³⁶³ Al-Ajlan (n 355) 207.

the shareholders. A company has no physical existence of its own, although it owns property and is used for entering into contracts with other entities. Shareholders invest their capital in a company, but may or may not be actively engaged in the actual running of the company's business. It is the directors who actively manage the property owned by the company and the capital provided by the shareholders. Therefore, directors stand in a relationship with both the company and the shareholders³⁶⁴. The corresponding duties and responsibilities of directors are derived from the countries' statutory law codification and the obligations that have arisen in practice and have come to be widely accepted by all parties involved in the corporate governance process. Therefore, the nature of these relationships has to be explored in detail before moving on to a discussion of the duties that directors owe and to whom they owe these duties.

4.5.1 Theories on Corporate Relations Arrangements

Historically, two conflicting views on directorship have evolved: one considering directors as the agents of the company, and one considering them as trustees. The primary difference between the two theories is in the nature of the power and relationship existing between the parties in the corporate world, as well as the duties that directors owe to the company and its shareholders. As will be demonstrated, the agency theory considers directors to be more or less independent from their principals (read shareholders of the company): they are appointed to manage the company on behalf of the principals, while the principals control their actions in order to achieve desirable results for themselves. In contrast, the trusteeship theory posits that the directors are entrusted with the capital and/or property of the principal, who is the ultimate beneficiary through the equitable title. As will be demonstrated below, however, both theories assume the presence of fiduciary duties.

4.5.1.1 Agency Theory

An agency relationship arises when a principal hires an agent to act on his or her behalf. The principal relies on the agent to duly perform the duties outlined within the scope of an agency contract between the two parties. Even though potential issues arising in the agency theory were formulated as early as the 18th century by Adam Smith, the paradigm of the agency

³⁶⁴ In many countries, the term 'stakeholders' is more commonly used with regard to the relationships arising from the corporate governance process. However, as was shown in the previous section, neither England nor Saudi Arabia recognise the significance of other entities except for the shareholders. Therefore, this thesis does not include the discussion of other stakeholder types, although the researcher admits that they contribute to the process of corporate governance as well.

theory was theoretically defined in the economic studies conducted in the 1970s³⁶⁵. Since then, the theory of agency contract has become one of the most dominant theories of corporate governance upon which both corporations and legislators relied³⁶⁶.

In the corporate context, the Agency Theory addressed the relationships between shareholders and managers (directors). The major focus of the theory has been the problem of aligning the interests of agents (the directors, who are willing to control the business) and the principals (the shareholders, who have the goals of maximizing their wealth)³⁶⁷. While in companies where large blockholding is common, shareholders are able to exercise the power of dismissal and monitoring of the directors, the problem is not easily resolved in corporations where dispersed shareholding is present. Without due control, the directors are more likely to pursue their own goals rather than those of the shareholders³⁶⁸. As a result, the shareholders are likely to incur the 'agency costs' associated with the creation of incentives for the directors to act in their interests.

While there is a conflict of interests between the principal and the agent in the Agency Theory, the issue of duties can be considered important. In this regard, Dodd argued that the way to resolve the conflict between shareholders and directors is in considering the latter as agents with fiduciary duties: 'He, [the agent], on his part owes something more than a contract duty toward his principal. He is a fiduciary who must loyally serve his principal's interests'³⁶⁹. This idea that agents owe fiduciary duties to their principals has been widely supported by the Agency Theory scholars³⁷⁰. It is more important, however, to determine who exactly is considered principal in the corporate agency problem. Directors can be

³⁶⁵ See Jensen and Meckling (n 241); also see Stephen Ross, 'The Economic Theory Of Agency: The Principal's Problem' (1973) 63 *American Economics Review* 134.

³⁶⁶ Edward Zajac and James Westphal, 'The Social Construction Of Market Value: Institutionalization And Learning Perspectives On Stock Market Reactions' (2004) 69 *American Sociology Review* 233.

³⁶⁷ Kathleen Eisenhardt, 'Agency Theory: An Assessment And Review' (1989) 14 (1) *The Academy of Management Review* 57.

³⁶⁸ See Berle and Means (n 238) 1049.

³⁶⁹ Marrick Dodd, 'For Whom Are The Corporate Managers Trustees?' (1932) 45 (7) *Harvard Law Review* 1145.

³⁷⁰ See, for example, William Gregory, *The Law Of Agency And Partnership* (3rd edn., St. Paul, MA, West Group 2001); Marianne Jennings, *Business: Its Legal, Ethical, And Global Environment* (London, Thompson Learning 2006) 709; Paula Dalley, 'Shareholder (And Director) Fiduciary Duties And Shareholder Activism' (2006) 8 *Houston Business and Tax Law Journal* 301.

considered agents to the shareholders, thus justifying the existence of the agency problem, since the latter are interested in pursuing their own interests. From this standpoint, and by using Agency Theory terminology, it follows that shareholders should have wider control over directors, while the boards should focus primarily on the advancement of shareholder's interests³⁷¹. However, shareholders do not always have a complete control over the board and are not always considered liable for the acts of the latter, as the Agency Theory implies³⁷². Further, directors manage assets, which are assigned to the company, not the shareholders³⁷³. Therefore, within the Agency Theory it is more logical to conclude that shareholders are the principals of directors through the company.

4.5.1.2 Trustee Theory

Trust is a term frequently applied in common law legal systems. It defines the relationship between two parties, a settlor (also referred to as a grantor or donor) and a trustee, where the settlor entrusts property to the trustee but retains the equitable title to it³⁷⁴. In a typical trust relationship, a settlor imposes a number of obligations on the trustee, which are fiduciary in nature³⁷⁵. While the settlor has the ultimate right to the property, the trustee is treated in common law as a holder of the 'legal title' to it with the ability to use it in order to achieve the objectives of the trust. Therefore, in general terms, a trustee can be considered as the officer under a trust, who pursues the goals under the trust and owes fiduciary duties toward settlors. Modern trust practice recognises three types of trusts: express trusts, resulting trusts, and constructive trusts³⁷⁶. These types involve different purposes behind their creation and grant different powers to the trustees.

An express trust is a trust which has been declared intentionally and openly by a settlor. In this type of trust, specific property is entrusted to the trustees under the terms identified by

³⁷¹ Lucian Bebchuk L, 'The Case For Increasing Shareholder Power' (2005) 118 (3) Harvard Law Review 833, 835 and 843; Iman Anabtawi, 'Some Skepticism About Increasing Shareholder Power' (2006) 53 Companies Law Review 561, 568-69.

³⁷² See Deborah DeMott, '*Disloyal Agents*' (2007) 58 Alabama. Law Review 1048, 1050-51.

³⁷³ See Dalley (n 370) 312.

³⁷⁴ Alastair Hudson, *Equity And Trusts* (6th edn., Oxford: Routledge-Cavendish 2010) 43.

³⁷⁵ *ibid* 44.

³⁷⁶ These are the three recognised by The Law of Property Act 1925. The Act also recognises a category known as implied trusts, although these kinds of trusts are very rare today.

the settlor³⁷⁷. It is, however, important that the property and the settlor be clearly defined and that the property title is transferred to the trustees before the trust is established; otherwise a settlor may simply declare him or herself a trustee, and no property transfer will take place. Resulting trusts are not created intentionally; instead, they are implied by the courts, where the rights to a property are transferred unintentionally, without clear identification of the beneficiary, or when it is implied that the property was held for the benefit of another person³⁷⁸. Finally, a constructive trust is a form of remedy established by the court to benefit the party who has been deprived of property due to the unconscionable behaviour of the trustee³⁷⁹.

In relation to company law, the trustee theory holds that directors are trustees of the shareholders' property. Shareholders, in turn, are the trust beneficiaries, since they entrust the company property into the hands of the directors. The idea was originated by Berle, who regarded shareholders as beneficiaries and directors as their trustees as a way to resolve the principal-agent problem³⁸⁰. In favour of the trustee theory of corporate governance are the facts that directors do not always follow the orders of shareholders, while they possess significant control over the company assets and their use. Moreover, as is often the case with companies in common law countries, shareholders remain far from being actively involved in the company's affairs, and even their ownership of the company seems doubtful³⁸¹.

As seen above from the discussion of the agency and trustee theories, the terms 'agents' and 'trustees' are quite different in many aspects. The application of each term to the company directors in their relations with the shareholders and the company would involve different principles of work and imply different responsibilities. It is, however, highly likely that different views of directors, as either agents or trustees, may emerge based on differences in countries' legal systems, the nature of the company boards, and historically established

³⁷⁷ English courts have readily recognised express trusts. See, for example *Re Kayford* [1975] 1 WLR 279; *Paul v Constance* [1977] 1 WLR 527; *Bowman v Secular Society Ltd.* [1917] AC 406.

³⁷⁸ *Westduetshe Landesbank Girozentrale v Islington LBC* [1996] AC 669.

³⁷⁹ Hudson (n 374) 46.

³⁸⁰ Adolf Berle, 'Corporate Powers As Powers In Trust' (1931) 44 Harvard Law Review 1049.

³⁸¹ These are typical features for the separation of ownership and control, which is prevalent in common law countries. The issue was extensively discussed in section 4.2 of this chapter.

corporate governance practices. The following section considers whether directors are treated more as agents or as trustees in England and Saudi Arabia.

4.5.2 Fiduciary Relationships in Agency and Trusteeship

From their origins in trust law and their embedding in agency relationships, fiduciary obligations have been evolving as exclusive benefit principles and prophylactic measures against the other party's self-dealing³⁸². It has been established, therefore, that the fiduciary has to primarily serve the interests of the beneficiary³⁸³. To ensure the security of this relationship, the fiduciary is to refrain from any deals involving the beneficiary assets which could either bring the fiduciary personal gain or harm the beneficiary in some way. For this, the fiduciary is entitled to compensation for performing the duties regarding the beneficiary's property, based on confidence and trust. This notion of exclusive relationships and mutual benefits encompasses the nature of the fiduciary duties applied in corporate law, which determine the strictures that serve the purposes of retaining these relationships while restraining fiduciaries from engaging in self-aggrandizing behaviour³⁸⁴.

When the fiduciary relationships are considered in the context of a company, a special configuration of interests and needs have to be considered. In essence, directors' fiduciary duties, even though not formally attributable to the concept of agency, are basically the same as those of agents. These duties can be considered as owed to the company itself, its shareholders, or both³⁸⁵. Nevertheless, directors' fiduciary duties do require, at least theoretically, self-denying behaviour, which prohibits them from engaging in activities that undermine the company property or use it as a source of self-enrichment. Whether this notion is followed in practice depends on the specific legal, business and social circumstances surrounding the nature of the relationships between directors as fiduciaries and shareholders or companies as beneficiaries. This, in turn, is largely determined by the nature of the legal position of a director. Taking into account certain differences among different types of directors, as discussed above, the following discussion reviews the legal positions of different

³⁸² For an extensive discussion on this topic, see Victor Brudney, 'Contract And Fiduciary Duty In Corporate Law' (1997) 38 (4) Boston College Law Review 595.

³⁸³ *ibid* 601.

³⁸⁴ *ibid* 602.

³⁸⁵ A detailed discussion of whom the fiduciary duties owed will be carried in the next two chapters.

types of directors in England and Saudi Arabia and identifies the limits of applicability of fiduciary duties to each directorship type.

4.5.3 The Legal Position of a Company Director in England

The legal position of a company director in England has undergone serious changes over the course of history. The early company cases tended to treat directors as trustees³⁸⁶. This was possibly because the early English companies were not incorporated, and the company property was vested in trustees³⁸⁷. However, even after the Joint Stock Companies Act 1844, the courts preferred to treat directors as trustees³⁸⁸. In *Re Lands Allotment Co*³⁸⁹, Lindley LJ stated that the law has been treating directors as trustees of the company money, which was under their control. A similar view was shared by Jessel G in *Re Forest of Dean, Coal Mining Co*³⁹⁰, who posited that ‘directors are called trustees. They are no doubt trustees of assets which have come into their hands, or which are under their control’³⁹¹.

Nevertheless, with the introduction of the Joint Stock Companies Act 1844, there was some shift in judicial thinking regarding the treatment of corporate directors. For example, in *Aberdeen Railway Co v Blaikie Brothers*³⁹², Lord Cranworth stated that ‘a corporate body can only act by agents,’ who have to promote the interests of the company, for which they run business affairs. The idea of treating directors as agents was expressed in *Isle of Wight Rly Co v Tahourdin*³⁹³, which established the shareholders’ right to dismiss directors under the Companies Clauses Act 1845³⁹⁴. Earlier, in *Smith v Anderson*³⁹⁵, James LJ expressed the idea

³⁸⁶ See, for example, *Re Cameron's Coalbrook Railway Co* (1854) 18Beav 339; 52 ER 134; *Ferguson v Wilson* (1866) LR 2 Ch App 77; *Overend Gurney & Co v Gurney* (1869) LR 4 Ch App 701.

³⁸⁷ Len Sealy, ‘The Director As Trustee’ (1967) 25 The Cambridge Law Journal 83, 86-87.

³⁸⁸ *A -G v Belfast Corporation* [1844] Ir Ch 11; *Grimes v. Harrison* [1859], 26 Beav. 435, 33 L. T. 115.

³⁸⁹ [1894] 1 Ch 616 (Ca).

³⁹⁰ [1878] 10 Ch D 450. also, see *Great Eastern Ry Co v Turner* (1872) LR 8 Ch 149.

³⁹¹ *Re Forest of Dean, Coal Mining Co* (1878) 10 Ch D 450 453.

³⁹² [1854] 1 Macq 461 (Cranworth) 471, HL (Sc).

³⁹³ [1884] LR 25 Ch D 320

³⁹⁴ Section 90 provided that directors were limited in their authority to manage company affairs. The limitations were provided by the appropriate legislation and regulations from the general shareholders meeting.

³⁹⁵ [1880] IS Ch D 247 275.

that directors were clearly distinguishable from trustees, and a number of subsequent cases treated them as only ‘quasi-trustees’³⁹⁶.

At the beginning of the twentieth century, there was still confusion as to whether directors were considered trustees. In *Gramophone and Typewriter Ltd v Stanley*, Buckley LJ dismissed the idea of agency in relation to company directors:

‘The directors are not servants to obey directions given by the shareholders as individuals; they are not agents appointed by and bound to serve the shareholders as their principals. They are persons who may by the regulations be entrusted with the control of the business, and if so entrusted they can be dispossessed from that control only by the statutory majority which can alter the articles. Directors are not, I think, bound to comply with the directions even of all the corporators acting as individuals’³⁹⁷.

However, in *Re City Equitable Insurance Co*³⁹⁸, Romer J observed that while directors were fiduciaries (like trustees), their duties were different from those of trustees. Romer argued that in the process of managing a company, directors are entitled to make investment decisions and take risks which could not be taken by trustees. As a result, directors have different roles from trustees’ discretions and expectations to fulfill. He explained:

‘[i]t is sometimes said that directors are trustees. If this means no more than that directors in the performance of their duties stand in a fiduciary relationship with the company, the statement is true enough. But if the statement is meant to be an indication by way of analogy of what those duties are, it appears to me to be wholly misleading. I can see but little resemblance between the duties of a director and the duties of a trustee of a will or marriage settlement. It is indeed impossible to describe the duty of a director in general terms, whether by way of analogy or otherwise’³⁹⁹.

³⁹⁶ *Re Exchange Banking Co (Flitcroft's Case)* [1882] 21 Ch D 519 534; *Leeds Estate, Building and Investment Co v Shepherd* [1887] 36 Ch D 787 798

³⁹⁷ [1908] 2 KB 89 101-102.

³⁹⁸ [1925] Ch 407.

³⁹⁹ *ibid* 426.

Following the decision of *City Equitable Insurance Co*, directors are not trustees in the full sense. However, trust law is important in this case, since directors are still considered fiduciaries⁴⁰⁰, and fiduciary duties are embedded in trust law⁴⁰¹.

Modern English law tends to agree with the idea that company directors are agents rather than trustees. This notion has been developed because a) there is a duty of care and skill, which allows directors to take reasonable risks in conducting business⁴⁰²; b) directors do not own property on behalf of either shareholders or the company⁴⁰³; and c) they act as agents in conducting company business⁴⁰⁴. As agents, directors are, however, held as fiduciaries to their principal. Davies effectively put these ideas together:

‘to describe directors as trustees seems today neither strictly correct nor invariably helpful. In fact, directors are agents of the company rather than trustees of its property. But as agents they stand in a fiduciary relationship to their principal, the company’⁴⁰⁵.

It should be remembered, however, that the Agency Theory principles work well in cases where there is substantial controlling power of a principal. In relation to modern English corporate fabric, a high level of shareholder control over directors can be observed in private enterprises, where blockholding is more common. However, in large public corporations, as discussed above, there is a strong presence of dispersed shareholding, meaning that such control is nearly impossible. Therefore, in large public companies, directors occupy a pre-eminent position in management, and this makes it harder for principals to control them. This was recognised in *Gramophone and Typewriter v Stanley*⁴⁰⁶ and, recently, in *Towcester Racecourse Co Ltd v Racecourse Association Ltd*⁴⁰⁷. The position of the courts in these cases

⁴⁰⁰ See *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 at 159; *Ultraframe (England) Ltd v Fielding* [2005] EWHC 1638 (Ch); *Foster Bryant Surveying v Bryant* [2007] EWCA Civ 200, [2007] IRLR 425, [2007] 2 BCLC 239;

⁴⁰¹ Sealy (n 387) 86.

⁴⁰² *Daniels v Anderson* [1995] 37 NSWLR 438; 16 ACSR 607.

⁴⁰³ *Re Lands Allotment Co.* [1894] 1 Ch. 616 631 and 638; *Salomon v Salomon* [1897] AC 22.

⁴⁰⁴ *Hely-Hutchinson v Brayhead Ltd.* [1968] 1 Q.B. 549; *Multinational Gas and Petrochemical Co v. Multinational Gas and Petrochemical Services Ltd* [1983] Ch 258.

⁴⁰⁵ Paul Davies *Principles of Modern Company Law* (7th edn., London, Sweet and Maxwell 2003) 380. See also *Mills v Mills* [1938] 60 CLR 150 185, where Dixon J called directors ‘fiduciary agents’.

⁴⁰⁶ [1908] 2 KB 89.

⁴⁰⁷ [2002] EWHC 2141 (Ch), [2003] 1 BCLC 260.

was that neither the legislation nor shareholders could exercise sufficient powers over directors in order to create a true principal-agent relationship. That is, the idea of directors being agents cannot be uniformly applied within English corporate reality.

Because directors in public companies are less controlled, the issue of shareholder protection arises. English courts recognised this matter by applying in some cases certain trustee duties to company directors. The key case in English company law in this sense is *Regal (Hastings) Ltd v Gulliver*, which involved the board of directors acquiring shares of another company, for which their company was legally but not financially in a position to acquire⁴⁰⁸. The court held that the profits obtained from the purchase of shares were to be attributed to the company, and that the directors were in breach of their duty of loyalty. A similar decision was reached by the court in *Industrial Development Consultants v Cooley*, where a director left his company and entered into a contract with another company without providing due information⁴⁰⁹. The court held that the director occupied a fiduciary position to his company and had, therefore to disclose such information. In *Belmont Finance Corp v Williams Furniture*⁴¹⁰ and, later, in *JJ Harrison (Properties) v Harrison*⁴¹¹ the courts explained that even in the absence of express appointment of the director as a trustee, he assumes the trustee duties in relation to the company's property by virtue of his appointment to the office. Both cases involved the acquisition of properties by directors without due disclosure. Similarly, the court held that a director who tries to poach his company's clients, is in breach of his fiduciary duties and is liable to the company for all the resulting profits⁴¹².

The cases discussed above demonstrate that English law tends to treat directors as owing certain duties under the trustee theory. Specifically, they can be linked to the doctrine of constructive trusteeship, which protects beneficiaries (in this case, companies) against the actions of trustees (directors) who lack due diligence and loyalty. Indeed, while in several cases this conclusion can be reached deductively based on trust law, in *Industrial Development*, *JJ Harrison*, and *Regal*, the courts explicitly pointed out that the directors'

⁴⁰⁸ [1942] 1 All ER 378.

⁴⁰⁹ [1972] 1 WLR 443.

⁴¹⁰ [1980] 1 All ER 393..

⁴¹¹ [2002] BCC 729.

⁴¹² *Item Software (England) Ltd v Fassihi* [2003] EWHC 3116; [2003] 2 BCLC 1.

actions were considered as a breach of constructive trusteeship. Here is an explicit note by Chadwick LJ:

‘A company incorporated under the Companies Act is not a trustee of its own property; it is both legal and beneficial owner of the property. [...] the directors owe fiduciary duties to the company in relation to [their] powers, and a breach of those duties is treated as a breach of trust. [...] It follows from the principle that directors [...] in breach of their fiduciary duties are treated as having committed a breach of trust that a person who receives that property with knowledge of the breach of duty is treated as holding it upon trust for the company. He is said to be a constructive trustee of the property’⁴¹³.

As seen above, the legal position of a director in England hints at the dual nature of the office, based on the fusion of some elements of agency and trusteeship. Specifically, it is clear that, while the courts widely recognise directors as agents of their companies (not as agents of shareholders, however), they are also considered to a certain degree to be in a constructive trustee relationship. This is reflected through the presence of certain duties and obligations pertaining to such a relationship as recognised by the English courts⁴¹⁴. Both agents and trustees are subject to specific duties owed to either principal or beneficiary. However, the nature of these duties is not the same, and the nature of relationship between the two parties will depend on each particular case. The discussion above was applicable to the legally appointed directors, which makes it suitable for the de jure type of directorship. At the same time, as was demonstrated above, in the absence of a unified definition of ‘director’ the nature of the directorship office somewhat varies depending on the type of directorship that an individual holds. Therefore, for further discussion of the fiduciary duties owed by the company directors, it is worthwhile reviewing the legal position of each directorship type present in England and identifying what duties, in general, each directorship position may owe.

4.5.3.1 Legal Position of Shadow Directors

As mentioned earlier, although the CA 2006 does not define the term ‘director,’ it does define what shadow directors are. Further, section 170 (5) of the Act provides that the general (statutory) duties apply to these directors to the extent that common rules or equitable

⁴¹³ *JJ Harrison (Properties) v Harrison* [2002] BCC 729 [25]-[26].

⁴¹⁴ This, however, does not relate to all types of directors in an equal manner, as will be demonstrated in detail in Chapter 5.

principles apply. However, as English case law has clarified, shadow directors do not owe the same number of fiduciary duties as legally appointed directors do. Here, we are returning to the case of *Ultraframe England Ltd v Fielding*, which serves as a good illustration of the modern case law approach toward the duties owed by shadow directors. The case is a landmark decision in the sense that 1) it separated shadow directors from de facto directors; 2) based on the distinctive nature of shadow directors it determined their unique position in relation to the company and its assets; and 3) it narrowed the scope of the fiduciary duties owed by shadow directors, based on their unique position.

By creating a tradeoff between de facto and shadow directors, the court in *Ultraframe* laid a foundation for a different approach to the latter's legal position in a company. This approach seems logical, taking into account the fact that the statutory law clearly distinguishes shadow directors from the legally appointed directors. As Lewison J held, 'If the intention of Parliament had been to equate 'shadow directors' with 'directors' *for all statutory purposes*, this could have been achieved simply by extending the definition of 'director' to include a 'shadow director' (para. 1279). Whether the real intention of the legislator in separating the two types of directorship was really to underline the difference in fiduciary duties remains questionable; however, in the present form of the statutory law, it provides the courts with flexibility in interpreting this separation, as was the case in *Ultraframe*.

The unique legal position of shadow directors to the company requires further consideration. The court in *Ultraframe* admitted that shadow directors may have different interests from the company's and, therefore, give directions that could be regarded as being opposed to the shareholders' interests. This seems logical in cases where shadow directors do not have direct relationships with the company in question. In this case, such requirements as loyalty and not pursuing goals of profiting, which are typical for legally appointed and de facto directors, could become too constraining. The situation, however, is different when the direct relationships are present, because then trust relationships deriving from property would necessarily emerge. This, in turn, would impose fiduciary duties on a shadow director. From this standpoint, while shadow directors may not have the same scope of fiduciary duties toward a company as de jure or de facto directors, in cases when a direct relationship to the company property emerges, these duties would arise from the matter of trust law. This point was clearly outlined in *Ultraframe* as well by stating that a shadow director may be subject to specific fiduciary duties where his acts go beyond indirect influence on the company's assets.

As seen, despite shadow directors being equal to de jure directors in terms of duties as outlined in the CA 2006, English case law refuses to impose all fiduciary duties on shadow directors. Indeed, even if we look at the wording of the CA 2006 section 270 (5), it does not state that a shadow director owes the same duties to a company as a legally appointed director: it merely states that the general duties outlined in the Act apply in special circumstances. As the case of *Ultraframe* demonstrated, shadow directors owe only the duty of care and skill and they are not liable, as constructive trustees, to their company. Lewison J stated that shadow directors are only indirectly involved in the acts concerning the company's assets, and that was the reason for not imposing fiduciary duties upon them⁴¹⁵.

4.5.3.2 A Special Case of Nominee Directors

The legal position of a nominee director in England is a vexed one because of the likely presence of divided loyalties to the appointor and the company. This is also an area of corporate governance where the commercially recognised position of a director in a company may interfere with the legal principles. Yet the position of English courts in this respect has been ruthlessly strict: nominee directors owe their duties to the company first, and the duties to their appointors should be fulfilled only where these do not interfere with the interests of the company, thus implying the prevailing of section 172 of the CA 2006. The two recent cases, *Cobden Investment* and *Hawkes*, addressed the issue and outlined the scope of duties owed to companies by nominee directors. *Cobden Investment*, however, provided a more detailed approach to the issue and introduced some interesting observations that are worth considering.

In *Cobden Investment*, the court held that a nominee director, just like any other de jure director, has, among other duties, to act in the interests of the company, avoid conflicts of interest, and not make unauthorized profit. It is worth noting that, in delivering his opinion, Warren J re-emphasised the rigid frame of English law regarding nominee directors, regardless of any relevant flexibility that is applied in other British countries, such as Australia⁴¹⁶. As such, nominee directors could be held liable for the breach of duty in cases when they follow the instructions of their appointors which are not in line with the interests of

⁴¹⁵ *Ultraframe* (n 400).

⁴¹⁶ *Cobden Investments v RWM* [2008] EWHC 2810 (Ch) [65].

the company. In other words, just like regular de jure directors, nominees are considered true holders of fiduciary duties toward a company, and this cannot be overridden by the fact of their appointment to the directorship by another person or entity. This, in turn, creates a relationship of a constructive trust, which is triggered by the breach of duty toward a company. To summarise, a nominee director in the English legal system holds fiduciary duties toward a company, based on the notion of a constructive trust, while his or her duties toward the appointor are secondary in matters of legality.

At the same time, based on the *Cobden Investment* ruling, it can be argued that the context of the application of fiduciary duties to nominee directors is subject to modification. While stressing the supremacy of duties owed to a company over those owed to an appointor, Warren J acknowledged that there could be cases where fiduciary duties could be lifted⁴¹⁷. For this, however, he argued that the consent of all shareholders should be given. This note has a different power of application in public and private companies. Considering the dominance of dispersed ownership in public companies in England, the possibility of all shareholders assenting to allow the subjugation of fiduciary duties by a nominee director is extremely small. This means that nominee directorship in public companies imposes fiduciary duties on its holders in an unrestricted sense. Another matter, however, is the case of private companies where a small number of shareholders are present. The fewer the shareholders, the more likely it is that a nominee director may receive a consent to fiduciary duty relief. It is here, perhaps, that the extent of the fiduciary duties of nominee directors could be considered on a case specific basis.

Another important point to note when considering the nature of nominee directorship is the application of duty, based on section 172 of the CA 2006 (promotion of the company's success). Warren J in his judgment noted that the antecedent of the matter and the matter itself were highly subjective. This approach seems quite logical considering the wording of the provision, which includes such things as consideration of what is likely to promote the success⁴¹⁸. Based on this, the courts could, in theory, consider nominees not liable for breach of duty to act in the best interests of a company provided that the directors' belief was such. However, there could be still a case for the breach of duty of care (section 174 of CA 2006).

⁴¹⁷ *ibid* [67].

⁴¹⁸ CA, s 172. Explanatory Notes to the Act also confirm this approach, noting that business decisions undertaken by the company are within the scope of directors' responsibilities, not the courts'. This is, however, applicable in cases where good faith is present.

4.5.3.3 Legal Position of Non-Executive Directors

The legal position of non-executive directors in English law remains largely unsettled. In many aspects, it is little discussed and poorly understood in relation to their fiduciary relationship with a company. The major recent case that attempted to clarify the position of NEDs and to determine their roles and duties was the *Equitable Life Assurance v Bowley*⁴¹⁹. The court considered a general approach to treating NEDs as executive directors in terms of the general duties owed to a company; however, in reading the judgment, Langley J admitted that in practice this could not be the case. By stating this, he referred to the objective test of negligence, which provides different degrees of the duty owed to a company. At the same time, the court dutifully asserted that a lack of knowledge and skill do not prevent NEDs from exercising their rights in monitoring the acts of executives and controlling their actions. Another important point emphasised by the court is that NEDs are likely to possess different levels of knowledge, skill and experience from the executive directors who are actively involved in the business operations of a company.

This leads us to two main inferences. First, NEDs can be found in breach of duty even if they believe that no wrongdoing has taken place from the side of the executive directors due to failure, in a reasonable manner, to monitor and control the actions of executive directors. At the same time, it is clear that the degree of a director's competence has to be assessed by reference to the role that has been assigned to him or her. Therefore, the duties and responsibilities of NEDs are linked by the decision of *Equitable Life* to what is reasonably expected from an individual serving in that capacity. This deviates from the application of a strict standard of duties as applied to executive directors.

The observation noted above can be reasonably applied to individual acts of NEDs acting on their own. However, it is unlikely that the test could be applicable in decisions involving boards as a whole. In this case, all directors, including NEDs, are considered equally accountable. If a breach of duty occurs while all board members are present when the wrongful act is approved, then liability is approached from a joint perspective, and there is no defence on the part of NEDs such as being part-timers or having little understanding of the act, as was duly observed above. For these purposes, NEDs are in the same position as regular directors, as trustees of a fund, and can be found liable in relation to the company

⁴¹⁹ [2003] EWHC 2263.

assets and property, as demonstrated by *El Ajou v Dollar Land Holdings plc*⁴²⁰. Therefore, the legal position of NEDs in a company can be summarized as follows: 1) as legally appointed directors of a company, they owe certain core duties toward it; 2) in practice, however, these duties could be limited based on a test of reasonably expected capacities of the position of an NED; 3) NEDs are in the position of trustees of company property whenever serving on a board when wrongful decisions are undertaken.

A special case for fiduciary relationships in the case of NEDs is that of competing directorships. Unlike trust law, where a fiduciary cannot directly compete with the beneficiary, English company case law does not clearly provide the same rule for company directors. Nor does the CA 2006 provide any clarification regarding this point. Therefore, whether a director can compete with the company has been an open topic for discussion since the decision in *London Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd*⁴²¹, where Chitty J recognised that directors do not breach their duties when competing with their companies either directly or by holding a directorship in a competing company. The controversy related to competing directorship arises from the clash of the inherent rules embedded in English law, where the heritage of *Mashonaland*, which has been accepted as authoritative by a number of cases and scholars alike⁴²², allowing directors to compete with their companies, meets the duty of loyalty and the duty to avoid conflict of interests when serving as a company director.

While the idea of conflict of interest has been frequently referred to in English statutory and case law, the concept is not so easily grasped, as there is some tendency to confuse it with such concepts as negligence and misrepresentation. It can be stated that a conflict of interest arises from the fact of owing a fiduciary duty to another person or entity. To say that a director, for example, is a fiduciary to a company would mean that there is a special relationship of trust and confidence, which gives the director the ability to represent a

⁴²⁰ [1994] 2 All ER 685.

⁴²¹ [1891] WN 165.

⁴²² *Bell v Lever Bros* [1932] AC 161; *Cook v Deeks* [1916] 1 AC 554; *Mordecai v Mordecai* [1988] 12 NSWLR 58; *Waite's Auto Transfer Ltd v Waite* [1928] 3 WWR 649; for scholarly works see, for example, Paul Davies, *Principles of Modern Company Law* (7th edn., London Sweet & Maxwell 2007); Robert Pennington, *Company Law* (4th edn., London, Butterworths, 2001).

company's assets when dealing with third parties⁴²³. On the basis of trust and confidence from the side of the company, directors have access to the company's confidential information and have the ability to use this information in business transactions. However, directors may also use this power and information access to pursue their own interests, which could be contrary to those of the company. Therefore, the position of a company in this case is a position of vulnerability, which requires reliance on some sort of protection⁴²⁴.

The protection from the conflict of interest that directors might have is provided by section 175 (1) of the CA 2006. The provision reads that 'A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company'. What needs to be addressed here, however, is the absence of a direct reference to competition with a company. Can NEDs competing with a company be categorised under section 175 (1) of the CA 2006 and, therefore, be involved in a breach of fiduciary duties? Unfortunately, this has not been so clear from the case law evidence. In the already mentioned *Masholand* case, Chitty J refused to accept that an NED, who never acted as a director and never attended board meetings was in breach of fiduciary duty by being a director of a competing company. This belief was later re-emphasised by Blanesburgh L in *Bell v Lever Bros*⁴²⁵. However, in *Scottish Co-operative Wholesale Society Ltd. v Meyer*⁴²⁶, Denning LJ found breach of duty in continuous association with the co-operative society when that society set up its own rayon department. Further, decisions in *Bray v Ford*⁴²⁷ and *Cook v Deeks*⁴²⁸ acknowledged that trustee-like duties of good faith and loyalty are inherent in the nature of directorship.

⁴²³ See for example, *Bristol & West Building Society v. Mothew (t/a Stapley & Co)* [1996] 4 All ER 698 (Millett) 711-12: a fiduciary is 'someone who has undertaken to act for or on behalf of another in a particular manner in circumstances which give rise to a relationship of trust and confidence'.

⁴²⁴ This idea has been expressed numerous times at the courts. See, for instance, *Hospital Products Ltd v. US Surgical Corp* (1984) 55 ALR 417 (Dawson) 488; see also *LAC Minerals Ltd v. International Corona Resources Ltd* [1989] 2 SCR 574; *Frame v. Smith* (1987) 42 DLR (4th) 81 98-99.

⁴²⁵ [1932] AC 161;

⁴²⁶ [1959] AC 324.

⁴²⁷ [1896] AC 44.

⁴²⁸ [1913] 1 AC 554 (PC).

An attempt was made to finally clarify the controversial nature of competing directorships, in the recent case of *Plus Group Ltd v Pyke*⁴²⁹, where a director who had been excluded from performing his duties as a director in a company (but remained officially a director), launched a competing business and attracted a former company client. While the court held that there was no breach of duty in Pyke's actions, of most interest to our discussion on NEDs is the opinion of Sedley LJ, who on the one hand posited that a director's fiduciary duty to the company is 'uniform and universal',⁴³⁰ and on the other hand held that there are elements and facts related to a case which may exclude a director from the breach of duty liability⁴³¹. Following these statements, the two primary questions related to the context of this discussion are: 1) whether the *Mashonaland* approach is inconsistent with the modern view on fiduciary duties of directors (specifically, whether it is in conflict with section 175 of the CA 2006); and 2) whether it is possible to embrace the 'special circumstances' that would exclude NEDs from fiduciary duties.

With regard to the applicability of the *Mashonaland* approach to competing directorships, there is a substantial difference in the way that the treatment of a director's obligations has been conducted. It should be remembered that Chitty J's argument in allowing directors to compete was based heavily on the notions of the absence of contractual duties or company article provisions prohibiting these. However, a purely contractual approach to the resolution of the conflicts of interest has been struck in a number of cases that attached fiduciary duties to directors in a trustee-like manner even without the presence of explicit contractual provisions⁴³². Further, the long survival of the *Mashonaland* approach is likely to be due to the doctrine of corporate opportunity, which supports the elimination of unnecessarily rigid limits to entrepreneurship. However, while such a concession is needed, allowing directors to compete with the company and rejecting the conflict of interest in this case is unlikely to be the best way to address it. By allowing directors to compete, the burden would be shifted onto the company to monitor activities to ensure that directors do not abuse their power and negatively affect the company's assets. Such activities would be needed on a continual basis,

⁴²⁹ [2002] 2 BCLC 201.

⁴³⁰ *ibid* [80].

⁴³¹ *ibid* [89].

⁴³² See, for example, *Bray v Ford* [1896] AC 44; *Cook v Deeks* (n 422); *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324; *Regal (Hastings) Ltd v Gulliver* (n 422).

while putting a burden on directors in determining the limits of conflict of interest would require a rather modest effort (to resign or inform the board) on their side. Therefore, applying the *Mashonaland* approach to treating competing directorships is inconsistent with the modern understanding of the nature of directorship and the way it is understood within the corporate opportunity doctrine. As a result, the fiduciary obligation to avoid a conflict of interest, as established by section 175 of the CA 2006, is out of question.

A more difficult situation arises with the notion of some facts that may determine the absence of breach of duty. Here, Sedley LJ clearly undertook the approach of substance over facts. Indeed, despite remaining an NED, Pyke neither participated in the decision-making process, nor ran the company's affairs to any degree. Another aspect is that, according to Sedley, what relieved Pyke from the breach of duty was the poor treatment on the part of his company. While the facts of the case laid out by Sedley are clear, the correctness of his statement that actual involvement in the company affairs determines the extent of fiduciary duties seems questionable. Granted, given the particular circumstances of the *Pyke* case, where there is a clear hint on constructive dismissal from the director's duty, the Lord Justice's reasoning seems fair, but not in terms of the extent of applicability of the rules. Indeed, if Sedley's approach is true, then the courts, in determining the breach of duty, would have to determine the extent of the necessary involvement of a director in the company's affairs, and whether the reasons for the lack of involvement are sufficient, or whether there should be exclusion from all areas of company operations or only selected ones. Clearly, there is a substantial amount of subjectivity involved in this process, and the case law regarding NEDs' fiduciary duties would become more complicated. Therefore, with regard to the rejection (or loosening, for that matter) of strict applicability of the duty to avoid conflict of interest as a basis for fiduciary duty, serious complications may arise in determining where and why it can be applied.

Further, the fact that a director is unfairly treated could also pose a threat to the objectives of the fiduciary duty of loyalty, which has been applied to defend companies from inappropriate behaviour on the part of directors and to maintain the relationship of trust and confidence⁴³³. However, if poor treatment is taken into account, there will be no complete loyalty assurance until the poorly treated director resigns. In the light of the previously conducted discussion,

⁴³³ See *Bray v Ford* (n 432); *Regal (Hastings) v Gulliver* (n 422); *Hodkinson v Simms* [1994] 3 SCR 377.

the extent of the director's involvement in the company's affairs would matter more than his or her loyalty.

Continuing the discussion on this matter, it is worth noting that another recent court decision considered a case of an NED competing with a company, where an individual only carried the title of director, but was not involved in company affairs. In *Coleman Taymar Ltd v Oakes*⁴³⁴, the court found that the director owed full scale fiduciary duties to the company. However, the director was still acquitted of charges based on section 727 of the Companies Act 1985⁴³⁵. From the legal perspective, this approach is, perhaps, preferable to the one articulated in *Pyke*, since it admits the fiduciary nature of directorship, but leaves some leeway to the court in applying this concept fairly in specific cases. The two cases also establish the link to the duty of avoiding a conflict of interests, although the consequences of application and treatment of the breach of that duty are left to the court's discretion in reviewing each particular case.

4.5.4 The legal position of a company director in Saudi Arabia

While there is an extensive amount of literature, both academic and professional, regarding the legal position of a director in England, similar studies in a Saudi Arabian context are virtually absent. Several researchers have looked into different aspects of corporate governance in the Kingdom, including the issues of ownership, types of companies, structure of the board, and the rights of shareholders⁴³⁶, however, none have specifically addressed the issue of the legal position of a company director. Taking into account the scarcity of available research and the inability to obtain legal documents⁴³⁷, the researcher takes the approach of

⁴³⁴ [2001] 2 BCLC 749.

⁴³⁵ CA 2006, s 1157 allows the court to relieve a director of liability for breach of duty in the case where the director acted honestly and reasonably.

⁴³⁶ See Al-Ajlan W (n 355); Al-Harkan (n 271); Al-Jeber (n 345). See also an interesting discussion on the agency theory principles in Islamic Financial Institutions by Assem Saffieddine, 'Islamic Financial Institutions And Corporate Governance: New Insights For Agency Theory' (2009) 17 (2) Corporate Governance: An International Review 142.

⁴³⁷ In Saudi Arabia, obtaining official court minutes is nearly impossible, taking into account the government's prohibition on their publication. As a result, there is little academic contribution to the analysis and interpretations on the issues related to Saudi company law.

analysing the related statutory basics of corporate governance in Saudi Arabia and the general requirements outlined within *Shariah*, as the supreme law of the Kingdom.

The CL 1965 establishes directors in Saudi companies as agents who are appointed by shareholders. Consequently, the primary and secondary pieces of Saudi legislation heavily favour shareholders by granting them numerous rights over directors, including appointment and dismissal⁴³⁸, voting on business issues⁴³⁹, suing the board members⁴⁴⁰, and holding preemptive rights to stock⁴⁴¹. Although there has been a recent trend in legislation to increase the independence of the board in Saudi companies, blockholding by the government and rich Saudi families allow them to dictate their will to directors with little opposition. Moreover, as was shown above, directors are appointed by the blockholders, and they tend to overwhelmingly act in the latter's favour⁴⁴².

Considering the significant power of blockholders in Saudi companies, the statutory position of a director in a Saudi company as an agent is confirmed in practice. The corporate realities in Saudi Arabia strongly point toward the main principles of the Agency Theory, including the basic duties of agents and principals. This is evident in several ways. First, the Theory assumes agents to be acting on behalf of their principal, who exerts control over them⁴⁴³. In Saudi companies, extensive control over directors is exerted by the government or large family blockholders. Since these parties either elect or appoint directors to their positions, the latter primarily act on their behalf and in accordance with their interests. Directors in Saudi companies also act within the scope of the duties and powers attributed to them by the controlling shareholders⁴⁴⁴. The principals (large blockholders), in turn, compensate directors for conducting business and indemnify the claims and liabilities against their appointees.

⁴³⁸ CL 1965, article 66 and CGR 2006, article 5 (a).

⁴³⁹ CL 1965, article 89 and CGR 2006, article 5 (d).

⁴⁴⁰ CL 1965, articles 76, 77 and 108 outline many reasons for this action.

⁴⁴¹ CL 1965, article 136.

⁴⁴² See Part 4.3.2. of the chapter.

⁴⁴³ See Jensen and Meckling (n 241).

⁴⁴⁴ Saudi company legislation grants many issues of corporate governance to be decided by the company articles. However, in the majority of cases, large blockholders use their power to establish their own agenda within those articles, or simply ignore company bye-laws, as is the case of the government appointment of their director nominees, thus circumventing the need for calling a general meeting.

One major difference between Saudi Arabia and Western countries is the strong influence of religion. Directors in Saudi Arabia are not only under a contractual obligation to maximize their company value, but also a more compelling duty to conduct business in a manner that is compliant with *Shariah* law. Therefore, it is necessary to go beyond simply statutory analysis of a director's role and include the influence the supreme law has on it. Of particular interest to this discussion is the notion of wealth planning, the duty of acting in good faith, and the rule against uncertainty, all of which are mentioned in *Qur'an*.

The first important aspect to consider is the Islamic way of wealth planning. Under *Shariah* law, any person who has duties toward others' property is considered a trustee of their property⁴⁴⁵. Applying this principle to the process of corporate governance, it can be stated that the relationship between the company and directors is that of a trustee, since directors have duties toward the property of the company as a separate entity. *Shariah* law also explicitly specifies the duty to act fairly and in good faith. Saudi courts often consider not only the legal, but also the social and moral implications of individuals conducting business transactions⁴⁴⁶. As such, there is a clear implication of the existence of a duty of honesty, which also fits more closely with the trusteeship relations⁴⁴⁷. Finally, *Shariah* law includes the rule against uncertainty. This rule, which is generally viewed in relation to the prohibition of gambling, also has strong implications in commercial law, because it is applied to any operation containing an elevated amount of risk⁴⁴⁸. Risk avoidance, embedded in *Shariah* law and, therefore mandatory for all to follow, once again points to the possible presence of trustee features in the legal position of Saudi company directors.

As follows from the review of the legal position of Saudi directors in a company, certain features of both agency and trusteeship are present. While the legal framework of company law in the Kingdom points to the type of relationship between shareholders and directors as

⁴⁴⁵ More on this will be discussed in Chapter 6.

⁴⁴⁶ See Abderrahman (n 133).

⁴⁴⁷ It should be noted that the duty of honesty has not been so strongly relied upon in the common law countries, including England. In those countries, the legal constituents of the deals are considered much more important than moral obligations.

⁴⁴⁸ Abderrahman (n 133) 143. At the same time, *Shariah* experts, taking into account present economic realities, admit that the literal prohibition of all kinds of risk could hamper economic development. See William Ballantyne, 'The Shari'a: Bridges or conflict?' *A Foreword to the Newsletter of the Arab Regional Forum of the IBA, 1 (1) 1994*.

of a principal-agent kind, *Shariah*, as the supreme law of the land, indicates several features that are closer to a beneficiary-trustee type of relationship.

4.5.4.1 Legal Position of Non-Executive Directors

While the main company law statute of the Kingdom, the CL 1965, says nothing regarding the role and position of NEDs in Saudi corporate governance structure, recent legal developments seem to grant a stronger role to these individuals. This is clearly seen in the provisions of the CGR 2006. One of these states that non-executive directors should be present ‘in sufficient number’ on all committees that might involve a conflict of interest, including the committees dealing with the generation of reports, reviews of deals with the related parties, nominations to the board and to the position of executive director, and directors’ remuneration⁴⁴⁹. Another provision states that NEDs are subject to sufficient disclosure of information to them by the board, so that they can ‘perform their duties and responsibilities in an effective manner’⁴⁵⁰.

While the CGR represents a type of non-binding ‘soft’ law, the intention of the Saudi legislator to provide NEDs with a wider degree of power and responsibilities is evident. However, at least at the moment it is impossible to determine to what extent the legal position of NEDs stretches in Saudi legal system. Besides the non-binding nature of the CGR 2006 and the absence of an NED definition and determined roles in the CL 1965, it is hard to determine what construes the ‘duties and responsibilities’ of NEDs. Nor it is evident to what extent the NEDs are fiduciaries in the context of Saudi company law. The intention of the Saudi legislator to introduce more NEDs to corporate boards and committees could be related to the desire to have better control over family controlled enterprises, which are dominant in the Kingdom. However, it is clear in the light of the discussion above that NEDs are likely to represent individuals in the form of appointees in cross-directorship links, which are common in Saudi corporations. In this regard, the initiative of the Saudi legislator may not be that effective after all. This, however, is yet more evidence that further developments in the country’s company law codification are necessary in order to better define the roles and positions of NEDs.

⁴⁴⁹ CGR 2006, article 13c.

⁴⁵⁰ CGR 2006, article 11g.

4.5.4.2 Legal Position of Shadow Directors

Unlike English company law, Saudi statutes do not recognise shadow directors. This may be explained by the fact that, historically, the Saudi legal system has governed a business environment that did not spur the development of multiple forms of business governance structures. Even the recently issued regulations by the CMA draw very definite lines for directors in public companies by defining directors as only those who are members of the board. Consequently, all legal provisions regarding the roles of directors and the board of directors refer to one type of director: there is no statutory distinction between, for example, *de jure* and shadow directors as in English company law⁴⁵¹. On the one hand, this makes the identity of a company director more direct and easy to establish: the only criterion is to determine whether the person has a position on the board. On the other hand, individuals who may influence the board without serving there cannot be statutorily found liable for their misdeeds. In this regard, the issue of property exploitation may not be adequately addressed in relation to all potential abusers, such as shadow directors.

As was noted above, the situation is a little bit more encompassing in the case of non-public companies. But even there, the definition involves only managers and executives who influence the strategic decision making process. In other words, some definite managerial title held in the company is likely to be required in order for someone to be considered a director. Besides, the definition does not seem to include outside persons, who could be involved in the actions of the company by influencing the members of the board. Therefore, it seems that neither public nor privately held companies in Saudi Arabia can be protected, at least by means of statutory law, from the actions of those who are called shadow directors in England. Outside persons, even though influencing the board decisions, are in no way covered in the corresponding acts of Saudi company law statutes.

So, the legal position of shadow directors in Saudi company law is neither that of agents nor trustees. Moreover, the concept of shadow director is not even recognised in Saudi legislation. Can this fact be attributed to the absence of necessity to regulate shadow directors? In the researcher's opinion, it is hardly so. When the CL 1965 was signed into law, there were not many variations in corporate governance structures in Saudi Arabia due to the newness of corporations as legal entities. Such concepts as shadow directors could have been easily omitted because they were unknown at that time. However, with the rapid development

⁴⁵¹ CL 2006, ss 250 and 251.

of corporate businesses in the Kingdom and the constantly increasing complexity of the business and legal environment of company law, such concepts as shadow directors need to be reviewed and addressed appropriately. The absence of regulation of shadow directors (whether in the same or other manner than de jure directors) leads to the situation where neither the company, nor shareholders or any other stakeholders are appropriately protected from the acts of outsiders who may influence the company. Moreover, the present definition of director as provided by the CMA effectively excludes the possibility of including outsiders into the group of people who have fiduciary duties toward the company.

4.6 Chapter Summary

This chapter concludes the second step in the functionalist comparative approach, which serves as the basis for the current research, by outlining the common issue faced by the legal systems of England and Saudi Arabia. As was argued, effective codification of law to govern the multifarious nature of relationships existing between corporate directors and company property is acute in both countries' legal systems. It was also demonstrated that effective regulation of the fiduciary relationship that directors have toward company property is dependent upon the ownership structure in the companies as well as the legal position of company directors. After determining the major similarities and differences in the main aspects related to directorship institutions in England and Saudi Arabia, it is now time to proceed to the next step in the functionalist method of comparative study, which is the analysis of the approaches used to resolve the common issue in both legislations.

Chapter Five: Directors' Fiduciary Duties towards Company Property in England

5.1 Introduction

The previous chapter reviewed the principal similarities and differences between English and Saudi law in terms of the definition of the term 'director', in light of the theories and approaches related to the ownership structure and the classification of companies under both legal systems, identified the legal meaning and types of company directors in both countries, and examined the legal nature of a company director in both countries. By doing so, the chapter completed the second step in the functional analysis chosen for this research. The next step, accordingly, is the presentation of the systems' approaches in order to solve the problem in question⁴⁵². At this stage, the comparatist builds his comparative framework by describing the legal norms, concepts and institutions of each legal system. This function can be described as the 'epistemological function' of understanding legal institutions and rules as a way of solving the problem at hand⁴⁵³. As was noted in the previous chapter, the issue upon which this study focuses is the regulation of directors' fiduciary duties toward company property. The aim of this regulation is to effectively prevent exploitation of property, while not impeding the foundations of free enterprise.

This chapter provides an analysis of the regulations in the English legal system to regulate directors' fiduciary duties toward company property. The chapter starts with the discussion of what is considered property in English company law. The major, second section of this chapter analyses the provisions of the statutory code that regulates directors' fiduciary duties toward property (mainly sections 175, 176, and 177 of the CA 2006) and examines to what extent they are consistent with the previous case law. The third section of the chapter analyses the approach taken by English company law in protecting company property from directors' exploitation. To obtain a broader picture of the approach, English legislation is compared to the other countries with common law systems: the United States and Canada. From a comparative perspective, the section determines whether property protection in English law comes into conflict with the economic laws of free market and enterprise. The chapter concludes with a brief summary.

⁴⁵² Zweigert and Kötz (n 53) 43.

⁴⁵³ Michaels (n 58) 364.

5.2 Company Property in English Law

The discussion about fiduciary duties toward company property should rightfully begin by answering the question of what is considered property for the purposes of analysis. In general, property can be thought of as a physical or intangible entity that belongs to an individual or a group of individuals. This definition suggests that the key to understanding property is the concept of ownership. What makes property different from the other legal categories, such as restitution or a contract, is the presence of two key elements: 1) property can be purchased and sold, and 2) property can be excluded from use by others⁴⁵⁴. Therefore, company property can be considered as something that can be bought, sold and legally protected from unpermitted usage by other parties, including directors.

Traditionally, English law considers two major types of property: company assets and intellectual capital, such as trademarks, patents, and copyrights. Misuse of corporate physical or intellectual assets poses no legal problem, since it is clear that directors cannot use a company's land or trademark as though they belong to him or her. Difficulties, however, arise when the question of misusing corporate opportunity and information emerges. The heart of the problem here rests in the much more subtle nature of opportunities and information, which from the legal perspective are not so evidently suitable for protection as a piece of property would be.

5.2.1 Information and Opportunities

Unlike physical objects and intellectual capital, the referencing of information and opportunities⁴⁵⁵ as parts of company property has been inconsistent in English law. Indeed,

⁴⁵⁴ Roger Smith, *Property Law* (Pearson Education Limited 2009) 3-4; also see James Penner *The Idea Of Property In Law* (Oxford University Press 2000) Chapter 4.

⁴⁵⁵ Information about opportunity and opportunity itself are, in fact, hard to distinguish for legal purposes. See, for example, Pearlie Koh, 'Principle 6 Of the Proposed Statement of Director's Duties' (2003) 66 (6) *The Modern Law Review*, 894, 897; also consider *Brown v Bennett* [1999] 1 BCLC 649, where Morritt LJ noted that directors 'form knowledge' based on the presentation of an opportunity; an excellent further explanation is provided by David Kershaw 'Does It Matter How The Law Thinks About Corporate Opportunities?' (2005) 25 (4) *Legal Studies* 533, 547: 'Intuitively the idea of an opportunity suggests progression towards the realisation of the information about the opportunity. [...] such a distinction can be made because [...] it assumes the opportunity exists in a way distinct from information prior to it being 'used' by the director. However, prior to its 'use' an opportunity is always information and knowledge. It does not make sense, therefore, to regulate 'opportunities' differently from 'information'.

opinions in favour and against this proposition are common⁴⁵⁶. Perhaps the decision in *Boardman v Phipps*⁴⁵⁷ can be considered the main authority in this matter, as it directly addressed the issue of equating information to a piece of company property, and revealed the absence of a cohesive view that information and knowledge were company property. The case involved the purchase of a company's shares by two individuals (Boardman and Phipps) who were considered fiduciaries of a trust⁴⁵⁸ which held a minority stake in the company. The purchase put the fiduciaries into effective control of the company, which they used to conduct a restructuring and substantially increased the company value in the process. The information used by Boardman and Phipps for the company financial valuation was acquired by them in their capacity of trust fiduciaries. The question eventually arose as to whether that information could be considered as trust property, thus assigning any resulting profits to the trust. In the court decision, Lord Hodson openly dissented from the opinion that information cannot be described as property⁴⁵⁹. Concurring with the opinion, Lord Guest emphasised that there was 'no reason' not to consider information and knowledge as trust property⁴⁶⁰, while extending the application of this rule beyond just confidential information. A less determined position was demonstrated by Viscount Dilhorne who, although admitting that some information may still be regarded as property, stated that the information in the case was not considered property in an equal sense to that of the trust shares⁴⁶¹. Similarly, Lord Cohen argued that information was not 'property in the strict sense of that word'⁴⁶². Finally, Lord Upjohn completely dismissed the idea that information, even if confidential, would be considered as the company's property. His lordship argued that while confidential

⁴⁵⁶ General discussion on uses of confidential information can be found in Lord Goff and Gareth Jones *The Law Of Restitution* (Sweet & Maxwell, 2002) 754-56. In favour of considering confidential information a piece of company property are decisions in *Re Keene* [1922] 2 Ch 475 and *A-G V Guardian Newspapers Ltd* [1989] 2 FSR 81 99-100. Against such treatment are decisions in *North And South Trust Company V Berkeley* [1970] 2 Lloyd's Rep 467 481 and *Fraser V Evans* [1969] 1 QB 349 361.

⁴⁵⁷ [1967] 2 AC 46.

⁴⁵⁸ Boardman was a solicitor and a fiduciary, while, technically, Phipps was a beneficiary and would not normally be considered a fiduciary. However, Phipps chose to be regarded as a fiduciary.

⁴⁵⁹ *Boardman* (n 457) 107.

⁴⁶⁰ *ibid* 115.

⁴⁶¹ *ibid* 90.

⁴⁶² *ibid* 102.

information is often described in property terms, that did not mean that it would be regarded as property⁴⁶³.

Following the comments provided by the judges in *Boardman v Phipps*, it is possible to discern the two different approaches to the language of property employed in the case. The first approach treats information as property in the strict sense of the term, meaning that it is considered as an intangible entity that a company has the right to use and exclude others from using. This approach was taken by Lords Hodson, Guest, and Upjohn, who analysed the case from the position that information was compared to such types of property as real estate or shares. Consequently, Lord Upjohn's argument that something that is open for everyone to see or hear could not fall under ownership rights⁴⁶⁴ seems logical. However, the concept of property is quite flexible. As Kershaw pointed out, it does not establish the nature of the rights attached to information; rather, it defines the relationship of ownership that can be viewed in different ways⁴⁶⁵. This relationship of ownership, which does not fully encompass ownership as discussed earlier, is central to the doctrine of corporate opportunities, which considers the logic and language of the concept to define the nature of a qualified form of ownership between a company and a director.

The corporate opportunities doctrine, as a proprietary concept, has been actively developed in the US legal system in recent decades⁴⁶⁶. The key aspect of the doctrine is the treatment of opportunity and information in terms of ownership. The major criterion of legal relevance in the doctrine is to whom, the company or the director, the presented opportunity 'belongs'⁴⁶⁷. This aspect of belonging has been scrutinised in the landmark Delaware case of *Guth v Loft*⁴⁶⁸, where the court developed a set of rules establishing the presence of opportunity

⁴⁶³ *ibid* 128. The same opinion was expressed in a criminal law case *Oxford v Moss* [1979] 68 CR App Rep 183, where information was deemed not to belong to property for the purposes of theft.

⁴⁶⁴ *ibid* 127.

⁴⁶⁵ Kershaw (n 455) 549; also see Goff and Jones (n 456) 755, where they argue that categorisation of information as property does not resolve such complex issues as the scope of duties.

⁴⁶⁶ John Lowry and Rod Edmunds 'The No-Conflict – No-Profit Rules and the Corporate Fiduciary: Challenging the Orthodoxy of Absolutism' (2000) *Journal Of Business Law* 122, 123.

⁴⁶⁷ See, for example, the decision in *Re Digex, Inc Shareholders Litigation* 789 A 2d 1176 At 1188 (Del, 2000), where the key phrase is 'a corporate opportunity belonging to Digex'.

⁴⁶⁸ 5 A 2d 503 (Del, 1939).

ownership by the company⁴⁶⁹. Importantly, however, while the language of property is commonly used in corporate opportunity cases, the doctrine does not aim to establish absolute property rights to information against third parties. Rather, it is concerned with what resembles personal rights between the company and the director⁴⁷⁰. Therefore, the use of the words ‘property’ and ‘belonging’ in this case serves as a proxy to define a different set of opportunity rights from those that might be attached to physical objects or intellectual property. Nevertheless, it should be noted that a certain commonality to the logic of property is present, since in the case of a successful resolution in favour of the company, the other party (director) will be excluded from using the opportunity.

Returning to *Boardman v Phipps*, the language of Viscount Dilhorne and, perhaps, Lord Cohen could be considered as talking in the corporate opportunities sense when applied to information and the opportunities it carries. Indeed, both Dilhorne and Cohen treated information not as a piece of property, but as if it was a piece of property, with all the subsequent legal applications. The cornerstones of Viscount Dilhorne’s argument were two early cases in English law: *Aas v Benham*⁴⁷¹ and *Dean v MacDowell*⁴⁷². In both cases, the court applied an ownership framework in addressing information and opportunity issues⁴⁷³. While referencing these cases, Viscount Dilhorne referred to the usefulness of the ‘scope of business test’, arguing that the acquiring of shares by Boardman and Phipps was outside the scope of their trust’s business. In other words, Viscount Dilhorne, while accepting the fact that information and opportunity could be treated as property in certain cases, acknowledged that it was not so in *Boardman v Phipps*: the opportunity of acquiring shares did not ‘belong’ to the trust.

⁴⁶⁹ This case will be discussed in detail below. For the matters of current review, the most important fact is its treatment of opportunity in terms of ownership.

⁴⁷⁰ See, for example, *Graham v Mimms* 111 App 3d 751 (Ill, 1982) 762; also see *Re Trim-Lean Meat Products, Inc.* 4 Br 243 (Del, 1980) 247.

⁴⁷¹ [1891] 2 Ch 244. This was a partnership case, which established the ‘scope of business’ test to determine whether an opportunity could be exploited by a partner. As will be shown later, the test’s applicability to company law was dismissed in *O’Donnell v Shanahan* [2009] EWCA Civ 751. However, there is some strong scholarly support to apply the ‘scope of business’ test in order to relax the strict English position regarding conflicts of interest. These issues are reviewed in detail in section 5.3.2.2.2.5.

⁴⁷² [1876] 8 Ch D 345.

⁴⁷³ *Dean v Macdowell* (n 472); *Aas v Benhman* (n 471).

As seen above, the corporate opportunities framework allows the language of property to be applied to information and opportunity in a qualified sense. Granted, information and opportunity cannot be considered property in the full meaning of the term, and even the CA 2006 refers to property, information, and opportunity as separate constructs⁴⁷⁴. However, within the corporate opportunity framework, both information and opportunity are treated as if they were property in order to define the nature of the rights and duties existing between the company and the director, when it comes to both information and opportunities. Considering the growing influence of the doctrine in English case law, which is evidenced from the majority of recent cases regarding information and opportunities within the organisational context, this chapter treats corporate information and opportunities as if they were pieces of corporate property. This distinction will become clear in the section dealing with directors' loyalty as applied to resignation cases, which have strong links to the maturing business opportunity doctrine.

5.3 Directors' Duties with Respect to Company Property

The nature of directors' duties represents one of the key aspects of modern English company law. Taking into account that all company activities are conducted by human beings, even though under the veil of corporate personality, and the fact that human directors are the main actors in the corporate governance process, directors' duties toward the company and other parties become central to the legal control of companies. As discussed in the previous chapter, directors in English law are considered company agents, and are thereby subject to the full strictness of the fiduciary duties imposed by equity to ensure directors' compliance with the principle that they are not to benefit from their entrusted positions.

The earliest examples of English case law where fiduciary duties were analysed date back as early as the eighteenth century and encompass relationships of trust⁴⁷⁵. By adopting the case law by analogy, the courts later extended the application of fiduciary duties onto directorship positions. Given nearly two centuries of case law development in this field, it is notable that the English legislator attempted to reduce the main aspects of fiduciary relationships to several pages in a statutory code⁴⁷⁶. Whether that was a successful undertaking is a major

⁴⁷⁴ CA 2006, s 170 (2)(a).

⁴⁷⁵ Most notably, *Keech v Sandford* [1726] EWHC Ch J76.

⁴⁷⁶ Fiduciary duties of company directors are covered by sections 170-179 of the CA 2006 on five pages of text.

question that the rest of the chapter will address, although, due to the nature of the research, which deals with fiduciary relationships concerning property, the focus will remain on three sections of the CA 2006: the duty to avoid a conflict of interest (Section 175), the duty not to accept benefits from third parties (Section 176), and the duty to declare an interest in a proposed transaction or arrangement (Section 177). However, before delving into a discussion of these sections, it is necessary to address the key question, which, hopefully, will help clarify the general nature and scope of directors' fiduciary duties, namely: to whom do directors owe fiduciary duties?

5.3.1 To Whom Are the Duties Owed?

While there has been much debate on the issue of to whom company directors owe fiduciary duties in the past, the CA 2006 seems to make it clear: the ambit of the statutory scheme is provided in Section 170 (1): 'The general duties specified in sections 171 to 177 are owed by a director of a company to the company'. The wording of this section leaves no doubt about the ultimate receiver of directors' duties: the company only. Subsequently, this means that the CA 2006 established the company as the proper claimant related to directors' breach of duties.

However, just stating that the duties are owed to the company is not really insightful. As discussed in the previous chapter, companies, as entities, act through human beings. The question inevitably arises, therefore, about the nature of the company's interests: would those constitute the interests of the relevant groups such as shareholders, employees and creditors, or would the company's interests be set aside? Surprisingly, English courts have remained indecisive regarding this matter. In *Greenhalgh v Arderne Cinemas Ltd*⁴⁷⁷, for example, Evershed MR held that the company is not separated from its members as a distinct commercial entity. As such, the court dismissed the corporate realism approach⁴⁷⁸ and aligned company interests with those of shareholders as the general corporate body. Further,

⁴⁷⁷ [1950] Ch 286.

⁴⁷⁸ The corporate realism approach advocates that a company is an independent entity from its members. The idea was introduced by Otto Gierke *Political Theories of the Middle Age* (1900) in Maitland J (trs and ed) (Cambridge University Press 2002). The normative and legal consequence of this assertion is that a company is entitled to have its own interests and duties and own property. Therefore, corporate realism distinguishes corporate property from shareholders' property. Shareholders cannot own the company and therefore it is not run for their benefit only. The company, in essence, as a real and independent entity, may have its own interests, which may or may not align with those of the shareholders. With the emergence of the managerial firm, this theory became quite popular. See Alan Dignam and Michael Galanis *The Globalisation of Corporate Governance* (Ashgate Publishing 2009) 14.

in the *Report of the Second Savoy hotel Investigation*⁴⁷⁹, a Board of Trade Inspector had to determine whether directors' could remove an asset from a company to avoid its takeover. The Board ruled that directors could not simply act in the short-term interests of the company, but had to also consider the long-term interests of the members, including future members⁴⁸⁰.

English courts have been willing to recognise certain circumstances where shareholders' interests had to be taken into account by directors. This was notable in *Gething v Kilner*, where the court held that in takeover recommendations directors owed a duty of honesty to the company shareholders⁴⁸¹. The decision in *Gething*, however, effectively excluded future shareholders' interests by recognising the interests of the current shareholders only. This approach was further emphasised in *Heron International Ltd v Lord Grade*⁴⁸², where Lawton LJ posited that in takeover bidding the primary company interests are with the current shareholders. A similar position was expressed in *Stein v Blake*, where Millet J stated that in special circumstances a director might owe certain personal duties to a shareholder, where the latter sustains personal losses as a result of the director's actions⁴⁸³. Further, in *Glavanić v Brunninghausen*⁴⁸⁴, the court acknowledged that while directors owe duties to the company and not to the shareholders, in situations where the transaction concerns only specific shareholders and not the company as a whole, a fiduciary duty can be recognised as owed to those shareholders.

A particular situation recognised by English courts is the close family company situation. In *Coleman v Myers*⁴⁸⁵, Mahon J found that directors owed fiduciary duties to the shareholders of the company, which was acquired in a takeover bid by one of the shareholders.

⁴⁷⁹ See Dignam and Lowry (n 287) 302.

⁴⁸⁰ *ibid.*

⁴⁸¹ [1972] 1 WLR 337.

⁴⁸² [1983] BCLC 244.

⁴⁸³ [1998] 1 All ER 724 727d and 729g. An example could be a shareholder induced by a director to part with shares at a loss. This was contrasted with the devaluation of shares because of a director's misappropriation of the company's assets, where the director would not be personally (as distinct from the company) liable for the loss.

⁴⁸⁴ [1999] 46 NSWLR 538 547-560.

⁴⁸⁵ [1977] 2 NZLR 225.

Interestingly, while admitting the correctness of *Percival v Wright*⁴⁸⁶, Mahon J argued that in small private companies with a high degree of ownership concentration, directors would have a duty of disclosure, which established a direct fiduciary relationship with the shareholders and not with the company.

In general, the position of English courts regarding the fiduciary duties of directors can be summarised as the following: the duties are owed to the company, while in certain situations, directors owe fiduciary duties to shareholders as well. Indeed, while there is a growing number of cases that provide specific circumstances where fiduciary duties to shareholders arise⁴⁸⁷, to say that court decisions in these cases assume a parallel fiduciary obligation to shareholders would be incorrect. In this regard, it is useful to refer to the judgement by Mummery LJ in *Peskin v Anderson*⁴⁸⁸. His lordship held that the legal relationship between directors and the company which gives rise to fiduciary duties does not exist between directors and individual shareholders; instead, ‘they are dependent on establishing a special factual relationship between the directors and the shareholders in that particular case’⁴⁸⁹. In essence, Mummery LJ admitted that there could be events where ‘direct and close contact’ with shareholders may generate duties owed to shareholders, but that these must not cut across the general duties that directors owe to the company. The reason for such an approach was explained as an attempt to protect the shareholders from ‘improper and unfair advantage’ being taken by the directors⁴⁹⁰. In the broadest sense, cases like *Peskin* and others discussed above acknowledge the duty of good faith when directors act in an advisory capacity to the company shareholders. In a general capacity, however, the company does remain the only entity to whom the fiduciary duties are owed. It is to this extent that the wording of section 170 (1) of the CA 2006 should be regarded.

⁴⁸⁶ [1902] 2 Ch 401. The case emphasised that directors owe a duty of loyalty to the company alone, and not to the shareholders. The core argument was codified in the CA 2006, s 170.

⁴⁸⁷ In addition to the cases mentioned above, also see *Re Chez Nico* [1992] BCLC 192; *Platt v. Platt* [1999] 2 BCLC 745; *Peskin v Anderson* [2001] 1 BCLC 372; *Glandon Pty Ltd v Strata Consolidated Pty Ltd* [1993] 11 ACSR 543; *Glavanics v Brunninghausen* [1999] 46 NSWLR 538.

⁴⁸⁸ [2001] 1 BCLC 372.

⁴⁸⁹ *ibid* [33].

⁴⁹⁰ *ibid* [34].

While the CA 2006 emphasises the company as the only receiver of directors' fiduciary duties, attempts have been made to protect the interests of minority shareholders too. Prior to the Act, minority shareholders, except in certain circumstances, could not generally sue directors for any wrongs done to the company⁴⁹¹. In theory, the CA 2006 changed this by introducing sections 260-264 which deal with the procedures for filing derivative claims. Under the sections, any member of a company can file a claim resulting from any existing or potential act or omission involving such acts by directors as negligence, default, breach of duty and breach of trust. While the attempt by legislators to protect minority shareholders' interests deserves some praise, the wording of section 260 needs further comment. It says that 'a member' of an organisation may bring a claim, which might refer to a single shareholder who, in fact, does not even have to have been one at the time when the wrongdoing took place.

Unsurprisingly, there was some speculation regarding the possibility of putting pressure on directors by activists and pressure groups, even despite the fact that the Act created some procedural barriers targeting unreasonable actions⁴⁹². An example could be a union's acquiring of shares to bring derivative claims against directors in the takeover process that would lead to layoffs. Nevertheless, a number of recent court decisions have dismissed the possibility of filing derivative claims especially when there is unfair prejudice involved. For example, in *Mission Capital Plc v Sinclair & Anor*⁴⁹³, the court decided that a derivative claim under Section 261 of the CA 2006 could not be filed when there was not much importance attached to the claim and the alleged damage was highly speculative. In *Franbar Holdings Ltd v Patel and Ors*⁴⁹⁴, the court refused to give permission to proceed with a derivative claim based on the possibility of filing a claim under 'unfair prejudice' and on several factors that a hypothetical director would consider, among which were the likelihood of the claim's success, damage to the company's reputation in case of the claim's failure, and

⁴⁹¹ Certain exemptions did exist, but rather as exceptions to the well established rule formulated in *Foss v Harbottle* [1843] 67 ER 189. Derivative claims have been 'very scarce', as noted in Geoff Yates and Mike Hinchliffe, *A Practical Guide to Private Equity Transactions* (Cambridge University Press 2010) 332.

⁴⁹² For example, section 263 provides that before the court gives permission for the claim, the claimant has to clearly establish a prima facie case. Further, section 264 lists a number of requirements that have to be met in order for a claim to be processed: acting in good faith, consideration of the degree of importance of the claim, and consideration as to whether the action in question is likely to be authorised by shareholders.

⁴⁹³ [2008] EWHC 1339.

⁴⁹⁴ [2008] EWHC 1534 (Ch).

the cost of litigation. Similarly, in *Stimpson & Ors v Southern Landlords Association*⁴⁹⁵, a hypothetical director's test was used in order to prevent a derivative claim's proceeding. Finally, in *Iesini v Westrip Holdings Ltd*⁴⁹⁶, the court emphasised the importance of filing derivative claims based on acts of negligence, default or breach of duty: none of these was found present since the directors followed the advice of respected professionals. As seen above, at least for the moment English courts are inclined to interpret strictly the possibility of bringing a derivative claim. It may seem, therefore, that the concerns of activist shareholders in the post-Act legal era are unfounded. Yet, arguably, the very fact of the possibility of filing a claim, which may well be dismissed by the court, might give some advantage to the shareholders in the short term period at least. The Act does not anyhow prohibit the filing of unfounded or speculative claims, which could, in theory, slow down or disrupt the directors' decision making process.

To complete the discussion on this topic, it is useful to see how the current statutory code interacts with the previous case law on the matter. The key question here is whether the CA 2006 is intended to be an exhaustive legislation codifying the major duties of the directors and naming the one who is the primary receiver of these duties. Section 170 (3) is helpful in this matter, as it reads:

‘The general duties are based on certain common law rules and equitable principles as they apply in relation to directors and have effect in place of those rules and principles as regards the duties owed to a company by a director’.

This section can be interpreted as providing that the directors' general duties are based on the pre-existing case law and equitable principles; however, the statutory principles will have effect in place of those principles. Consequently, it can be assumed that, in the general course of events, the statutory code replaces the pre-existing case law on the matter with the exception of cases where case law could clarify unclear statements within the code. This should, however, be read together with Section 170(4), which provides that:

‘The general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties’.

⁴⁹⁵ [2009] EWHC 2072 (Ch).

⁴⁹⁶ [2009] EWHC 2526 (Ch).

From this, it may be concluded that while the CA 2006 places the new rules over the pre-existing case law, these rules are to be interpreted regarding established case law principles. It then follows that the duties listed in section 10 of the Act can be added and further developed by subsequent case law. This brings up two issues, however. First, it is not certain how the principles laid out in the CA 2006 could possibly be equated to equitable principles, since the courts are not capable of either overruling or significantly altering the sense of the sections. Second, it remains unclear to what extent the codified duties may replicate or replace the duties outlined in pre-Act case law⁴⁹⁷. Keeping these facts in mind, it is time to review the fiduciary duties of company directors which involve property rights.

5.3.2 Duty to Avoid Conflicts of Interest

5.3.2.1 Purpose and Codification

The duty to avoid a conflict of interest is one of the main tenets of the law relating to fiduciary duties⁴⁹⁸. The interests referred to are the directors' personal and fiduciary interests. The requirement of avoiding a conflict of interest has two important consequences in English law: the fiduciary has to account for the resulting profits derived from the conflict⁴⁹⁹ and avoid any situations when the conflict of interest might arise⁵⁰⁰. The rationale for avoiding a conflict of interest is further established in the prevention of situations where directors might exploit opportunities for personal benefit⁵⁰¹. Parker LJ in *Murad v Al-Saraj*⁵⁰² noted that one of the reasons for enforcing the policy of avoiding a conflicts of interest is 'the perceived difficulty in determining what might have happened but for the fact that the fiduciary had

⁴⁹⁷ This chapter will further argue that directors' duties identified in sections 175 and 176 of the CA 2006 are not particularly reflecting the equitable principles established in the relevant case law.

⁴⁹⁸ Hudson (n 374) sec 12.5.

⁴⁹⁹ *Regal Hastings ltd v Gulliver* (n 432); *Boardman v Phipps* (n 457)

⁵⁰⁰ *Boardman v Phipps* (n 457); *CMS Dolphin Ltd. v Simonet* [2001] 2 BCLC 704; *Sinclair Investment Holdings Sa v Versialles Trade Finance Ltd* (No 3) [2007] EWHC 915.

⁵⁰¹ See, for example, *Kingsley Consulting Ltd v Mcintosh* [2006] EWHC 1288 (Ch); [2006] BCC 875 55.

⁵⁰² [2005] EWCA Civ 959 107.

placed himself in a position of conflict'. This view is also shared in scholarly work on English law⁵⁰³.

The regulation of the rule to avoid a conflict has been codified in section 175 of the CA 2006. The core fiduciary duty is presented in section 175 (1):

‘A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company’.

The wording of this paragraph implies that the duty is much broader than, for instance, a duty to avoid profiting from the conflicts of interest or causing financial loss to the company by exploiting the conflict. As such, the duty is considered to have been breached if a director fails to avoid a situation where a conflict of interest is present or may be present. Notably, while the paragraph mentions conflicts of interest⁵⁰⁴, it does not clarify what the interest may mean⁵⁰⁵. As such, the CA 2006 has somewhat failed to resolve the breadth of this rule’s application. Unlike the use of tangible or intellectual property of a company, the assessment becomes more difficult in cases where directors take opportunities that could be used by their companies. Indeed, earlier cases dealing with the conflicts of interest varied in their approach: some applied quite a narrow view of which opportunities are caught⁵⁰⁶, while some took a broader view⁵⁰⁷. For example, *Regal (Hastings) Ltd v Gulliver*⁵⁰⁸ and *Boardman v Phipps*⁵⁰⁹ (although the latter is not a company case, it is still considered a major authority in English company law) took a wide view on the opportunities by considering anything of possible interest to the company (even impossible to practically or legally pursue) a ‘corporate opportunity’. On the other side of the scale is the ‘scope of business’ approach

⁵⁰³ See, for example, Davies (n 405) 392-394: the courts would face difficulties in assessing the fairness of a transaction if a director claimed that the same transaction would take place in a situation where there was no conflict.

⁵⁰⁴ The final section 175(7) also emphasises that the application of the entire section 175 of the CA 2006 refers to both a conflict of interest and duty and the conflict of duties.

⁵⁰⁵ Reference to defining interest was made, for example, in *Bray v Ford* [1896] AC 44 51-52.

⁵⁰⁶ See, for example, *Balston Ltd v Headline Filters Ltd* [1990] FSR 385 412; Also See *IDC v Cooley* [1972] 1 WLR 443.

⁵⁰⁷ See *Bhullar v Bhullar* [2003] EWCA Civ 424; also see *Allied Business Consultants Ltd v Shanahan* [2009] EWCA Civ 751.

⁵⁰⁸ [1942] 1 All ER 378.

⁵⁰⁹ [1967] 2 AC 46.

mentioned above. Finally, a tighter definition, but one giving some freedom to directors in pursuing personal interests, is the maturing business opportunity, which limits conflicts of interest to real and maturing opportunities pursued by directors⁵¹⁰. In similar fashion, some courts have determined that a conflict arises only if a company has some ‘specific interest’ in the relevant opportunity⁵¹¹.

While a wider formulation of the rule has prevailed historically in English case law, the narrow view seems to find applications as well, especially in modern cases. The introduction of section 175(4)(a) in the CA 2006, too, seems to serve the purpose of relaxing the strict application of the conflicts of interest rule. Nevertheless, the section is not sufficiently well defined to clarify the extent of the exceptional situations in which the conflict of interest would not arise. From this standpoint, the lack of clarification in the CA 2006 is likely to prolong the legal debates regarding the scope of the conflict of interest rule. It could be easier for the courts if the statutory code made it clearer. Some suggestions regarding such clarifications are made at the end of this study.

Section 175 of the CA 2006 continues with a particular definition of the scope of the rule stating that a director is not permitted to exploit the company’s property, information or opportunities even if the company could not take advantage of these⁵¹². Section 175 (2), therefore, mentions a specific case of the rule application, which is exploitation. The Act suggests that exploitation should be referred to in broad terms, meaning any use of property, not simply the abuse thereof. The section also reinforces the equitable rule that ‘it is immaterial whether the company could take advantage of the property, information or opportunity’. This generally accords with the approach that was taken in *Keech v Sandford*⁵¹³, as well as in *Regal (Hastings) Ltd v Gulliver*⁵¹⁴. Notably, section 175 of the Act is applied to both current and former directors⁵¹⁵. The primary issue, therefore, is not when the conflict emerged, but whether the conflict related to the exploitation of property, information and

⁵¹⁰ As will be discussed later, this approach has received wide discussion in cases related to resigning directors.

⁵¹¹ *Balston Ltd V Headline Filters Ltd* (n 506).

⁵¹² CA 2006, s 175(2).

⁵¹³ [1726] EWHC Ch J76.

⁵¹⁴ [1942] 1 All ER 378.

⁵¹⁵ As stated in Section 170(2) (A) of The CA 2006.

opportunity and whether the director was ‘aware at a time he was director’ of the exploitation⁵¹⁶. The wording of the corresponding section in this sense, however, seems to require that exploitation, not the presence of a conflict of interest, should be within the director’s consideration. This is a strange limitation, in that it concentrates on directors’ avoidance of exploitation, and not all kinds of conflict of interest.

Sections 175(3)-175(6) deal with the exceptions to the general rule of avoiding conflicts: namely, limitations in relation to transactions with companies; limitations arising from shareholders’ consent; and limitations for situations that cannot reasonably be considered as likely to bring a conflict of interest. Two issues deserve attention here. First, the section distinguishes between the approaches taken by private and public companies in authorising situations potentially leading to conflicts of interests. Specifically, section 175(5)(a) states that in private companies the conflict could be authorised by the board of directors (unless otherwise disallowed by the company’s constitution), while section 175(5)(b) states that in public companies, authorisation has to be expressly permitted by the company’s constitution. Such a distinction seems logical, given the fact that in the majority of English private companies the directors also hold a significant number of shares, thus giving them considerable power over when to permit a conflict. In contrast, large public companies, where the separation of ownership and control are common, require stronger protection for shareholders, who have much less power in controlling directors⁵¹⁷. The second point to note is in section 175(4) (a), that the reasonableness test can be applied to determine whether a conflict took place. On the basis of this section, it is possible that the courts will be able to somewhat loosen the strict boundaries of the conflict rule application. For example, based on a reasonableness test, it could be that directors would be able to pursue opportunities which a company considers and rejects on a properly informed and bona fide basis⁵¹⁸.

⁵¹⁶ CA 2006 s 175(2).

⁵¹⁷ These issues have been extensively discussed in Chapter 4, section 4.1.2.

⁵¹⁸ This was the issue in the highly controversial case of the Canadian Supreme Court. See *Peso Silver Mines, Ltd. (N.P.L.) v Cropper* [1966] SCR 673. See section 5.3.2.2.2.4 of the current chapter for an in-depth discussion of this issue.

5.3.2.2 Avoiding Conflicts of Interest in Case Law

5.3.2.2.1 The Principle in General

As mentioned above, the basis for section 175 of the CA 2006 is pre-Act case law. The roots of the equitable principle of avoiding a conflict of interest in English case law is based on the need to prevent fiduciaries from usurping their position for self benefit by acting unconscionably⁵¹⁹. The earliest example of the conflict avoidance rule is found in *Keech v Sandford*⁵²⁰, where the court decided that a fiduciary (specifically, a trustee) is not authorised to make profits from his position⁵²¹. The principle was further explicitly laid out in *Bray v Ford*⁵²²:

‘It is an inflexible rule of the court of equity that a person in a fiduciary position [...] is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interests and duty conflict. It does not appear to me that this rule is [...] founded upon principles of morality⁵²³. I regard it rather as based on the consideration that, human nature being what it is, there is danger, in such circumstances, of one person holding a fiduciary position being swayed by interest rather than duty, and thus prejudicing those whom he was bound to protect. It has, therefore, been deemed expedient to lay down this positive rule’.

The strictness of the rule defined in *Keech v Sandford* has been reinforced in two landmark cases in English law, mentioned earlier: *Regal (Hastings) v Gulliver*⁵²⁴ and *Boardman v Phipps*⁵²⁵, which used different approaches to regulating opportunities⁵²⁶. In *Regal*, the key

⁵¹⁹ See *Yugraneft v Abramovich* [2008] EWHC 2613, [2008] All ER 299 373, where unconscionable behaviour is mentioned with reference to *Westdeutsche Landesbank v Islington* [1996] AC as the basis principle in cases involving a constructive trust.

⁵²⁰ Although a trustee case, it has been widely applied to fiduciary duties of directors in English company law. It has basically served as a foundation of a strict approach to defining the scope of duties and corporate opportunities.

⁵²¹ [1726] EWHC Ch J76. A good discussion of the principle itself can be found in Hudson (n 374) 535-564.

⁵²² [1896] AC 44.

⁵²³ This view has been somewhat reconsidered recently. In *Bhullar v Bhullar* (n 507) Parker LJ mentioned ‘ethics’ as an important factor in the case.

⁵²⁴ [1942] All ER 378.

⁵²⁵ [1967] 2 AC 46.

⁵²⁶ Detailed analysis of both cases and the rules they relied upon is provided in the next section.

approach to deciding whether the conflict of interest took place was based on the question of whether profit was derived as a result. Drawing on trust law, the court held that the breach of duty resulting in the exploitation of property was established as long as:

‘(i) what the directors did was so related to the affairs of the company that it can properly be said to have been done in the course of their management and in utilisation of their opportunities and special knowledge as directors; and (ii) what they did resulted in profit to themselves’⁵²⁷.

As seen above, profit is the key factor in Lord MacMillan’s judgment. Since the directors made profits on the shares while acting as fiduciaries for the company, they had to account for those profits. Importantly, per Lord Russell’s judgment, the directors’ obligation to account for profits did not relate to acting in bad faith; rather, the mere fact of making a profit in given circumstances was sufficient⁵²⁸. Lord Russell in his judgment never mentioned the no-conflict principle per se. Instead, he strongly relied on the *Keech v Sandford* principle that a fiduciary cannot make a profit from his position in the office. Following the judgment in *Regal*, the no-profit rule can be summarised as follows: a director is in breach of his fiduciary duty to a company if he makes a profit by taking an opportunity in the course of and by reason of being in a directorship position, whilst it is irrelevant whether he acted in good faith or whether the company also received profit from his actions⁵²⁹.

In *Boardman v Phipps*⁵³⁰, the court took a somewhat different approach. Despite the split of judgments, all of their lordships in the case agreed on the presence of the core equitable principle, which can be seen from Lord Upjohn’s opinion⁵³¹:

‘The relevant rule for the decision on this case is the fundamental rule of equity that a person in a fiduciary capacity must not make a profit out of

⁵²⁷ [1967] AC 153 (Lord Macmillan).

⁵²⁸ *ibid* 386.

⁵²⁹ The decision in *Regal* also addressed an issue of financial incapacity of the company. It was equally dismissed as a relevant issue. Lord Wright, at 157f, noted that the court could not adequately assess the matter of financial capacity of the company in most cases. However, it does seem unlikely that the Lord Justices would have changed their opinion on the matter even if financial incapacity of the company were evident. See David Kershaw, *Company Law In Context: Texts And Materials* (Oxford University Press 2009) 479: ‘the court in *Regal* puts the deterrence of wrongdoing and a policy concern about the court’s ability to assess financial capacity above issues of fairness to the parties’.

⁵³⁰ [1967] 2 AC 46.

⁵³¹ *ibid* [32].

his trust which is part of the wider rule that a trustee must not place himself in a position where his duty and his interest may conflict’.

As follows from this dictum, the conflict of interest approach is considered the key, while the no-profit rule is only viewed as its application. The exact nature of this approach was clarified by his lordship (although it was a dissenting opinion): ‘it means that the reasonable man looking at the relevant facts and circumstances of the particular case would think that there was a real sensible possibility of conflict’⁵³². In this sense, whenever considering a case where a fiduciary makes a profit from an opportunity while acting as a fiduciary, it should be asked whether the fiduciary’s personal interests come into conflict with the beneficiary’s.

Treatment of the no-profit rule as an application of the no-conflict principle can be justified in several ways. The main reason lies in the interpretation of the no-profit principle. If taken in the manner defined in *Regal*, the no-profit rule would dismiss the possibility of any profit made by directors. This could potentially refer to the cases where the duty of loyalty, which is considered fundamental in fiduciary relationships, would not always apply. For example, what if a director is privately advised by a broker on the last block of shares that is expected to substantially gain in value or what if the company did not want to pursue a particular opportunity which a director took? Within the no-profit rule the directors would be accountable for profits due to profiting in the course of directorship, although such a decision would hardly be linked to being disloyal to the company. However, if the same shares were advised for purchasing at the company board meeting, but the director took an opportunity for himself, it would clearly involve a conflict of interest because the director made a profit in a disloyal manner by misusing his position. Second, the treatment of the no-profit rule within the context of a no-conflict framework allows for a better reading and interpretation of the *Regal* decision. Indeed, the ruling of *Regal* within the no-profit rule raises some potentially conflicting questions, such as whether the directors could have been more persistent in negotiations with the landlord (which was, in fact, the main argument behind the *Keech v Sandford*), or whether the transaction in question could have been arranged on behalf of the company. Circumstances may be such that there is no conflict of interest, but the director takes the opportunity in the course of directorship and by reason of directorship. In these

⁵³² *ibid* [33].

cases, the core duty of loyalty would not be infringed, thereby giving no reason for the director's accounting for profits⁵³³.

If the no-profit rule can be considered as an application of the no-conflict rule, then a question arises: would the *Regal* decision remain the same under the no-conflict approach? Arguably, within a broader application of opportunity regulation than the no-conflict rule provides, it would be logical for the decision to remain. The opinion of the researcher is that it is indeed so. As was demonstrated earlier, the directors in *Regal* had a conflict of interest with their company by refusing to provide personal financial guarantees, thus paving the way for personal pursuit of the opportunities, and by failing to accordingly capitalise the subsidiary while the subsequent sale was considered, during the time that the new theatres were purchased. The presence of a conflict of interest, therefore, would probably be established⁵³⁴. From this perspective, the judgment in *Regal* does not interfere with the no-conflict rule. Similarly, in the case of *Boardman v Phipps*, the court disallowed the solicitor to retain the profits in order to preserve the purity of the avoiding of conflict rule established in *Keech v Sandford* and *Bray v Ford*.

Nevertheless, the status of the no-profit rule in relation to the no-conflict rule in English law remains far from certain. Authority exists both in favour of standalone treatment of the no-profit approach⁵³⁵ and its treatment as an application of the no-conflict rule⁵³⁶. As will be

⁵³³ This notion will be further developed in the section comparing English company law to the laws in other common law system countries, notably, the United States and Canada. The chapter further argues that under the standalone principle of the no-profit approach, it is not possible to effectively develop a more balanced approach to regulating opportunities in English law.

⁵³⁴ Another strong point in favour of this conclusion is the presence of s 175 (2) of the CA 2006 stating that 'it is immaterial whether the company could take advantage of the property, information or opportunity'. As a statutory law, this section would dismiss the claim that the company in *Regal* was not able to pursue the opportunity as 'immaterial'. In such way the court in *Regal* would not be in need of making speculative claims as to whether the company was financially capable of pursuing the opportunity. At the same time, allowing directors to pursue an opportunity in cases when the company has little chance of doing that could decrease directors' incentives for doing their best to promote the company's interests. Subsequently, the conflict of interest would emerge.

⁵³⁵ See in case law: *Ultraframe (UK) Ltd v Fielding* (n 400); *Plus Group Ltd. v Pyke* [2002] EWCA Civ 370; [2002] 2 BCLC 201; *Wilkinson v West Coast Capital* [2005] EWHC 3009 (Ch); *Don King Productions Inc v Warren* [2000] Ch 291; in scholarly articles, see Koh (n 455) 406; Robert Austin, 'Fiduciary Accountability For Business Opportunities' in Finn P (ed) *Equity And Commercial Relationships* (The Law Book Company 1987) 146-147.

⁵³⁶ *Boardman v Phipps* (n 457); *Item Software v Fassihi* (n 412). For scholarly commentators, see Kershaw (n 455) 538-539; Ben Pettet, *Company Law* (2nd edn, Longman 2005) 168; Graham Moffat, *Trusts Law: Text And Materials* (Butterworths, 1999) 631.

demonstrated later, the CA 2006 did not manage to completely resolve the matter. Further, there is still much uncertainty about the extent of the application of the no-conflict rule. This was the reason for the split judgment in *Boardman*. Lord Cohen, for example, considered the presence of conflict of interest in a case where the fiduciary takes on an opportunity, which could be possibly pursued by the beneficiary. Based on the facts of the case, in relation to company directors, such an approach would mean that a conflict of interest is present when a director advises his company on an opportunity and takes it himself. In contrast, Lord Hodson dismissed the importance of the beneficiary's pursuit of the opportunity. In his view, 'whether or not the trust or the beneficiaries in their stead could have taken advantage of the information is immaterial'⁵³⁷.

Lord Hodson's dictum has served as the basis for the CA 2006 section 175(2), which means that statutory law, in essence, takes a strict approach in defining conflicts of interest. It is necessary, however, to understand the nature of the conflict rule application to see whether it matches the formulation provided in the CA 2006. In both *Regal* and *Boardman*, as well as in the underlying *Keech v Sandford* case, the beneficiaries (companies or trust) were not entirely excluded from the opportunity by fiduciaries. Whether it is the landlord's actions in *Keech*, financial problems in *Regal*, or refusal to obtain court approval in *Boardman*, it is clear that the fiduciary could have acted in some way to resolve the matter. Consequently, that could have influenced the outcomes: for example, the fiduciary in *Keech* could have attempted to persuade the landlord, if it was possible, to renew the lease in his own favour; the directors could have provided financial guarantees to obtain financing in *Regal*; and the trustees could have made the case for authorisation of their actions in *Boardman*. While it is hard to judge whether those actions would have been successful, the existence of the possibility is always present. However, the CA 2006⁵³⁸ makes these considerations immaterial. The problem with this is that neither case law nor the CA 2006 provides what is considered 'immaterial'. Hence, it is impossible to say what exactly would fall into this ambit: just the circumstances of the three cases mentioned above, just the fact that the company could not take the opportunity as mentioned in the CA 2006, or all 'capability facts'. An interesting example to consider in this sense is when seizing an opportunity which for the company is legally impossible to pursue for a company (such as, for example, due to

⁵³⁷ *Boardman v Phipps* (n457)

⁵³⁸ CA 2006, s 175(2).

anti-trust law), but is legal to pursue by a director. The opportunity is clearly there, but the question is whether the director will be in breach of his fiduciary duty by acquiring the company opportunity.

Following the decisions in *Regal* and *Boardman*, two important cases were decided in relation to conflict of interest and opportunity regulation. The findings in these cases help to further assess the degree of compatibility between the case law and the codified principles of section 175. In the first case, *Industrial Development Consultants (IDC) v Cooley*⁵³⁹, the court considered fiduciary wrongdoing on the basis of information misuse⁵⁴⁰. The defendant, the managing director of the company, received information about a potentially profitable project but concealed that information from the company and used it for personal advantage after resigning under false pretences. The circumstances of the case were such that the director was approached as an individual and his services were regarded as those of an individual consultant not associated with the company where he served as a director. The court found those circumstances irrelevant. The information obtained by the director was considered by the court as being of concern to the company, hence making it the director's duty to pass it on to the company. The court re-emphasised that the company was entitled to the benefits despite the fact that it was unlikely to pursue the opportunity had the director presented the appropriate information, although 'if the defendant is not required to account he will have made a large profit as a result of having deliberately put himself into a position in which his duty to the plaintiffs who were employing him and his personal interests conflicted'⁵⁴¹. The case is important for several reasons. First, it recognised information about opportunity as having the same value as the opportunity itself. Second, it confirmed the approach taken by Lord Hodson in *Boardman*, which is now codified in the CA 2006 section 175(2). Finally, the ruling provides that the basis for the decision was the presence of a conflict of interest.

⁵³⁹ [1972] 1 WLR 443.

⁵⁴⁰ Notably, it was information about the opportunity and not the opportunity itself which was subject to consideration. As Roskill J acknowledged, the chance that the opportunity would have been taken by the company was quite slim. *ibid* 454.

⁵⁴¹ *ibid* 453.

The second important case to consider is *Bhullar v Bhullar*⁵⁴². Unlike the directors in *Cooley*, the defendants in this case did not divert the opportunities pursued by the company: by chance and without reliance on information confidential to the company they acquired a piece of property which the company later claimed it should have been informed about. Notably, the company, which was the claimant in the case, made a statement prior to the directors' action that it would not acquire any additional properties. The court decided that the opportunity represented by the property purchase had to be communicated to the claimant company, and that the directors held that property on constructive trust. The court, again, reasserted that the constructive trust is not predicated on misuse of the property, but rather is based on the conflict of interest due to a 'sensible possibility of conflict',⁵⁴³ thus applying the *Boardman* equitable principle.

The importance of *Bhullar* stems from several factors. First, the court considered whether the opportunity was in line with the company's main business activities and whether the opportunity would be 'worthwhile' to pursue, to determine if the opportunity was corporate⁵⁴⁴. This is an interesting observation, which slightly resembles the 'line of business test,' which is popular in US company law⁵⁴⁵, but not so much in English jurisdiction⁵⁴⁶. The directors in *Bhullar* did not pursue the opportunity in the course of or by reason of their directorship in the wide sense. Rather, they pursued the opportunity that was potentially worthwhile for the company and failed to communicate it accordingly. As such, the decision in *Bhullar* extends the criteria for defining corporate opportunity. According to Paul Davies⁵⁴⁷, this represents a positive development in English law: the decision recognises that

⁵⁴² [2003] EWCA Civ 424.

⁵⁴³ *ibid* 42.

⁵⁴⁴ *ibid* 41.

⁵⁴⁵ The test is one of the main differences between the ways that English and US company law regulate opportunities. It will be discussed in detail later. For now, it is worthwhile noting that the general provision of the test is that the opportunity pursued within the existing business of the company is a corporate opportunity. It is irrelevant in this case whether information or property is deployed by a director to acquire the opportunity.

⁵⁴⁶ In the classic English partnership case *Aas v Benham* (n 471), the court established the 'scope of business test' that allowed partners to take opportunities that fell outside the scope of the company's business. This approach, however, has been largely ignored by English company law courts since the decision in *Boardman V Phipps*. The Court of Appeal in *O'Donnell v Shanahan* (n 507) unequivocally rejected the test's applicability to English company law.

⁵⁴⁷ Paul Davies, *Gower and Davies' Principles of Modern Company Law* (8th edn, Sweet and Maxwell 2009) 566.

the fiduciary duties of directors are omnipresent, not only applied in certain particular circumstances. Indeed, should the directors' actions be justified by the court, based on the argument of, for example, acting in a different capacity rather than as a director, then it would create a strong precedent for fiduciaries who might have used the argument to justify taking direct or indirect advantage of their positions.

The second important aspect of *Bhullar* is that the court completely ignored in its ruling the fact that the company, prior to the defendants' taking the opportunity, openly stated that it would not seek to acquire additional properties. Still, the company managed to reverse that decision, based on the opportunity presented in the case⁵⁴⁸. This kind of behaviour seems opportunist: the company, which officially limited the scope of its activities, successfully managed to obtain account for profits that were earned from a line of business not related to that of the company at the moment when the property was acquired⁵⁴⁹. This issue is related to the first issue raised in *Bhullar*: if English courts decide to extend liability within the corporate opportunities model beyond the actual line of business of a company, then it seems that the no-profit rather than the codified no-conflict rule would prevail. Indeed, requiring directors to account for profits from the opportunities that are rejected by the company seems to increase the burden of a directorship position, because directors would be at risk of losing such opportunities to the company. This is especially true in the case of non-executive directors, who are not actively involved in company activities⁵⁵⁰.

Subsection 175(5) of the CA 2006 considers authorisation, by the board, of directors taking an opportunity that is within the scope of corporate opportunity. However the Act at the same time fails to resolve the issue where a company, through its board, limits the scope of business, which could have a direct effect on the scope of corporate opportunities. Why does

⁵⁴⁸ Basically, it seems that the claimant seized the opportunity when it arose by ignoring its previous declaration of not pursuing such opportunities.

⁵⁴⁹ Davies also considered company behaviour in *Regal* to be 'opportunistic': see Davies (n 547) 566. However, the two situations are not entirely similar: the company in *Regal* never openly stated it was limiting its scope of business, but the circumstances of the case led to the situation where the company, although questionably, could not obtain financing to acquire the properties. Besides, in *Regal*, the purchase of additional theatres was discussed at the board meeting, where directors failed to provide guarantees for the purchase thus opening an opportunity for personal pursuit, thus creating conflict of interest. In *Bhullar*, the company decided not to purchase additional properties not because it was financially incapable of doing so, but for other reasons, which were closer to its business focus.

⁵⁵⁰ The absence of any formal distinction between different types of directors in English codified law increases confusion regarding the application of the no-conflict rule.

authorisation by the board fail to resolve this? First, a problem may arise when all directors (or the majority to establish a quorum) agree to pursue an opportunity. Second, if directors are to report on any opportunity to the board, including those from beyond the scope of the company's business, that would jeopardize the entire aspect of taking that opportunity, as far as the director is concerned: other directors or the company itself are likely in this case to pursue the opportunity as well, thus acting in an opportunistic way.

It is perhaps worth emphasising that a company's ability to take advantage of the opportunity being 'immaterial,' as stated within subsection 175(2) of the CA 2006, is protecting the integrity of fiduciaries that owe duties to the beneficiaries (in this case, directors owing duties to their companies) and is beneficial for the purposes of avoiding any possibility of conflict of interest. However, if it is extended to any line of business, including those out of the scope that is clearly drawn by the company, the rule could come directly into conflict with subsection 175(4)(a), which states that the duty is not infringed if 'the situation can reasonably be regarded as unlikely to give rise to a conflict of interest'. It is, therefore, suggested that clarifying changes related to the scope of business and opportunity should be introduced to resolve this issue.

5.3.2.2.2 Exceptions to the No-Conflict Rule

So far, this chapter has concentrated on the rule of avoiding conflicts between the personal and fiduciary positions of company directors in English law. It was demonstrated that there is no full consistency between case law and the codified duty to avoid conflicts of interest due to often differing views on what the conflict implies. Central to understanding the full scope of the rule would therefore be impossible without a detailed review of the corporate opportunity doctrine and the way it is applied in English law.

As the review of the most prominent recent cases on conflicts of interest has demonstrated, English case law has been particularly incoherent in drawing the line between what opportunities can and cannot be pursued by company directors so that conflicts of interest can be avoided. Cases like *Regal*, *Boardman*, and *Bhullar* seem to take such a broad view on corporate opportunity that it is expanded to situations where anything pursued by company directors is accountable for profits, including when a company cannot or even refuses to seize the opportunities. Section 175(2) of the CA 2006 put this into statutory force by claiming that it is 'immaterial' whether the company could take advantage of the opportunity. At the same

time, strong dissenting opinions expressed in these cases⁵⁵¹ suggested that not every justice was ready to accept the strictness of the principle. Furthermore, two recent case decisions, *Murad v Al-Saraj*⁵⁵² and *Foster v Bryant*⁵⁵³, have shown that English courts might no longer be so inclined to follow the equitable rule outlined in earlier cases.

In *Murad v Al-Saraj*, two sisters formed a joint venture with Al-Saraj to purchase a hotel, a transaction for which Al-Saraj was to receive profits from the vendor. The court found that Al-Saraj acquired profits from his fiduciary position without proper authorisation (now required by section 175(4) (b) from the Murad sisters, thus holding him accountable for breach of fiduciary obligation and pursuing corporate opportunities. Importantly, however, in this case the court's ruling was based on an examination of the causal link between a fiduciary's profit and accountability for seizing the opportunity. In this regard, Arden LJ acknowledged that the equitable rule formulated in *Boardman*, which imposed a constructive trust on fiduciaries acting bona fide, was not universal. Instead, her approach to fiduciary liability was based on the wrong conducted by the defendant:

‘It may be that the time has come when the court should revisit the operation of the inflexible rule of equity in harsh circumstances, as where the trustee has acted in perfect good faith and without any deception or concealment, and in the belief that he was acting in the best interests of the beneficiary. [...] it would not be in the least impossible for a court in a future case, to determine as a question of fact whether the beneficiary would not have wanted to exploit the profit himself, or would have wanted the trustee to have acted other than in the way that the trustee in fact did act. Moreover, it would not be impossible for a modern court to conclude as a matter of policy that, without losing the deterrent effect of the rule, the harshness of it should be tempered in some circumstances. In addition, in such cases, the courts can provide a significant measure of protection for the beneficiaries by imposing on the defaulting trustee the affirmative burden of showing that those circumstances prevailed’⁵⁵⁴.

In delivering the decision in *Foster v Bryant*, Rix LJ also raised a concern regarding the rigidity of the principle defined in *Boardman*. The case involved a company director, Mr. Bryant, who following the layoff of his wife, left the company and established one of his

⁵⁵¹ Most notably, Lord Upjohn's opinion in *Boardman v Phipps* (n 457).

⁵⁵² [2005] EWCA Civ 959.

⁵⁵³ [2007] EWCA Civ 200.

⁵⁵⁴ *Murad v Al-Saraj* [2005] EWCA Civ 959 [82].

own. Several days prior to his resignation letter taking effect, Mr. Bryant was negotiating with one of his former company's key clients, who wanted him to work on a project together with his former company. Eventually, when Mr. Bryant started working with the client, his former company sued him for breach of fiduciary duty and demanded he account for the earned profits. The court dismissed the company's claims, finding that the unusual circumstances of the case and Bryant's acting in good faith rendered the case fact-specific⁵⁵⁵. As such, just like Arden LJ, Rix LJ felt that the rule established in Boardman had to be reviewed on a merit basis, thereby acknowledging that its absolute application is, arguably, incorrect.

As seen above, the absolute application of the Boardman rule may be, after all, inconsistent with the business realities that English company law has to deal with. Therefore, some means to limit the degree of opportunity prohibition needs to be established. Apparently, both case law and the CA 2006 have recognised this fact to a certain degree. Overall, four different circumstances may eventually lead to relieving a director from the fiduciary obligation not to pursue corporate opportunities. The circumstances in question are: 1) obtaining authorisation to pursue an opportunity; 2) ceasing to be a director for reasons not connected to pursuing corporate opportunities; 3) having no powers to act within the directorship position; and 4) in situations where taking a corporate opportunity 'cannot be reasonably regarded as the one giving rise to the conflict of interest'.⁵⁵⁶ Each of these circumstances is reviewed below.

5.3.2.2.2.1 Authorisation to Pursue Opportunity

Section 175(4)(b) of the CA 2006 states that a director does not exploit corporate opportunity if he has obtained the permission of the board to pursue such an opportunity. Consequently, section 175(5) of the Act formalises the procedure that leads to the board's authorisation (it is also different between public and private companies, as was noted above). Granting the board such a right is, arguably, supplementing the general approval rights provided in the shareholder authorisation doctrine, which is common in English law⁵⁵⁷. Still, this presents a

⁵⁵⁵ Another related case, also cited by Rix LJ, was *In Plus Group Ltd v Pyke* (n 535), where a director, after being effectively excluded from his position and only technically remaining a director launched a company competing with his former employer.

⁵⁵⁶ Per s 175(4) (A) of the CA 2006.

⁵⁵⁷ It states that directors can be relieved from their duties if authorised by shareholders. See s 168 of the CA 2006.

significant innovation to English common law, which traditionally did not consider the board's waiver of the duty. Indeed, the common rule has been that the impartial advice of all directors was required to bind the company⁵⁵⁸. The major innovation produced by section 175(4) (b) of the CA 2006, therefore, is the inclusion of members of the board in the authorisation process⁵⁵⁹.

The process of authorisation is conducted by means of a quorum, during which the director in question, as well as any other interested director, is excluded from voting⁵⁶⁰. While the position of the director seeking exclusion from exploitation of the opportunity rule is clear, the case of the 'interested director' is somewhat confusing, because it is nowhere clarified who can potentially fall in this category. Further, the Act only disallows the director in question to vote on the matter of authorisation, while he can freely participate in the discussion regarding authorisation, thus having an opportunity to influence the board's decision making process. The author considers this an undesirable omission. Granted, the position of the director seeking authorisation has to be clearly explained in order to make a case for authorisation. However, this can be conducted by presenting a report in the due manner. The presence at the meeting of the director whose proposal for exclusion from exploitation of opportunity is likely to carry a potential conflict of interest is simply not appropriate.

Still, the most important question remaining is whether the codified approach is a desirable change to English common law. Here, it is useful to look at the relationship of entrepreneurship and responsibility that the decision entails. The traditional requirement of shareholders' approval seems to fit well with preserving the intent to keep directors from acting irresponsibly. However, it is also quite a tedious process that may discourage directors from taking certain actions in pursuing business activities. Besides, as was noted in Chapter

⁵⁵⁸ If no such advice was available, authorisation by the board was not absolute. In such a way, non-involved board members were excluded from authorisation process. See, for example, *Benson v Heathorn* [1842] 1 Y & Ccc 326 341-342; also see *Imperial Mercantile Credit Association v Coleman* [1871] LR 6 Ch.App. 558 567-568.

⁵⁵⁹ This is further advanced by s 180(1) of the CA 2006, which posits that no transaction or arrangement with the company can be set aside by reason of shareholders not giving their approval. It is mentioned that the rule applies to the entire section 175 of the Act, of which corporate opportunity is a part. Still, it seems that directors are given the right to authorise only in cases prior to potential exploitation. Refer to s 239(2). Davies (n 547) 568, noted, based on clause 6 of CLR Proposals to the CA 2006, that directors' authorisation referring to s 175 was implied for ex ante uses only.

⁵⁶⁰ By means of s 175(6) of the CA 2006.

4 of this thesis, shareholders in English public companies may have little power to control directors' actions. On the other hand, due to the small number of directors and their close interactions with each other, approval by the board may lead to the situation of mutual exploitation approvals, which would certainly involve the breach of other fiduciary duties. It is, perhaps, for these reasons that the CA 2006 leaves the ultimate power with the company articles, where such situations can be mentioned and resolved⁵⁶¹. In private companies, the board can authorise such actions unless the articles say otherwise, while in public companies, the articles have to specifically provide permission for such authorisation⁵⁶².

As seen above, the Act imposes stricter rules on authorisation by the board members of public companies. This may well be based on the fact of dispersed shareholding, which is typical for English public companies. In this case, it is much harder to resolve all kinds of collective action problems, to which authorisation belongs. Nevertheless, by introducing directors into authorisation matters, the Act seems to shift the responsibility of authorising away from shareholders who, once authorisation is approved by the directors, may be effectively left out of such decisions. The reason for this is that the Act does not require the board to report on authorisation given to directors⁵⁶³. As such, shareholders are likely to be excluded from any developments regarding corporate opportunities that occur at the top level of the company, being uninformed and therefore unable to ratify or prohibit the exploitation in question. Consequently, it remains largely the task of the board of directors to determine which cases of opportunity exploitation to grant. Granted, the members of the board are generally subject to fiduciary duties. This means that in deciding whether to authorise a certain action or not, they would be, theoretically, guided by section 172 of the CA 2006. However, such a breach of fiduciary duties could be extremely hard to prove⁵⁶⁴.

What about the situation where all directors are pursuing an opportunity? As was mentioned above, the Act does not provide an answer to how to resolve such gridlock. Granted, Section

⁵⁶¹ CA 2006, s 180(4)(b). The effect of s 180, however, is hard to assess due to the lack of clarity regarding what exactly can be authorised by the members in advance.

⁵⁶² Per CA 2006, s 180(4).

⁵⁶³ This is especially surprising, given that such recommendation, apparently, existed in the CLR Review: See Final 1, Para 3.25.

⁵⁶⁴ See a good discussion on this in *Regentcrest Plc v Cohen* [2001] 2 BCLC 80 120 per Parker LJ: 'no doubt, where it is clear that the act or omission under challenge resulted in substantial detriment to the company, the director will have a harder task persuading the court that he honestly believed it to be in the company's interest; but that does not detract from the subjective nature of the test'.

175(5) of the CA 2006 includes the provision that authorisation is only effective if it is granted by the company's constitution; however, if such permission is given (in public companies) or not prohibited (in private companies) and the directors pursue an opportunity, the issue remains. Moreover, such permission could also serve as a protection from Section 173 (independent judgement), which specifically mentions protection from duty whenever the company constitution accordingly grants it. So, in such cases, the Act evidently leaves it up to the shareholders to seek the solution. It would be interesting to see whether any case law will be developed regarding this matter.

Directors' authorisation codified in section 175 of the CA 2006 is the first of its kind in English law, and virtually no relevant case law authority exists to support the view that directors could authorise the taking of an opportunity by other directors. Still, some pre-Act court decisions indicate that not informing the board about the opportunity taken is a breach of duty. In the widely known *IDC v Cooley* case⁵⁶⁵, a managing director was offered an opportunity by a third party on the basis that it would deal exclusively with him, and not with his company. The director left his company without informing it about the opportunity, and entered the contract. The court held that the defendant was a fiduciary to his company and was obliged to provide information about the opportunity to the board in order to obtain authorisation. Similarly, in *Crown Dilmun v Sutton*⁵⁶⁶, the court found that a director breached his fiduciary duty by taking an opportunity and not informing the board and obtaining approval of the action. It is still unlikely that had a disclosure been made by the directors, the board would have willingly authorised that taking of an opportunity.

In general, it remains uncertain whether directors should be allowed to provide authorisation to exploit corporate opportunities. It is possible that directors, considering the subtlety of the process, may consider 'helping' other directors in exchange for support in the future⁵⁶⁷. Further, it is unclear whether the courts will strictly follow the requirements for authorisation as laid out in section 175(5) of the CA 2006: for example, in consideration of the 'interested' directors being included in the voting process or the active participation of the director in

⁵⁶⁵ [1972] 1 WLR 443.

⁵⁶⁶ [2004] 1 BCLC 468.

⁵⁶⁷ Arguably, this could be dangerous in view of s 173 of the CA 2006 (exercising independent judgment). However, it could become hard to prove in the court that the breach occurred, especially in cases where opportunities are extremely hard for the company to pursue.

question in the decision making process of the board to allow him to take the opportunity. From this standpoint, it seems that the general equitable rule, based on shareholder authorisation, could be retained. However, at present, the way it is formulated within section 180 of the CA 2006 makes it hard to see what exactly can be authorised by the company members⁵⁶⁸. While directors are granted the right to authorise exploitation of property, permission to do so ultimately rests with the shareholders who vote on the company articles. It is through the articles that the primary role of shareholders in the company authorisation process can be retained. Consequently, the burden of setting the rules shifts to the company articles, and it is in shareholders' interests to unequivocally provide whether directors can or cannot pursue the opportunities per se, or whether the board may authorise that process.

5.3.2.2.2 Ceasing to Be a Director

It is possible for company directors to pursue opportunities not only when engaged in the position of directorship, but also when they leave that position. In theory, in order to avoid fiduciary liability when taking an opportunity, a director could simply resign from the office and then start actively pursuing the opportunity of which he became aware during his directorship tenure. This issue has become very important in English law. Firstly, it should be noted that directors have the full right to resign even in cases when such resignation would be harmful to the company⁵⁶⁹. Therefore, by itself, resignation in no way constitutes a breach of fiduciary duty. Nevertheless, the CA 2006 in section 170(2) established that the duty to avoid a conflict of interest is still applicable to former directors regarding information, opportunity and property of which he became aware whilst he was a director. The section, in essence, states that the duties in sections 175 and 176 of the Act are to be applied to former directors although 'subject to the necessary adaptations'. The true nature of these 'adaptations' is never clarified, although some commentators have opined that it would refer to replacing 'director' with 'former director' whenever there was a need to do so⁵⁷⁰.

⁵⁶⁸ CA 2006 s 239 also deals with ratifications of directors' breaches of duty. According to the section, acts related to breaches of duty and trust, among other things, must be ratified by the members without counting the votes of the shareholders favouring the director or persons related to him/her. Just like s 180, however, this section fails to specify the actions that can be ratified.

⁵⁶⁹ This was addressed in *CMS Dolphin Ltd v Simonet* (n 500).

⁵⁷⁰ See, for example, *Kershaw* (n 529) 522.

The extension of the directors' duty to avoid conflicts of interest is a strong deviation from the pre-Act case, which would normally refuse to extend this duty beyond resignation⁵⁷¹. The general approach used by English courts prior to the CA 2006 was the maturing business opportunity test. The two most evident cases in this regard were *Island Export Finance Ltd v Umunna*⁵⁷² and *CMS Dolphin v Simonet*⁵⁷³. In *Umunna*, the managing director of a company, who had been a central figure in obtaining from the Cameroon postal authorities an order to provide postal boxes, resigned from his position claiming general dissatisfaction with the company. Shortly after that, the director set up his own company and obtained additional orders from Cameroon. The director's company sued for breach of fiduciary duties and asked the court to account for profits acquired from the additional orders. In *CMS Dolphin*, a director of the company resigned from his position and set up a competing business with other individuals. The company sued, claiming that the director had diverted corporate opportunities, which included contracts and client relationships. In both cases, the English court heavily relied on the maturing corporate opportunity test applied earlier in *Canadian Aero Service v O'Malley*⁵⁷⁴. In *Canadian Aero Service*, the court combined the no-conflict framework with the corporate opportunities framework to establish that a fiduciary could not 'obtain for himself [...] any property or business advantage either belonging to the company or for which it has been negotiating'⁵⁷⁵. Further, the Court held that a director could not seize the 'maturing business opportunity' which the company was actively pursuing⁵⁷⁶, and for reasons of which he resigned.

Interestingly, the Canadian Court never defined what a 'maturing business opportunity' consisted of, although it duly mentioned that in deciding whether breach of duty is present, the court has to consider multiple factors pertaining to each case. The decisions in both *Umunna* and *CMS Dolphin* acknowledged the application of the maturing business

⁵⁷¹ Unless it was explicitly evident that the resignation was prompted by the desire to take an opportunity and the true reason for resignation was not disclosed to the company. See *IDC v Cooley* (n 506).

⁵⁷² [1986] BCLC 460.

⁵⁷³ [2001] 2 BCLC 704.

⁵⁷⁴ [1974] SCR 592.

⁵⁷⁵ *ibid.*

⁵⁷⁶ *ibid* [25].

opportunity test as reasonable for English law⁵⁷⁷. Consequently, the decisions of both cases were based on the maturing corporate opportunity: in *Umunna*, the director was found not liable for the reason of no presence of a maturing business opportunity, and in *CMS Dolphin*, the director was found liable because the opportunities he took were found to be maturing business opportunities. An important point to note here is that in *Umunna*, Hutchinson J hinted that in deciding whether there was a breach of fiduciary duties, the primary motive for resignation was taken into account⁵⁷⁸. Therefore, the court established the importance of whether resignation was related to pursuing the corporate opportunities.

The inevitable questions that emerge from the cases of resigning directors are what opportunities are counted and how long the duties still remain in effect after resignation. The first question was addressed in *Balston v Headline Filters Ltd*⁵⁷⁹, where a director who had resigned set up his own business before one of his former company's clients approached him and offered work. In the court's decision, Falconer J emphasised that the case facts did not present a maturing business opportunity, because the director did not divert the opportunity himself; rather, it was presented to him after he had launched his own business. Following the decision in *Balston*, as well as the cases reviewed above, it becomes clear that English courts could not find a uniform application of the maturing business opportunity rule, as they tended to rely on many different factors that could influence the outcome of the case, as was laid down in *Canadian Aero Service*. In general, however, the extent of opportunities that could be seized by directors, according to English company law, could be summarised as the following: unless otherwise stated in the contract, nothing prevents a director from resigning and engaging in activities that could be considered a breach of fiduciary duty before resigning, although use of company property or information acquired over the course of the directorship to seize the opportunities, or resigning specifically to do so, is prohibited.

The second issue is the timeframe for the fiduciary duty application. Clearly, directors still hold some obligations to the company, even after resigning, but for how long? Unfortunately, there is nothing in English company law (even after the passage of the CA 2006) that could

⁵⁷⁷ Notably, see Collins J in *CMS Dolphin* (n 500) 733: 'The underlying basis of the liability of a director who exploits after his resignation a maturing business opportunity of the company is that the opportunity is to be treated as if it were the property of the company in relation to which the director had fiduciary duties'.

⁵⁷⁸ [1986] BCLC 476.

⁵⁷⁹ [1990] FSR 385.

provide clarification regarding this matter. Obviously, it would be inappropriate to consider directors as fiduciaries of the company forever, because that would significantly hinder the economics of free competition, but the time boundaries are not so easy to establish. This was addressed in *Southern Real Estate Pty Ltd v Dellow and Arnold*⁵⁸⁰, where the court recognised that ‘There is an obvious tension between a reasonable period during which the former director remains subject to his fiduciary duties, and freedom of competition’. Intuitively, the longer the time that passes after the resignation, the less likelihood there is of breach; however, to define a specific period after which there is no breach is extremely hard.⁵⁸¹ This is largely because of various case specific factors, some of which could be the nature of the directorship position and the amount of information related to it, the type of company, or the kind of business that the company is engaged in.

It seems, however, that the major issue which the courts have considered in relation to resigning director cases has been not when the opportunity was exploited, but when and under what circumstances it was acquired by the director. Consequently, if the opportunity was acquired when the director was in his position, then the opportunity could not be taken even after resignation. Once again, however, this issue strongly depends on evidence: the longer the time that passes after resignation, the higher the chances that the director will not be found accountable. Here, the classic English law case is *IDC v Cooley*⁵⁸², which considered the resignation problem through the no-conflict lens. In that case, the director did not obtain any profits over the course of directorship in the company; however, he exploited the opportunity upon resignation. The defendant was found liable because he set up an opportunity while still being a director and then used it upon resignation. Subsequently, in the judgement, it was not mentioned whether a director has to be in breach prior to or after the resignation. A similar opinion was expressed in *Kingsley IT Consulting Ltd v McIntosh*⁵⁸³, where the court recognised that a director can set up the groundwork for seizing the corporate opportunity over the course of directorship.

⁵⁸⁰ [2003] SASC 318 [2003] 87 SASR 1 36.

⁵⁸¹ Koh (n 455) 427, suggested that a year would be an appropriate time, although it is difficult to justify this. Setting up a timeframe based on almost hypothetical suggestions is unlikely to find a place in statutory law.

⁵⁸² [1972] 1 WLR 443.

⁵⁸³ [2006] BCC 875.

After reviewing the major cases pertaining to directorship resignation, which have been mostly based on the maturing corporate opportunity rule, it is time to consider how the CA 2006 fits the pre-existing common law framework addressing former directors' breach of fiduciary duties. In this regard, it seems that the Act has done little to change the traditional position of the case law. Granted, the maturing corporate opportunity test could be considered as an extension of the general duty of loyalty in the case of resigning directors. As such, the test would be seen as an application of the no-conflict rule in case law covering former directorship. However, it should be remembered that the vast majority of pre-Act cases did not extend the no-conflict rule to resignation cases. Therefore, the argument that the maturing business opportunity fits within the no-conflict rule is, perhaps, wrong. Indeed, it is hard to find any English case law besides *IDC v Cooley*⁵⁸⁴ that addressed the problem strictly via the no-conflict framework. As such, this case can be considered the primary authority in the pre-Act case law to shed light on the extension of the no-conflict rule to former directors. Thus, following the decision in *IDC v Cooley*, a resigning director would be excused for seizing the opportunity (regardless of whether it was seized in business or private time) if 1) the opportunity was presented bona fide to the board prior to resignation; 2) no intent to exploit the opportunity was present prior to resignation; and 3) the reason for resignation was not to exploit the opportunity or because the director was effectively dismissed. In the post-Act 2006 era, the recent decision in *Foster v Bryant*⁵⁸⁵ (considered below) seemed to move English case law closer to this framework and away from the earlier maturing business opportunity test.

5.3.2.2.3 Absence of Directorship Power

There are, as stated, different instances surrounding the process of resignation and subsequent behaviour of directors. However, holding directorship office may, in fact, mean a different level of involvement in the company's affairs and different access and control over information. In this sense, Koh noted that a director's duties should not cease after resignation if the director has exerted great power and influence in the company's affairs, including the main lines of business, contracts and customer relations; although in cases where directors have little influence or control, this should not be the position⁵⁸⁶. This brings

⁵⁸⁴ [1972] 1 WLR 443.

⁵⁸⁵ [2007] EWCA Civ 200.

⁵⁸⁶ Koh (n 455) 425.

us to the second instance where directors may not be found liable for a breach of fiduciary duty: when they have little or no control over the company's affairs.

The issue was raised in the unusual case *In Plus Group Ltd v Pyke*⁵⁸⁷, where a director of the company, after being excluded from managing the company, set up a company of his own, while still being technically a director of the claimant company. Later, he entered into a contract with one of the key clients of his former company, and was sued on the basis of breach of fiduciary duty. The Court of Appeal found that the director was not in breach of his duty, because he neither usurped the company property nor made use of any confidential information acquired over the course of directorship in the company. However, the court primarily focused on the role of the defendant as a director. In this regard, Sedley LJ noted:

‘Quite exceptionally, the defendant’s duty to the claimants had been reduced to vanishing point by the acts (explicable and even justifiable though they may have been) of his sole fellow director and fellow shareholder Mr. Plank. [...] The defendant’s role as a director of the [company] was throughout the relevant period entirely nominal, not in the sense in which a non-executive director’s position might (probably wrongly) be called nominal but in the concrete sense that he was entirely excluded from all decision-making and all participation in the claimant company’s affairs. For all the influence he had, he might as well have resigned’⁵⁸⁸.

The circumstances of the case in *Pyke* were unusual. As such, the case is not so easy to compare to ‘hard line’ cases such as *Regal Hastings Ltd v Gulliver*. At the same time, the very fact that the court acknowledged that in some situations there could be exceptions to the corporate opportunity doctrine points to the dilution of the traditionally strict principle in English case law. Even though the case is largely considered as an exception to the rule, the subsequent court decisions started noting the extent of the necessary involvement of a director in company affairs, whether the reasons for the lack of involvement are sufficient, or whether there should be exclusion from all areas of company operations or only selected ones. This was extensively considered in the recent important *Foster v Bryant* case⁵⁸⁹.

The circumstances in the *Bryant* case were similar to those in *Pyke*; however, the court addressed the issue in more depth. Rix LJ, with Moses LJ and Buxton J concurring, defined

⁵⁸⁷ [2002] EWCA Civ 370.

⁵⁸⁸ *ibid* 90.

⁵⁸⁹ [2007] EWCA Civ 200.

the various situations that could arise in the course of a director's resignation. He argued that there were two extremes in resignation: one, where the director was deliberately planning a post-resignation exploitation of an opportunity in which he was actively involved⁵⁹⁰, and one where the director seizes the opportunity while being a director 'in name only,' and having little or no involvement in the company management⁵⁹¹. Rix LJ noted that the latter case represented a situation where the director would not be liable (and that was the case in *Bryant* as well⁵⁹²).

The cases of *Pyke* and *Bryant* are clear examples of the modern court's approach to opportunity regulation on a fact sensitive basis. Once again, it is emphasised that these decisions strongly break away from the traditional strict approach to the matter. If *Pyke* could be considered an exception in case law, the decision in *Bryant* seems to put a serious affirmation mark on the flexible approach to directors taking corporate opportunities. In this regard, Moses LJ, while generally agreeing with Rix LJ, noted that he 'almost felt nostalgic for the days when there were inflexible rules, inexorably enforced by judges who would have shuddered at the reiteration of the noun-adjective'⁵⁹³. How does this fact-sensitive approach fit into the realities of resignation and the framework of corporate opportunity regulation overall? Following the discussion in the cases considered above, it is clear that various situations surrounding directors' resignation exist. Therefore, it becomes impossible to develop and apply firm rules that would apply to all cases without exception. It follows then, that in situations where it is hard to determine whether the director acted in a director's capacity or not, an approach based on common sense and the merits of the situation is preferable. Rix LJ opined that the flexible approach reflected the equitable principles on which the director's duty was based⁵⁹⁴.

⁵⁹⁰ Like In *IDC V Cooley* (n 506).

⁵⁹¹ As in *In Plus Group Ltd v Pyke*, (n 535).

⁵⁹² [2007] EWCA Civ 200 87.

⁵⁹³ *ibid* 97.

⁵⁹⁴ *ibid* 77.

5.3.2.2.4 Competing and Multiple Directorships

English law does not generally prevent directors from establishing a directorship in a company competing with their former business⁵⁹⁵, even in cases where new business connections are a product of previous directorship⁵⁹⁶. What about the cases when directors attempt to compete with the company while still being a director? In English law, this situation refers not to conflicts of interest, but to the conflict of duties, which is codified in section 175 of the CA 2006⁵⁹⁷. The issue, by any standard, is one of the most difficult ones, and English case law has been very unclear regarding the matter. Before the enactment of the CA 2006, there was no statutory law precluding directors from competing with their companies. The early case in this regard was *London & Mashonaland Exploration Co v New Mashonaland Exploration Co*,⁵⁹⁸ where the court held that a director cannot be generally restrained from competition with his company. A number of cases that followed, ruled that employees are not to breach their duty of loyalty to their employer by being employed simultaneously by a competitor⁵⁹⁹, while that duty is considered less strict than the full good faith duty owed by directors as fiduciaries. Therefore, clear inconsistency in the law emerged: the relationship based on relaxed rules was enforced much more strongly than those based on stricter rules. However, as discussed in Chapter 4⁶⁰⁰, the *Mashonaland* view on competing directorships is not standing up to the passage of time.

The inevitable clarification of the competing directorship position came about only relatively recently, in the already mentioned *Pyke* case⁶⁰¹. Referring to the court judgements, the most important in this matter is the opinion of Sedley LJ, who expressed his doubt that the

⁵⁹⁵ See *British Midland Tool Ltd v Midland International Tooling Ltd* [2003] EWHC 466 (Ch); [2003] 2 BCLC 523 90 and 93.

⁵⁹⁶ See *Hunter Kane Ltd v Watkins* [2002] EWHC 186 (Ch); *In Plus Group Ltd v Pyke* (n 535); *Foster Bryant Surveying Ltd v Bryant* [2007] EWCA Civ 200; [2007] 2 BCLC 239 [8].

⁵⁹⁷ Section 175 (7) states that any reference to a conflict of interest [in section 175] also applies to the conflict of duties.

⁵⁹⁸ [1891] WN 165. The case has been deeply investigated in Chapter 4 in relation to non executive directors' legal position.

⁵⁹⁹ See, for example, *Hivac Ltd v Park Royal Scientific Instruments Ltd* [1946] Ch. 169, CA; also see connection to executive director per Lord Denning in *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324, HL.

⁶⁰⁰ See Section 4.5.3.3.

⁶⁰¹ [2002] EWCA Civ 370.

authority provided by *Mashonaland* was appropriate to contemporary business realities. Yet the court in *Pyke* refused to take a broad view on the matter, stating that it was beyond the scope of the case. Nevertheless, the court did provide a fresh look at the old rule by establishing that each case has to be viewed based on specific facts pertaining to it. From this standpoint, it would perhaps be useful to look at *Mashonaland* not as a case allowing competition per se, but as one where the no-competition rule cannot be applied. Indeed, according to the facts of the case, the defendant did not act as a director and did not attend the meetings, which made his position closer to that of *Pyke*. Still, a generalisation of *Mashonaland* holding to the situations where directors act in full capacities as directors of the company seems doubtful.

The introduction of section 175(7), which deals with the conflict of duties, can be considered a positive development in English law regarding competing directorships because it makes a case for these by specifically introducing the conflict of duty into the codified section relating to the conflict of interest. However, obtaining consent prior to the CA 2006 could be a troublesome affair, especially in public companies where dispersed shareholding is common. Section 175(4) (b) of the Act, however, makes it possible to obtain permission from the board. Some issues, however, remain unresolved. First, section 175 does not clarify the general declaration of interest in the same manner as, for example, section 177 of the Act. This means that a director would need to seek approval from independent directors on each matter regarding competing companies (such as new lines of business, or new clients). Second, and this is much more complicated, the director would have to be cautious with both companies in order to avoid a conflict of duty with either one. However, that would eventually lead to a situation where his commitment and contribution to both companies diminishes⁶⁰².

Considering significant difficulties that individuals might face under English law when serving as directors in competing companies, such cases are rarely met in practice. It is much more likely that competing directorships in modern English companies emerge within the paradigm of resignation and the subsequent launch of a director's own company⁶⁰³. Therefore, modern English company law focuses more on the situation where a director who

⁶⁰² A simple situation: when an opportunity arises, presenting it to either company may cause a conflict of duties with the other one. Therefore, there is an incentive not to present it at all.

⁶⁰³ The cases of *Umunna* (n 578), *CMS Dolphin* (n 500), and *Bryant* (n 596), *IDC* (n 506) confirm this notion.

plans to compete with the company after resignation, takes certain steps to prepare for this while still being the director. Here, the general court position seems to be that making plans to compete does not constitute the breach of fiduciary duty⁶⁰⁴. However, such activities must not pertain to actual competitive activities (for example, recruitment of the company's employees); otherwise, it is a breach of the duty of loyalty⁶⁰⁵. Where the fine line between preparation and actual competition lies is uncertain: under the British Midland approach, for example, preparatory activities already constitute a breach, while under the *Balston* approach, it is necessary to find out whether the preparatory activities were set up specifically to compete with the company and whether these activities are in actual competition. At first sight, the first approach is preferable, since it provides a more definitive guide to determining when an actual breach occurs. By accepting *Balston's* view, it is argued that the courts would be faced with a complicated task of defining what constitutes actual competing activities. On the other hand, complete restriction of preparatory activities may not fit well with the general public interest of free trade⁶⁰⁶. However, when considering the statutory code related to this matter, the former approach seems to prevail. Allowing directors to take preparatory steps for competition seems to be inconsistent with section 172 of the Act, which requires directors to promote the success of the company. Further, section 179 indicates that more than one fiduciary duty can be applied in any given case concerning directorship. Therefore, even if *Balston's* approach frees directors from liability under section 175 of the Act, they are likely to be liable under section 172.

Besides the nature of preparatory steps during a directorship, the courts also identified other factors which influence the final decision on whether competing is permissible. One of these situations, as discussed earlier, is where directors are effectively excluded from functioning in the capacity of directors and they did not actively seek to exploit corporate opportunities.

⁶⁰⁴ See for example, *Balston Ltd v Headline Filters Ltd* (n 506): the director embarked on some pre-competition steps, such as space leasing, while still employed by the company. Also see *Coleman Taymar Ltd v Oakes* [2001] 2 BCLC 749 769, where it was held that a director may form intentions to take preliminary steps in setting up a competitive business on condition that the competitive business is not launched until the directorship is terminated. See also *LC Services Ltd v Brown* [2003] EWHC 3024 (QB).

⁶⁰⁵ This was emphasised in *British Midland Tool Ltd v Midland International Tooling Ltd* [2003] 2 BCLC 523, at 77-92; Hart J also suggested that a director, when taking preliminary steps to compete with the company, should either inform the company or resign. Additionally, see *CMS Dolphin v Simonet* (n 500) 16-31 where duty to disclose intentions is discussed.

⁶⁰⁶ See *Balston* (n 506) 412. Also consider the argument in *Item Software v Fassihi* (n 412), where Arden LJ argues that the law should not be too restrictive in this sense in order not to hinder entrepreneurial activity.

This was demonstrated in the cases of *In Plus Group Ltd v Pyke*⁶⁰⁷ and *Foster Bryant Surveying Ltd v Bryant*⁶⁰⁸, discussed earlier in this chapter. It should be remembered, however, that despite the recognition of less fiduciary rigour in such cases, the directors after resigning will still be subject to any contractual restraints, the rules related to corporate opportunities learned while being in the directorship position, and any laws pertaining to intellectual property, such as trade secrets and copyrights.

The last element to consider within the framework of competing directorship is the time before establishing a competing company. As discussed earlier in relation to resigning directors, intuition suggests that the longer the time that passes between resignation and establishing the new business, the less chance there is that the resignation will be linked to initiatives related to establishing the competitive business. In this regard, the Australian case of *Southern Real Estate Pty Ltd v Dellow and Arnold*⁶⁰⁹ is helpful. The defendant in that case took preliminary steps prior to resignation to compete with her company by diverting the company clients to her new business. The court held the director liable while referring to *Robb v Green*⁶¹⁰, which addressed a passing of ‘reasonable time’ after resignation after which soliciting of clients could be considered permissible. In that sense, however, the court in *Southern* held that the reasonable period did not apply since the director started trading immediately after termination of her directorship. Although the decision was not placed within the no-conflict framework, the court found the director in breach of good faith⁶¹¹.

In order to complete the discussion on competing directorships, it is necessary to consider the issue of multiple positions. When talking about taking multiple directorships in competitive companies, the law is generally the same as described above, given that a director would be in a much more difficult situation regarding preserving fiduciary duties for all the companies. However, what about the situation where a director is engaged in multiple positions in companies that are not competing with each other? This, logically, creates a lesser possibility

⁶⁰⁷ [2002] EWCA Civ 370.

⁶⁰⁸ [2007] EWCA Civ 200.

⁶⁰⁹ [2003] SASC 318; [2003] 87 SASR 1.

⁶¹⁰ [1895] 2 QB 1.

⁶¹¹ [2003] SASC 318; [2003] 87 SASR 1 [29] and [32].

of conflict⁶¹². Still, it remains good practice to acquire consent from the boards of all the companies in order to avoid any possibilities of conflict. If a transaction between the two companies in which one is a director occurs, it is a matter of good practice to refrain from active directorship in one of them. In such a case, given that company articles have such provision, the CA 2006 seems to relieve directors from liability⁶¹³. Otherwise, directors are in a very difficult situation. Even in the case of non-competing directorships, any potential deal between the companies (such as, for example, a takeover) would create a situation where the duty of loyalty is likely to be breached for one of the companies⁶¹⁴. Such an uneasy legal conundrum may ultimately leave the director with no choice but to resign from directorship in one of the companies. How the case law will develop in this direction in the post CA 2006 era remains to be seen. However, with the present rules codified within the Act it seems that multiple directorships carry considerable risk.

5.3.2.2.5 Opportunities Not ‘Reasonably Regarded to Give Rise to the Conflict of Interest’

The final situation allowing directors to pursue corporate opportunities is mentioned in section 175(4)(a) of the CA 2006: ‘the duty is not infringed if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest’. The section clearly indicates an attempt to provide a more flexible approach to dealing with the conflict of interest duty. It seems that the section echoes the famous Lord Upjohn dissent opinion in *Boardman v Phipps* referring to ‘real, sensible possibilities by any reasonable man’⁶¹⁵. Does this make the situation easier for directors? As discussed earlier, the courts, following the decision formulated in *Boardman v Phipps*, seemed indeed to follow the methodology presented by Lord Upjohn on the basis that the court agreed on the equitable principle, but not on the application facts of the case⁶¹⁶. The analysis of *Boardman* and consequent cases revealed that

⁶¹² Further, in situations, where, for example, a non-executive director takes a non-executive position in a non-competitive company, multiple directorships are highly unlikely to cause any fiduciary problems at all.

⁶¹³ CA 2006, s 180(4)(b) states that the general duties are not infringed ‘where the company’s articles contain provisions for dealing with conflicts of interest’. Therefore, if the director acts accordingly within the boundaries that the company articles provide, there will be no breach. The issue here is to what extent the company shareholders would be willing to grant such rights.

⁶¹⁴ The action of withdrawal considered above could be possible, but it might cause a breach of the duty to promote the success of the company.

⁶¹⁵ [1967] AC 46 [33].

⁶¹⁶ See Section 5.3.2.2.1. of the chapter.

the company capability facts, which were not seen as ‘immaterial’ by the majority of the Lords in *Boardman*, are, indeed, treated as such in the subsequent cases regarding corporate opportunities. It is from this point that the Act’s intention to make the rule more flexible should be viewed. Indeed, it seems highly unlikely that the Act would include in one section two opposite resolutions regarding the capability facts. Section 175(2) provides that it is immaterial whether a company could take advantage of the opportunity, while section 175(4)(a) provides that, when reasonably the situation cannot be regarded as giving rise to the conflict of interest, the duty is not infringed. In other words, one section deems capability facts immaterial, and the other states that, in certain circumstances, the facts are, after all, material. In order to resolve such an unfortunate confusion, it is necessary to look at section 175(4)(a) not from the point of capability facts, but from the point of other instances, namely, the company’s rejection of the opportunity and how the opportunity fitted into the company’s line of business.

As the discussion above demonstrated, there is some authority to support the idea that the opportunity rejected by the company could be taken by directors. Perhaps the most famous decision in this regard was formulated by the Canadian Supreme Court in *Peso Silver Mines Ltd v Cropper*⁶¹⁷. In that case, the owner of mineral claims around the mines of *Peso Silver Ltd* offered to sell the claims to the company. After bona fide consideration of the claim, the company rejected the offer, which was then accepted by one of its directors. The company sued the director for breach of fiduciary duty by seizing the corporate opportunity. The court did not find the director liable, arguing that the *Peso Silver* board rejected the offer on the basis of good faith and in the best interests of the company. Furthermore, the information about the offer was not confidential, for *Peso Silver* only, but open to other potential purchasers as well. Therefore, the court held that in purchasing the claims, the director was acting in a private capacity, thereby causing no breach of duty.

Interestingly enough, the court in *Peso* referred to both *Regal (Hastings)*⁶¹⁸ and *Boardman*⁶¹⁹ when delivering the judgement. Still, it should be remembered that *Peso* was decided in the Canadian court, and the absence of similar cases in English courts hints at the desire to

⁶¹⁷ [1966] S.C.R. 673.

⁶¹⁸ [1942] 1 All ER 378.

⁶¹⁹ [1967] AC 46.

preserve a strict control over directors' actions within the boundaries of their fiduciary capacities. Some English authors have argued that the decision in *Peso* could be extended to English company law within section 175(4)(a)⁶²⁰. However, such a position is difficult to reconcile with the no-conflict principles set out in *Boardman v Phipps*, which is considered the major case authority regarding corporate opportunities. According to Lord Hodson's judgment, now codified in section 175(2) of the CA 2006, it is immaterial whether the director receives approval of his actions from the board. From this standpoint, pursuing opportunities rejected by the board is just another version of the capability facts: the director could always act more persistently in overcoming the board's rejection of an opportunity. This approach was taken in *Bhullar v Bhullar*, where Parker LJ referred to the rule of reasonable view on the facts of the case and argued that a director's taking of an opportunity after the company rejected it still fell under the no-conflict rule⁶²¹.

Following *Bhullar*, it is highly unlikely that English courts will consider a company's rejection of an opportunity as a special case under section 175(4)(a). It is almost obvious that Lord Upjohn's test for a 'real sensible possibility of conflict' has been used to provide that capability facts are immaterial to the identification of a possible conflicts of interest. At least two such facts can be identified in *Bhullar*: first, the board openly declared they had no interest in acquiring further properties; second, the company was in the obvious process of effectively ending its existence in its current form due to internal conflict. The presence of these facts significantly decreased the probability that the company would take on the opportunity in question or even, perhaps, any other opportunity at that time at all. From this standpoint, when directors seized the opportunity, there was only a hypothetical situation of corporate interest present. Nonetheless, the mere possibility of the conflict was emphasised in the ruling. This reinforces the strict position of the English courts in relation to corporate opportunity cases.

The other possible application of section 175(4)(a) of the CA 2006 is in the area of business restrictions. As discussed above, English courts have been generally following the strict formulation of the no-conflict rule by including the no-profit rule in their decisions. However, in some cases, it was noted that a very broad view of the rule could be somewhat unrealistic, even though the original goal was to ensure directors' loyalty. Indeed, should directors be

⁶²⁰ See, for example, Sealy and Worthington (n 234) 307.

⁶²¹ [2003] EWCA Civ 424 [41-42].

liable for profits from writing a book on general business or giving a speech at a university? Clearly, these activities fall outside the opportunities that directly relate to a company's business. However, do they fall outside the scope of the no-conflict rule now codified in English company law?

In other common law jurisdictions there is a 'line of business' test that determines whether a director could be excused for taking opportunities not related to company's activities. The test is particularly well established and applied by the United States courts, based on the landmark decisions of *Guth v Loft*⁶²² and *Broz and RFB Cellular Inc v Cellular Information Systems*⁶²³. First introduced in *Guth*, then refined and expanded in *Broz*, the line of business test allows directors to take an opportunity if: '(1) the opportunity is presented to the director or officer in his individual and not his corporate capacity; (2) the opportunity is not essential to the corporation; (3) the corporation holds no interest or expectancy in the opportunity; and (4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity'⁶²⁴. Under any of these tests, the existence of a corporate opportunity is recognised when there is a reasonable link between the opportunity and the current or prospective business of the company, which it also has a capacity to pursue. The American case law considers such cases on a factual basis, taking into account the circumstances that surround the issue.

In England, the classic case of *Aas v Benham*⁶²⁵ established an equivalent test in the context of partnerships. However, while acknowledged by English courts to a certain extent, the test is not regarded as an applicable authority in company law. This is evident from the recent cases of *Wilkinson v West Coast Capital*⁶²⁶ and *Allied Business Partners v Shanahan*⁶²⁷. The court in *Wilkinson* addressed a situation where directors pursued a business opportunity of which they learnt in a non-corporate personal capacity. One of the company owners sued two

⁶²² 5 A. 2d 503 (Del. Ch. 1939).

⁶²³ Del. Supr. 637 A2d 148 (1996) 155.

⁶²⁴ *Broz And RFB Cellular Inc v Cellular Information Systems* Del. Supr. 637 A2d 148 (1996) 155.

⁶²⁵ [1891] 2 Ch 244. The court established 'a corporate scope' test, which makes partners subject to fiduciary duties only if they fell within the scope of their partnership's business. Notably, the case was addressed and not challenged in *Boardman v Phipps*.

⁶²⁶ [2005] All ER (D) 346.

⁶²⁷ [2009] EWCA Civ 751.

directors for acquiring and selling a company through their own enterprise, which held 60% of the original company. The plaintiff argued that in doing so, the directors diverted a corporate opportunity that belonged to the original company. The original company had a shareholders' agreement that restricted the purchasing of property unless there was an approval by 65% of the shareholders. The plaintiff argued that the directors had to use all means necessary to persuade the shareholders to purchase the company and not to do it through their own enterprise.

In delivering the judgment, Warren J stated:

‘So *Aas v Benham* is an illustration of the importance of defining the scope of the duty before being able to decide whether a person is in breach of it and in particular whether the ‘no conflict’ rule or the ‘no profit’ rule applies’. [...] The case possibly establishes, or re-affirms, a negative proposition that there is no principle which entitles a firm to benefits derived from the use of information for purposes which are wholly outside the scope of the firm’s activities’⁶²⁸.

His lordship’s judgment is interesting from two positions: the objects clause and the company business area. On the side of the objects clause, Warren J suggested that the company’s interests can be restricted by the articles if these clearly state what business activities the company may engage in. On the other hand, a restriction similar to the one presented in the case (approval of property purchase by the majority of shareholders) would have no effect on limiting the interests, albeit in the situation where a director holds a sufficient amount of shares to block specific actions in order to exploit the opportunity. Therefore, only when a director is also a shareholder with sufficient power to influence the company’s actions, would the restriction rule for the purposes of the no-conflict rule apply: in this case, the conflicts of interest will be present. As such, Warren J made a useful distinction between the capability facts and structural limitations that a company can place on its business. Capability facts (such as company financial limitations), as was noted from the discussion of the cases above, are immaterial to the presence of a conflict of interest. On the other hand, structural restrictions (such as a clear indication, in the articles, of the businesses that the company is engaged in) do not seem immaterial⁶²⁹.

⁶²⁸ *ibid* [281] and [284]. Also note that the approach taken by the court is that no-conflict and no-profit rules are independent from each other.

⁶²⁹ Subject to the exception noted above: directors who have substantial power are capable of exerting additional effort to block or pass specific resolutions related to corporate opportunities.

On the side of the company business area, Warren J's judgment reflects on the actual and potential lines of business that could comprise the company's interests. According to Warren, activities significantly different from the company's business do not fall within the no-conflict rule, if the company does not express its interest in expanding into that business area. Warren J, however, abstained from clarification of how close the activities have to be to the actual area of business. Furthermore, in discussing hypothetical examples, he provided that a business that presents 'synergies with the company's area of business' would still fall within the company's interests⁶³⁰, thus implying a breach of fiduciary duty in the case of acquisition. This seems misleading, since synergies could be achieved between companies carrying on different lines of businesses⁶³¹. Therefore, while attempting to provide a flexible view on the issue of corporate interest in terms of business area, Warren J, in effect, provided more reasons to consider such situations on a case by case basis.

In general, the holding in *Wilkinson* could be considered as a restatement of the view expressed in *Bhullar v Bhullar*: there could be some scope for business restraints on the corporate opportunity doctrine. Warren's contribution in this matter can be considered recognition of the board members' power in limiting or broadening the scope of the company's interests. Still, the decision in *Wilkinson* can hardly be considered a definitive authority regarding the corporate opportunity exemptions as defined by section 175(4)(a). Looking at the judgment as a whole, it becomes clear that in attempting to integrate 'the scope of business' test into the no-conflict framework, Warren J could not define exactly how the limitation of the scope of business would restrict the company's interests. Perhaps, had the Act been in force by the time when the judgement was delivered, a more precise and robust discussion would have been available.

A more recent case, *Allied Business Partners v Shanahan*⁶³², rejected the applicability of the scope of business test within the corporate context. The case revolved around the purchasing of an office floor by one of the company directors for his own company. The director was sued for diverting a potential business opportunity. The High Court held that there was no breach, by considering the case within the *Aas v Benham* 'scope of business' test: the

⁶³⁰ [2009] EWCA Civ 751 301.

⁶³¹ Kershaw (n 529) 506 provides a good argument in this regard.

⁶³² [2009] EWCA Civ 751 301.

opportunity was found to be outside the company's business interests. The decision, however, was reversed by the Court of Appeal, which argued that the director was accountable for any profit, even one within an area of potential conflict only. Consequently, the 'scope of business' test was rejected on the grounds that it applied to partnership law, where fiduciary roles are much more clearly defined within the partnership agreement⁶³³.

It should be noted that the decision in *Shanahan* was delivered without consideration of the changes introduced by the CA 2006 generally and section 175(4)(a) specifically. Still, the position taken by the court (which relied heavily on *Keech v Sandford*) can be described as quite restrictive. However, the decision is not without flaws. As was noted above, the primary reason for rejecting the 'scope of business' test was the perceived differences between the fiduciary positions of partners and directors. This distinction, however, does not make much sense in practice, since both parties undoubtedly have certain universal obligations before their partners or companies, and the duty of loyalty remains the same regardless of fiduciary status. In the case of limited liability partnerships, to which the scope of business test is applied, partners' roles resemble those of corporate directors in the sense that LLPs are independent entities and partners do not carry individual responsibility for each other's actions. While the fiduciary duties of partners are generally defined within the contractual obligations, the CA 2006 Chapter 10 can be regarded as a universal contractual obligation for all directors. Therefore, considering the fiduciary role of directors as less explicitly defined is misleading at least.

It is useful to consider whether the court in *Shanahan* would have ruled otherwise following the *Aas v Benham* rule. The answer is not that obvious. It should be remembered that the company's business was not that well defined to easily decide whether the director's purchase of property was, indeed, outside its scope of business. Therefore, arrival at a different conclusion using the 'scope of business' test could be problematic. In that case, there would have been the need to clearly outline the boundaries of the scope of business test, which would have had to be much more precise than, for example, Warren's review in *Wilkinson*. On the other hand, holding the director liable in *Shanahan* under 'the scope of business' test, would create a precedent, where companies with unclear businesses and an absence of a clear business strategy would have an upper hand in holding their directors liable for potential breaches of duty. This would dilute the entire purpose of the 'scope of

⁶³³ *ibid* [68].

business' test. For these reasons, following a strict, well defined rule stated in *Keech v Sandford* may seem preferable.

Unfortunately, the CA 2006 does not clarify what the real intention behind section 175(4)(a) was⁶³⁴. What is clear, however, is the intention of the English legislator to introduce some flexibility to the matters related to corporate opportunity regulations. On the other hand, the English courts, which have been accustomed to follow the strict equity approach, would be unlikely to easily loosen the boundaries of the strict equity rule, and the decision in *Shanahan* serves as the best proof of this. Thus, the absence of specifics in section 175(4)(a), such as the areas of opportunity rejection by the company and opportunities not falling within the scope of the company's business, does not help the idea of flexibility to materialise.

5.3.3 Duty Not to Accept Benefits from Third Parties

5.3.3.1 Purpose and Codification

While section 175 of the CA 2006 regulates the issues within the no-conflict rule, section 176 deals with a special application of the no-profit rule, which, as was demonstrated above, is a part of the no-conflict framework. Section 176 deals specifically with the receipt of benefits from third parties. As such, the section serves as an attempt to prohibit personal gain by the misuse of a directorship position. The section is, therefore, connected with the no-conflict rule: if directors accept benefits from third parties, this might well involve some services in return (or vice versa, which does not change the essence of the application of the law), leading almost certainly to a breach of loyalty. It should be noted that, while not formally written as a 'duty of loyalty' in the CA 2006, this duty is universally recognised in English law, as well in other common law countries. With regard to English law, it can be argued that the duty of loyalty is expressed through the duties of promoting the company success (Section 172) and the duty to avoid a conflict of interest (Section 175).

Section 176 starts with the general provision that directors are not to accept benefits from third parties by reason of being a director or by doing (or not doing) anything as a director⁶³⁵. Therefore, the section implies that in order to prove wrongdoing, it is necessary to establish that there is a connection between the receipt of benefit and acting in the capacity of

⁶³⁴ Neither do the Explanatory Notes to the CA 2006.

⁶³⁵ CA 2006, s 176(1).

director⁶³⁶. In this regard, the section seems to proscribe what can be referred to as bribes and secret profits, which are detrimental to the duty of loyalty⁶³⁷. The section is also linked to the no-conflict rule formulated in section 175 within sections 176(4) and (5) which cover situations where the duty is not infringed ('if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest') and mentioning that 'any reference in this section to a conflict of interest includes a conflict of interest and duty and a conflict of duties' respectively. But these sections are, essentially, echoing sections 175(4)(a) and 175(7). Based on these findings, it may be questioned what the purpose of section 176 is, since it seems that the situations it deals with could generally be handled by section 175 of the CA 2006. In answering this question, one should pay attention to the fact that actions under section 176 cannot be authorised by the board. Receipt of benefits from third parties, therefore, is considered by English legislators as being too risky for the integrity of the director's conduct and performing his core duties. Therefore, it is accordingly left only for the general shareholder meeting to resolve (although the lack of clarity in section 180 regarding in advance authorisation plays a negative role here as well)⁶³⁸. Further, reliance upon section 176 and section 175 at the same time is granted by section 179 of the CA 2006⁶³⁹. Therefore, the purpose of section 176 is to extend the application of the no-conflict rule, and it should therefore be considered together with section 175.

5.3.3.2 Benefits from Third Parties in Case Law

While section 176 of the CA 2006 deals specifically with benefits, it does not provide an explanation of what benefits are. During the debates on the Act in Parliament, the Solicitor

⁶³⁶ It seems that the legal permission to accept benefits not related to directorship stems from agency law, which allows acceptance of benefits outside the agency relationship. See, for this matter, *Aas v Benham* (n 471).

⁶³⁷ This provision is in line with the equitable rule against bribes and secret commissions formulated in *Attorney General For Hong Kong v Reid* [1994] 1 AC 324, Pc.

⁶³⁸ Even though shareholders' permission is not covered within section 176, it is provided in section 180(4)(a). This, of course, almost certainly leads to a complete ban on receiving benefits from third parties, especially in public companies, where dispersed shareholding is common, making it extremely hard to obtain consent from the majority of shareholders. It is unlikely that English legislators did not consider this fact when drafting section 176. Therefore, it seems that the effort has been to exclude any attempts to receive such benefits by directors in order to avoid conflict with other duties. This, once again, demonstrates the dominance of the strict approach in English legislation: it nearly dismisses the possibility of situations where accepting benefits from third parties could be done without infringement of other fiduciary duties.

⁶³⁹ 'Except when otherwise provided, more than one of the general duties may apply'.

General proposed that the ordinary dictionary definition of the word be applied⁶⁴⁰. But what exactly can be attributed to this definition? Obviously, there are some items that can easily be defined as a benefit from third parties, such as financial rewards (money, stock, property holdings, etc.) or money's worth items such as paid travel, tickets to sports events or entertainment⁶⁴¹. Other cases, such as the receipt of corporate hospitality, are reviewed in the context within which they are given⁶⁴². Most usually, however, common law has applied the term 'benefits from third parties' to bribes and secret commissions.

As mentioned above, section 176 is predicated on the equitable rule formulated in *Lister v Stubbs*⁶⁴³, which imposed only a personal, not proprietary duty on a fiduciary who accepted a bribe. In other words, the plaintiff in this case is not entitled to any investment proceeds made as the result of not accounted profits by the fiduciary. This approach was strongly criticised in *Attorney-General for Hong Kong v Reid*,⁶⁴⁴ where the Privy Council stated that bribes and secret commissions received by fiduciaries have to be held on constructive trust, and all the profits acquired from this are also to be held on constructive trust. Technically, the decision in *Reid* is not binding on the English courts; however, it was approved in a number of High Court decisions⁶⁴⁵, although the most recent decision in *Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd*⁶⁴⁶ followed the rule established in *Lister*. The apparent tensions between the approaches in *Lister* and *Reid* are preserved up to date. Arguments can be found in favour of either approach: the *Lister* approach proponents may claim that it is not fair to put the victim of the fiduciary wrongdoing ahead of the other creditor parties of the properties; while the *Reid* approach deprives the wrongdoer not only of the immediate benefits of the bribes, but of all future benefits related to it.

⁶⁴⁰ HC Comm D 11 July 2006, At Col 621-622. According to *Oxford English Dictionary* (Oxford University Press, 2002) benefit is 'A favourable or helpful factor, circumstance, advantage or profit' 162.

⁶⁴¹ These are mentioned in *ICSA Guidance On Directors' General Duties* (2008) para 3.6.5.

⁶⁴² *ibid.*

⁶⁴³ (1890) 45 Ch D 1.

⁶⁴⁴ [1994] 1 AC 324.

⁶⁴⁵ *Ocular Sciences Ltd v Aspect Vision Care Ltd* [1997] RPC 289; *Dubai Aluminum Company Ltd v Alawi* [2002] EWHC 2051; *Tesco Stores Ltd v Pook* [2003] EWHC 823; *Daraydan Holdings Ltd v Solland International Ltd* [2004] EWHC 622.

⁶⁴⁶ [2011] EWCA Civ 347. It should be acknowledged, however, that the court called for a balanced approach between the two contradictory authorities.

Modern English law considers bribes through the lens of the no-conflict rule. Much of it has been said within the agent-principal framework. The Explanatory Notes to the CA 2006 at para 344 specifically mention bribes as a form of secret profits. This was confirmed in *Anagel Atlas Compania Naviera SA v Ishikawajimaa-Harima Heavy Industries Co Ltd*⁶⁴⁷, where the court held that a bribe ‘consists in a commission or other inducement, which is given by a third party to an agent as such, and which is secret from his principal’. Smith J in *Fiona Trust & Holding Corporation Ors v Privalov Ors*⁶⁴⁸ reasoned that the test as to whether a benefit offered is equal to a bribe is whether the agent is put in a position where his and his principal’s interest may conflict. He further noted that it is not necessary for the bribe to be linked to a specific transaction; rather, the possibility of either the conflict of interest or the conflict of duty emerging was what counted⁶⁴⁹. Here, once again, the English courts apply the ‘possibility of conflict’ test to deter wrongful conduct by fiduciaries. However, if in the case of section 175 the strictness of the rule could be challenged on the grounds of hindering entrepreneurial activities, as regards benefits from the third parties, in relation to whom the acceptance of bribes is the most frequently mentioned misconduct, the strictness of the law is completely justifiable.

Bribes are commonly associated with secret commissions in the sense that both are received without the knowledge of the principal. There is no concrete legal distinction between the terms for legal purposes in section 176 of the CA 2006, although epistemological differences are noted by some authors⁶⁵⁰. More important for the courts are the facts of the case. For example, English law recognises that some third party benefits can be too small to even fall under the possibility of the conflict rule⁶⁵¹. Such cases, however, are reliant on drawing a distinct line between what can be considered a ‘little present’ and when it becomes a bribe or

⁶⁴⁷ [1990] 1 Lloyd’s Rep 167 171.

⁶⁴⁸ [2010] EWHC 3199 (Comm) [73].

⁶⁴⁹ *ibid.*

⁶⁵⁰ See, for example, Francis Reynolds (ed) *Bowstead and Reynolds on Agency* (Sweet & Maxwell 1993) 246-247, who states that the difference is in the corrupt intent: when there is no corrupt intent in payment, it is more appropriate to consider it a secret commission. But the courts do not define the terms separately. See, for example, *Fiona Trust* [2011] EWHC 1312 [70], where Smith J treats bribes and secret commissions in the same way; also see *Daraydan Holdings Ltd V Solland International Ltd* [2004] 3 W.L.R. 1104, where ‘kickback’ commissions were deemed equivalent to a bribe.

⁶⁵¹ See *The ‘Parkdale’* [1897] P 53 58-9, where Barnes J decided that a ‘little present’ does not create a possibility of conflicts of interest or duties.

a secret commission. In this regard, the English courts refer to what is a ‘real possibility’ of a conflict⁶⁵². From the little authority available on this matter, it seems that there is no secret commission if the agent is not expecting the gift at the time of transaction.

As seen, the benefits covered under section 176 of the CA 2006 are different from those covered in section 175. Section 175 deals primarily with the corporate opportunities, which can be considered as benefits from third parties, because it assumes the acquisition of profits and other gains resulting from seizing an opportunity⁶⁵³. This type of benefit, however, is a legitimate one to be pursued by the company. Hence, the law protects companies from being ‘ripped off’ from what they can gain by pursuing the opportunity that is beneficial to them. In the case of section 176, however, neither bribes nor secret commissions can be regarded as legal ways of obtaining profits. These ‘benefits,’ therefore, the company cannot request, obtain, and use for itself under normal circumstances. While this distinction is not clearly apparent from the wording of the sections, it makes perfect sense in terms of their conceptual separation. Indeed, section 175(2) is worded quite broadly, which makes it possible to include the opportunities that the company cannot legally pursue. This means that there is no inherent separation of legal and illegal opportunities within the section itself. But then, section 175(2) makes it immaterial whether the company can take advantage of the opportunity. It is blatantly clear that taking advantage of illegitimate opportunity is by no means ‘immaterial’. This also explains why section 176 does not contain a similar provision or why it does not accept the board’s authorisation for receiving benefits from third parties. Most importantly, it helps narrow down and clarify the meaning of sections 175 and 176, which should be considered on a cumulative, not separate basis.

This was the position in the recently decided *Towers v Premier Waste Management Ltd*⁶⁵⁴. In the case, a company supplier provided one of the directors (Towers) with some machinery to renovate property that the director owned. Some equipment repairs were consequently passed through the company books, and the company was charged for them. Upon receiving the invoice, Premier Waste Management sued Towers for the breach of duty owed. In deciding the matter, the court looked at the issues of the conflict of interest and the issue of receiving

⁶⁵² See *Imageview Management v Jack* [2009] 1 Lloyd’s Rep 436 (Jacob LJ) [6].

⁶⁵³ Otherwise, there is little sense in pursuing the opportunity.

⁶⁵⁴ [2011] EWCA Civ 923.

benefits from third parties as codified in sections 175 and 176 of the CA 2006⁶⁵⁵. The court decided that Towers breached his fiduciary duties to the company by receiving the benefit and breaching the duty to avoid conflicts of interest. Importantly, while it was established that Towers did not receive any valuable benefits from the equipment, that the company would be unlikely to receive any benefits from leasing it either, and that the loss for the company was negligible, the court found that none of that was relevant. As Mummery LJ⁶⁵⁶ held:

‘The absence of evidence that the Company would have taken the opportunity, or has in fact suffered any loss, or that Mr Towers [...] had any corrupt motive or that, if there had been no free loan, Mr Towers would have hired that sort of equipment in the market; the fact that the value of the benefit to Mr Towers was small [...]: none of those matters supported the contention that there was no breach of the duty of loyalty or the no conflict duty’.

As follows, the breach of duty here arose not from depriving the company of some benefits that could be obtained from the third party, but, rather, from depriving the company of the consideration as to whether it wished to pursue the opportunity. In this regard, the breach of duty was established in accordance with the traditionally strict approach of English law in regulating the fiduciary duties of company directors. This creates a serious precedent in the post-Act case law, as even in the presence of relaxing the rules to regulate directors’ duties, traditionally strict views seem to be applied. Consequently, with regard to section 176 of the CA 2006, neither proof of loss, fraud or corruption (as in bribery cases) is likely to be required in the future: the wrongdoing of the director will be confirmed even on the legal basis and secret profits can be accounted for even though no profits, or negligible profits, were actually made.

Two major critical conclusions can be drawn after the analysis of section 176 of the CA 2006. First, section 176 of the CA 2006 does not allow authorisation by the board, although the possibility for authorisation by shareholders is still possible under section 180(4) which deals with the consent and approval of the company members and section 239 which deals with ratification of directors’ acts. These sections, respectively, allow prior and post approval of the breach of duty. However, in the light of the current discussion, section 176 is drafted to protect the company from the illegitimate acts of directors that it cannot pursue legally by

⁶⁵⁵ CA 2006, s 177 (Declaring Interest in the Transaction) did not apply because the matter was not considered as a transaction with interest; although the lack of disclosure became one of the key points of the case.

⁶⁵⁶ [2011] EWCA Civ 923 [51].

itself. As such, there seems to be a significant problem where a possibility of approving of an illegitimate act remains. Unfortunately, the Act does not provide an answer as to whether there are non-ratifiable breaches. Therefore, although it is clear that there are breaches in common law that should not receive the power of ratification, it remains very unclear as to how wide the rule actually is. What is clear, however, is that the general law does not prevent members' approval or ratification of directors' receipt of third party benefits. It could be argued that conscious shareholders would never allow receipt of such benefits by directors in view of the serious loyalty consequences that this entails and because it would entail tampering with the company property, actual and potential. However, the rule may not easily be followed in practice in companies where directors are also major shareholders. In this sense, the absence of statutory barriers to such behaviour is clearly unfair toward minority shareholders.

Second, in the light of the *Towers* case, it is clear that English courts are likely to follow the strict approach in the application of section 176 especially when considered within the framework of avoiding conflicts of interest. However, while the decision in *Towers* may seem to create a harsh precedent for directors, the Act still provides sufficient mechanisms to avoid such issues by declaring the interest to the board or the company members where appropriate. In this regard, section 177 also plays an important role in regulating the fiduciary duties of company directors towards property in England.

5.3.4 Duty to Declare Interest in Proposed Transaction or Arrangement

5.3.4.1. Purpose and Codification

Section 177 of the CA 2006 is the third of the general provisions of the Act which was designed to deal with the conflicts of interest and exploitation of property. Specifically, it deals with the conflict arising in the proposed transactions with the company. It is a major feature of English company law that a director has to avoid a conflict of interest with the company in situations where he might have personal interest in a transaction (it is known as the 'no self-dealing rule'). This principle is covered by section 175 of the CA 2006. Section 177 can be considered as an addition to this duty, because it requires directors to disclose any personal interest in a transaction or an arrangement⁶⁵⁷. The section provides that⁶⁵⁸:

⁶⁵⁷ It is, perhaps, worth noting that a conflict of interest covered by section 175 can eventually develop into a conflict of interest covered by section 177. For example, section 175 would regulate a situation where a

‘If a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, he must declare the nature and extent of that interest to the other directors’.

A director’s interest in transactions within the company may arise in different circumstances, although the term is not defined within section 177 of the CA 2006. It can be assumed, however, that such situations would arise when the director acts as a sole trader or acts as the other party in contracts that the company enters into. The key word here is ‘interested’: if it is considered in legal terms to cover property, then it would include transactions with trusts where the director has some equitable interest (direct or indirect). Therefore, the principle formulated in section 177 would also cover transactions with subsidiaries in which the director holds equity or in which he also serves as a director.

Section 180 of the CA 2006 introduces a serious change in how company law treats transactions with the companies⁶⁵⁹. According to the new rule, if directors act in compliance with section 177 of the Act, then, subject to the constitution, the transaction in question cannot be set aside based on the usual equitable rule demanding the shareholders’ consent. What are the situations where declaration of the interest is not required? According to section 177(5), declaration of interest is not necessary if the director is not aware of the interest or the transaction or arrangement in question. This defence is likely to be based on the belief that in modern complex business environments directors may not be aware of all the transactions that the company is engaged in, and thus, logically, be unaware of the resulting interest. Further, section 177(6) of the CA 2006 provides that directors are not obliged to declare an interest in situations that cannot be reasonably regarded as conflict of interest, if other directors are aware of the interest, and in cases where the interest relates to service contracts that were or will be considered by a meeting of directors or a remuneration committee. As seen, section 177, like sections 175 and 176, includes the provision of reasonable consideration of the conflict situation, which, once again, indicates the potential desire of English legislators to introduce some flexibility into the traditionally strict approach to the treatment of directors’ fiduciary duties. There is also another possible defence, which is not

company director holds shares in the company’s most valued suppliers. However, when a delivery contract with the supplier is signed, section 177 comes into force.

⁶⁵⁸ CA 2006, s 177(1).

⁶⁵⁹ Compare Companies Act 1985, s 317.

covered by section 177, although it is present in section 186: the sole director of a company is exempted from presenting a declaration to himself⁶⁶⁰.

5.3.4.2 Declaring Interest in the Proposed Transactions in Case Law

The founding equitable principle that is expressed in section 177 was expressed in *Aberdeen Railway Co v Blaikie Bros*⁶⁶¹:

‘[...] it is a rule of universal application, that no one, having [fiduciary] duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect’.

Section 177 serves a preventive function within the conflict of interest framework, because it requires the provision of a declaration about a director’s personal interest in a transaction before it is initiated. It may be recollected that the equity of the self-dealing principle, which in English law strongly relies on *Keech v Sandford*, entitles the company to avoid any transactions where a director’s interests are likely to come into conflict with the company’s and that even a possibility of bad faith or fraud can be opposed and rejected⁶⁶². Therefore, English case law provides companies with the option of setting aside the undesired transaction. However, section 177 of the CA 2006 provides some leeway in this regard: directors are allowed to proceed with the transaction if all the requirements under the section are met. Consequently, no defence can be applied in a situation where the parties entered the transactional terms as though acting at arm’s length. Similar provisions in English case law are valid in relation to a director’s purchases from other companies⁶⁶³. Importantly, English case law recognises that if the beneficiary allows the transaction, he cannot later demand its being set aside⁶⁶⁴.

⁶⁶⁰ The terms of arrangement still have to be presented in the company minutes.

⁶⁶¹ [1854] 1 Macq HI 461 (Lord Cranworth).

⁶⁶² *Ex P Lacey* [1802] 6 Ves 625.

⁶⁶³ However, articles of association in general give permission to such transactions. In this regard, see *Ireland Alloys Ltd v Dingwall* [1999] SLT 267, OH: the requirements for disclosure were listed in the articles, but not followed, which invalidated the board’s decisions.

⁶⁶⁴ *Holder v Holder* [1968] Ch 353.

Notably, in *Holder v Holder*⁶⁶⁵, the Court of Appeal expressed some flexibility by holding that the court, in general, could look into the nature of a trustee's intentions and knowledge about the transaction and then decide whether the beneficiary can void it⁶⁶⁶. In the case, an individual, who effectively stopped acting as an executor and purchased a piece of land next to his former place of tenancy at an auction was permitted to finish the transaction based on the good faith argument. Based on this case, it may be wondered then, whether a trustee (or a company director for that matter), who acts in good faith, can acquire property from a trust (or company) publicly available and at a standard market price. Apparently, the answer is negative. The reason is that such action would be in violation of the strict *Boardman*⁶⁶⁷ rule, which argues that even when no harm is done to the beneficiary and no advantage is taken of the beneficiary⁶⁶⁸, there is a conflict of interest. Therefore, the subsequent court decisions were relying more on *Lacey*⁶⁶⁹ rather than on *Holder*⁶⁷⁰. However, as mentioned above, the passage of section 177 of the Act provides certain flexibility to the rule. This, however, raises certain issues that need to be resolved.

Prior to the CA 2006, a company was allowed to automatically void any transaction if one or more directors had an interest in it, unless it was properly disclosed and approved at the general meeting⁶⁷¹. The rule is applied irrespective of whether the director acted bona fide for the company's benefit. Consequently, the company could recover any benefit acquired by the director from such transactions. This was primarily retained by the Act, which also extended the need to disclose an interest beyond the contracts entered into by directors, to those where

⁶⁶⁵ *ibid.*

⁶⁶⁶ Specifically, acting in good faith could help the trustee maintain the transaction.

⁶⁶⁷ [1967] AC 46.

⁶⁶⁸ An additional point of strictness comes from the fact that the defendant was not even an express trustee, but rather, a *trustee de son tort*.

⁶⁶⁹ [1802] 6 Ves 625.

⁶⁷⁰ See, for example, *Re Thompson's Settlement* [1986] Ch 99.

⁶⁷¹ See *Aberdeen v Blaikie*, (1854) 1 Macq 461. The first EC directive did not affect the right to hold transactions voidable: see, for example, *Cooperative Rabobank 'Vecht En Plassengerbeid' Ba v Minderhoud* [1998] 2 BCLC 507, ECJ.

he had an interest by acting in such roles as a partner, a shareholder, and others⁶⁷². At the same time, these do not apply to directors' spouses and personal contacts⁶⁷³.

Another difficult issue to address within section 177 of the CA 2006 is what represents a disclosable interest. The issue was addressed in *Cowan de Groot Properties Ltd v Eagle Trust*⁶⁷⁴, where the court had to decide whether a sales contract between two parties, where the defendant was a director in one and a shareholder in another, was an interest to disclose. The court was inconclusive on this, claiming that the interest would not be disclosable in most cases, but acknowledging that there could be exceptions, thereby informally acknowledging the reasonable likelihood of a conflict. Later, in *Runciman v Walter Runciman plc*, the court held that even in cases where the interest of a director was blatantly obvious, there is a need to disclose it⁶⁷⁵.

The situation described above, however, raises a question as to whether there is such a thing as an implied disclosure of interest to the board. Indeed, in the context of section 177(6)(b), the disclosure is not required if other directors are already aware of the interest, and this is one of the major relaxations, regarding the declaration of interest, introduced by the Act. The pre-Act case law's major decision regarding this point was expressed in *Lee Panavision v Lee Lighting*⁶⁷⁶. In this case, all the directors of the company were openly interested in one transaction with the company, but none appeared to disclose it. The Court of Appeal refused to consider non-disclosure of an interest as a breach of duty. In an obiter dictum, Dillon LJ separated a technical from a substantive breach, stating that the director's breach in this case was purely technical, which cannot be considered as a reason to void the transaction. This seems quite in line with what section 177(6)(b) of the CA 2006 implies.

There is, however, an issue with this approach. Formal declaration of an interest at the meeting discloses the interest not only to the directors but also to the shareholders because of

⁶⁷² See relevant case law in: *Transvaal Lands Co v New Belgium (Transvaal) Land & Development Co.* [1914] 2 Ch. 488, Ca; *Costa Rica Ry. v Forwood* [1901] 1 Ch. 746, Ca.

⁶⁷³ Only regular fiduciary duties will apply in this case, although the burden of proof is on directors. See *Newgate Stud Company v Penfold* [2004] EWHC 2993 (Ch).

⁶⁷⁴ [1991] BCLC 1045.

⁶⁷⁵ [1992] BCLC 1084. The same idea was expressed in *Re Neptune (Vehicle Washing Equipment) Ltd (No. 1)* [1995] 1 BCLC.

⁶⁷⁶ [1991] BCLC 575; [1992] BCLC 22 Ca.

its being recorded in the board meeting minutes. The importance of these notes cannot be underestimated, because these help avoid suspicions of secret dealings and some potential abuses from shadow directors. Indeed, a sole director or several directors may engage in beneficial transactions for themselves without due disclosure because the board apparently knows about their interest in the transactions. However, these transactions might not be recorded anywhere at all, thus allowing directors to be involved in such operations without due knowledge of shareholders. Similarly, such a rule greatly favours shadow directors who might easily engage in undisclosed transactions through their influence on the board or on its individual members. In other words, it is submitted that the rule declared in *Lee Panavision* and codified in section 177(6)(b) of the CA 2006 leads to a much lower degree of transparency, which favours directors but downplays the interests of shareholders.

Perhaps the court in *Re Neptune*⁶⁷⁷ considered at least some of these concerns, when holding that a sole director of a company had to disclose a self-authorisation of a redundancy payment for himself and duly report it in the board minutes. Granted, the subsequent full trial in *Neptune*⁶⁷⁸, found that the director had no authority in making the transaction per se, thus bringing up the issue of ‘substantive,’ not technical, non-disclosure. For these reasons, it still remains unclear what liabilities technical non-disclosure would involve. However, for the reasons outlined above, the absence of any certainty in this regard does not make the situation easier for the company shareholders. In the absence of well-defined liability for technical non-disclosure, the directors are given, perhaps, too much freedom and, hence, incentive to breach their fiduciary duties. At the same time, in the absence of information regarding such omissions to shareholders, it becomes much harder to bring a case against mischievous behaviour of company directors. In this regard, it is surprising that in the dominantly strict English company law there is such an evident fiduciary loophole.

The issue of technical non-disclosure, left open in *Neptune*, was also unresolved in *Runciman*⁶⁷⁹, where Brown J did not provide any definitive view on this, although the court allowed the transaction to go through. Further, in *Re Dominion International Group plc*⁶⁸⁰, it

⁶⁷⁷ *Re Neptune (Vehicle Washing Equipment) (No 2)* [1995] BCC 1000.

⁶⁷⁸ *ibid.*

⁶⁷⁹ *ibid.*

⁶⁸⁰ [1996] 1 BCLC 572.

once again distinguished between technical and substantive default, finding that if a genuine informed consent of shareholders is present, only technical non-disclosure applies (in the failure to hold a formal meeting), which is not substantial enough to make a transaction disqualification order. As in the other decisions above, however, the court failed to determine what consequences follow as a result of a technical non-disclosure. Recently, there was some shift in terms of the courts' perceptions regarding disclosure, as some cases argued in favour of a formal rather than partial or informal disclosure⁶⁸¹. However, indecisiveness regarding this issue is still prevalent in English courts⁶⁸².

5.3.5 Chapter Summary

This chapter provided an extensive review of the present situation in English law with regard to director's fiduciary duties related to company property, including information and opportunities. It was noted that the approach taken by English law has traditionally been stricter than in other common law countries, such as the United States and Canada. It also seems that English law has taken some cautious steps toward relaxation of some of its strict rules governing the relationship between companies and directors. In this regard, it was noted several times that the law has to walk a fine line between the certainty and stability that the strict approach provides and the liberty and innovation that the flexible approach brings. Regardless of which approach is chosen, however, to be effective the law has to be clear in application and enforcement and free of ambiguities, so that the rules of equity are effectively reflected in the statute, and thus easily applied in case law.

English company law has evolved from centuries old equitable rules and principles, yet the power of statute cannot be underestimated, especially in view of the fact that many provisions of the CA 2006 are the product of these equitable rules and principles. In this regard, the English approach to regulating the fiduciary duties of company directors towards property can prove a useful source of knowledge for legal systems where the statutory governance of company law has not yet reached full fruition. Therefore, certain aspects of regulating such duties can be studied for application in Saudi Arabia. At the same time, it was noted that English company law is not without flaws either. The problematic areas of the law identified

⁶⁸¹ See, for example, *Gwembe Valley Development Co Ltd v Koshy (No 3)* [2004] 1 BCLC 131 Ca; also see *Re MDA Investment Management Ltd* [2004] 1 BCLC 217.

⁶⁸² See, for example, *Re Marini Ltd* [2004] BCC 172, where the court did not consider the absence of formal minutes as a decisive argument regarding non-disclosure.

in this chapter are addressed again in the final chapter of the thesis, where suggestions for improvements in the Companies Act will be provided.

Chapter Six: Directors' Fiduciary Duties towards Company Property in Saudi Arabia

6.1 Introduction

This chapter continues the discussion of the approaches that the legal systems of England and Saudi Arabia apply to resolve the issue of effectively regulating fiduciary duties of company directors toward corporate property. This is, in effect, a continuation of the third step in the functionalist approach in comparative law⁶⁸³ which this study follows. Specifically, this chapter focuses on how the Saudi Arabian legal system deals with regulating the aforementioned issue.

The third and fourth chapters of the current thesis provided some insight into the specifics of the Saudi legal system, which is founded on principles and a philosophy different from those of the legal system of England. As mentioned, the Kingdom of Saudi Arabia recognises *Shariah* law as the primary legal source. Because the *Shariah* law a priori plays such a fundamental role in the Kingdom's legal system, it inevitably influences all matters within company law, including directors' duties and behaviour toward company property. Therefore, the discussion of the *Shariah* principles in relation to company property in Saudi Arabia is a logical start to this chapter. While the previous chapters defined the structure of the *Shariah* and the main sources of it, this chapter specifically concentrates on the corporate governance aspects of *Shariah* law and its perspectives on property exploitation. For a more effective discussion, some parallels with western law are provided. This is necessary because modern corporations that operate in the Kingdom are very similar in nature to their traditional Western counterparts.

The second section of this chapter presents the analysis of the fiduciary duties that directors owe in respect of company property. Such an analysis, however, has first to be placed within the appropriate context in which the duties would conventionally apply. This involves a discussion on what is considered property in Saudi law. The importance of *Shariah* law in the Kingdom prompts the discussion of property as defined in statutory company law and the *Shariah* as well as the analysis as to how these definitions match.

The third and main section of the chapter provides the analysis of the statutory code for director's fiduciary duties toward property, specifically, Articles 69, 70, 71, 72, and 73 of the CL 1965. The goal of this section is to examine to what extent there is a consistency or

⁶⁸³ Zweigert and Kötz (n 53) 43.

inconsistency between the *Shariah* principles on the one hand and the codification of directors' duties on the other. Following the same format as in the previous chapter, this section starts by defining to whom the company directors in Saudi Arabia owe fiduciary duties. Each duty's purpose and codification in the CL 1965 is discussed and compared to its traditional treatment within the *Shariah*.

6.2 The *Shariah* Law and Corporate Governance in Saudi Arabia

6.2.1 Importance of the *Shariah* Principles in Company Law

Chapter 3 of this thesis provided some insight into the importance of the *Shariah* as a set of legal rules governing any aspect of life in Saudi Arabia. This importance emanates from the philosophical foundations and attitudes of Saudis to Islam and its teachings. Islam can be translated as 'submission,' and 'Muslim' is, therefore, 'one who submits' to the will of God. The core belief of each Muslim is that God's will was conveyed to the Prophet through the Angel Gabriel and then imprinted in the *Qur'an* after the Prophet's passing away⁶⁸⁴. Therefore, the *Qur'an* is believed to include the very works of God. Similarly, the second major source of the *Shariah*, the *Sunnah*, is the practice of the *Shariah* that the Prophet instituted and of which he was the best exemplar⁶⁸⁵. An important consequence of these indications is that the authority of the *Shariah* is based on the will of God, not men. This is a fundamental distinction from the state basis of modern Western law, such as the one present in England. Nevertheless, one should understand that in Saudi Arabia the *Shariah* has a much broader definition and application than one might expect from a 'religious' law. In the Kingdom, the *Shariah* represents a fully-fledged legal system, which not only provides mandatory norms and behaviour in specific situations, but literally lays out the way of Saudi life in all its aspects: from political governance to real property transactions, dining etiquette and even sexual relations⁶⁸⁶.

⁶⁸⁴ See Foster (n 14) 5.

⁶⁸⁵ See Amin Islahi *Fundamentals of Hadith Interpretation* (Hashmi T trans) (Lahore, Al-Mawrid 1989) 28-29. <http://www.monthly-renaissance.com/DownloadContainer.aspx?id=71> , accessed 7 July 2011. The *Qur'an* also teaches that the Prophet was sent to teach God's law: 'It is He who has sent among the unlettered a Messenger from themselves reciting to them His verses and purifying them and teaching them the Book and wisdom - although they were before in clear error' (62:2). Note: hereafter all *Qur'an* passages are given as translated in www.quran.com.

⁶⁸⁶ See Wael Hallaq, 'Muslim Rage' and Islamic Law (2003) 54 *Hastings Law Journal* 1705, 1707.

For the purposes of this thesis, the *Shariah* also contains applicable rules and mechanisms that have to be followed by company directors. Granted, the ambit of the traditional Islamic law does not cover specific aspects of corporate governance, and the newly emerged economic entities in the Kingdom, such as corporations, required some kind of legislation to cover various aspects of their operations, which prompted the borrowing of company laws from abroad. However, in many respects, the *Shariah* covers general human behaviour and establishes the rules of behaviour that everyone must follow⁶⁸⁷. Therefore, directors in Saudi companies have to follow the general *Shariah* principles in all their actions. According to Lewis⁶⁸⁸, the *Shariah* establishes two major sets of duties: the ones that the individual owes to God (*Ibadat*) and the ones that the individual owes to others (*Muamalat*). The second set of mandatory duties inevitably covers the behaviour of company directors, who must follow the requirements and regulations of *Muamalat* as any Muslim would do.

How does the *Shariah* specifically influence the way that Saudi companies are run? In a broad sense, the *Shariah* establishes certain mandatory moral standards that have to be followed by the company directors and adhering to which is as important as producing high profits⁶⁸⁹. Lewis defined two major ways in which the *Shariah* influences Islamic corporate governance⁶⁹⁰. First, it determines the major ethical and social boundaries to which all Muslims must conform in their actions⁶⁹¹. Every individual has to follow these guidelines irrespective of their social status or position. With respect to company directors, these rules define the nature of their responsibilities and social priorities, which become an undeniable part of corporate governance standards. Second, the *Shariah* provides some specific principles and ethical business standards that guide company practices⁶⁹². Business ethics in

⁶⁸⁷ See Nabil Baydoun and Roger Willet, 'Islamic corporate reports' (2000) 36 (1) *Abacus* 71, 80: 'The Unity of God is defined by the Tawhid, which requires a total commitment to the will of God and involves both submission and a mission to follow the *Shariah* in all aspects of life'.

⁶⁸⁸ See Mervyn Lewis, 'Islam and accounting' (2001) 25 *Accounting Forum*, 103. *Ibadat* is evident through such instances as prayer (*Salat*), charity (*Zakat*), witness (*Shahada*), fasting (*Saum*), and pilgrimage (*Hajj*). *Muamalat*, on the other hand, covers such aspects of life as family relationships, economic transactions, and behaviour toward others.

⁶⁸⁹ Susan Gooden, 'Participation of Stakeholders in the Corporate Governance of Islamic Financial Institutions' (2001) 114 *New Horizon* 12, in Lewis (n 688) 13–14.

⁶⁹⁰ Lewis (n 18) 14–15.

⁶⁹¹ *ibid.*

⁶⁹² *ibid.*

Islam provides that these have to be Godly, ethical, humane and moderately balanced⁶⁹³. As a result, all actions of corporate governance by directors have to reflect these four characteristics to be fair and just toward others. As a matter of fact, many traditional Islamic concepts and rules determine the nature of contemporary business activities: the positive values to pursue, such as moderation (*iqtisad*), justice (*adallah*), patience (*sabr*), and meeting social obligations (*istislah*), and the negative values to avoid, such as greed (*hirs*) and hoarding of wealth (*iktinaz*)⁶⁹⁴.

Finally, the importance of the *Shariah* to company law in Saudi Arabia is reflected through its full state support and enforcement. The *Shariah*, based on the *Qur'an* and the *Sunnah*, is the official state law in the Kingdom, as emphasised by Article 1 of Chapter One of the Basic Laws of Governance⁶⁹⁵:

‘The Kingdom of Saudi Arabia is a sovereign Arab Islamic State. Its religion is Islam. Its constitution is Almighty God's Book, the Holy *Qur'an*, and the *Sunnah* (Traditions) of the Prophet (PBUH). Arabic is the language of the Kingdom. The City of Riyadh is the capital’.

This is a notable exception even from other Muslim states, whose constitutions either make the *Shariah* the principal source of law or create statutes based on it⁶⁹⁶. In either case, the ultimate power of the *Shariah* and its influence on society are diminished: in the former case, the *Shariah* is subject to interpretations for the legal purposes; in the latter, the ultimate power is transferred to the state. The supremacy of the *Shariah*, as a legal system in Saudi Arabia, does not mean, however, that it is the only law. In some respects, especially when modern economic and social developments are involved, the Holy Texts cannot provide a comprehensive answer to certain issues. As a result, the *Shariah* is supplemented by government issued regulations, and in the case of corporate governance these are the CL

⁶⁹³ Azaddin Kaliffa, ‘The Multidimensional Nature and Purpose of Business in Islam’ (2003) 7 *Accounting, Commerce & Finance: The Islamic Perspective Journal* 1.

⁶⁹⁴ These are discussed in Yahia Rahman *Interest Free Islamic Banking* (Kuala Lumpur: Al-Hilal Publishing 1994).

⁶⁹⁵ Basic Law of Governance 1992
http://www.saudiembassy.net/about/countryinformation/laws/The_Basic_Law_Of_Governance.aspx accessed 8 July 2011.

⁶⁹⁶ Foster (n 14) 8. For example, Article 2 of the Egyptian Constitution (as amended in 1980) provides that Islamic law is the principal source of law; Article 2 of the Kuwaiti Constitution establishes Islamic law as the main source of law. Neither, therefore, considers *Shariah* as the state law; but rather, as a source of it.

1965 and the CGR 2006. Still, these codes, like any other government-issued statutes, have to be fully compliant with the *Shariah* as with the supreme law of the Kingdom.

To sum up, the *Shariah* is an essential legal concept to consider when discussing any issues pertaining to corporate governance in general and directors' duties specifically, in Saudi Arabian companies. The *Shariah* creates a system of accountability that all Muslims (company directors among them) have to accept and follow. Directors, as the chief representatives of their companies, have to work within this system and be accountable to both God and the others (investors, stakeholders, and society as a whole) in all their actions.

6.2.2 Comparison to Western Style Company Law

As seen from the discussion above, the *Shariah* regimes are an undeniable part of modern company law in the Kingdom. Being superior to any government issued piece of legislation, the *Shariah* requires compliance in the same manner as, or even to a higher degree than the statutory codes governing all aspects of corporate governance. However, despite being an all-encompassing law, the *Shariah* does not provide specific guidance regarding the governance of contemporary corporations that have become common in the Kingdom. Perhaps this stems from the fact that the emergence of these corporations have occurred largely under the rules established in the regimes where the very form of corporation has been well accepted and understood⁶⁹⁷. As a result, a peculiar situation has emerged: the new economic entities have to be governed in compliance with the traditional Islamic law. In order to fully understand how this relationship might work, it is necessary to determine the main similarities and differences between the *Shariah* and traditional Western company law, under which corporations evolved.

⁶⁹⁷ The concept of 'corporation' is, indeed, alien to the *Shariah*. There are various arrangements such as *shirkah al-inan* (similar to limited partnership), *mudarabah* (similar to trustee financing), and even *mudarib* (similar to entrepreneurship). However, it is questionable whether and to what extent these arrangements fit the rules and arrangements of the contemporary corporations. The closest in this sense could be *mudarabahh*, where some individuals provide capital and others manage the business on their behalf. This was implied by Abdul Rahman, 'Issues in Corporate Accountability and Governance: An Islamic Perspective' (1998) 15 (1) *American Journal of Islamic Social Sciences*, 15. However, the similarity falls apart when goods or services are acquired on credit or when profits are reinvested further in the business. In this case, the workers (managers) become liable as partners. See Imran Nyazee *Islamic Law of Business Organizations: Partnerships* (New Delhi, Kitab Bhamn 1999) 275. Also see Lewis (n 18) 21. In addition, there is a clear distinction between corporate investors and 'investors' under *mudarabahh*: the latter does not give the depositors the rights of voting or exiting. *ibid*.

6.2.2.1 Similarities between the Shariah and Western Company Law

While Islamic law is often viewed as an impediment to business development⁶⁹⁸, it is, in fact quite the opposite: in many aspects, Islam has views similar to Western ones on the usefulness and benefits of business commerce. *Shariah* laws do not prohibit such activities as wealth creation, business or trade, but consider them morally justified and useful for society⁶⁹⁹. Therefore, Islamic law supports enterprising attitudes of individuals, respects contractual rights, and protects property and ownership⁷⁰⁰. In fact, the *Qur'an* uses the notion of contract to elucidate an individual's relationship with Allah and emphasises the importance of contract fulfilment⁷⁰¹. In addition to similarities in views on business and contracts, the *Shariah* displays a number of characteristics that are considered indispensable by Western-style company law. For example, both the *Shariah* and Western company law are founded on the principles of the facilitation and regulation of business and commerce where they can be practised by more than one individual and where profitable exploitation of capital is allowed and encouraged⁷⁰². Further, each of these law systems provides a number of mechanisms to regulate capital and commercial activity in different instances: where the source of capital is combined (partnership in Western law and *sharikah* in the *Shariah*), and where it is separated (limited liability company in Western law and *mudarabah* in the *Shariah*)⁷⁰³.

⁶⁹⁸ Rodney Wilson, 'Islam and Business' (2006) 48 (1) Thunderbird International Business Review 109.

⁶⁹⁹ See, for example, Kurshid Ahmad, 'The Challenge of Global Capitalism: An Islamic Perspective', in J Dunning (ed) *Making Globalisation Good: The Moral Challenges of Global Capitalism* (Oxford University Press, 2003) 192; also see Syed Uddin, 'Understanding the Framework of Business in Islam in an Era of Globalisation: A Review' (2003) 12 (1) Business Ethics: A European Review 23; also see Imad-ad-Deen Ahmad, 'Islam, Commerce, and Business Ethics' In *Plenary address at the Loyola Institute for Ethics and Spirituality in Business International Ecumenical Conference* (2004) <<http://www.minaret.org/islamcommercebusinessethics.pdf>> accessed 9 August 2011.

⁷⁰⁰ Miles and Goulding (n 18). Miles and Goulding also explain that property ownership is embedded in Muslims' fulfilment of their calling as the stewards of Allah: stewardship is impossible without property, *ibid* 132.

⁷⁰¹ In relationship to God, see, for example, *Qur'an* 2.245 'Who is it that would loan Allah a goodly loan so He may multiply it for him many times over? And it is Allah who withholds and grants abundance, and to Him you will be returned'; also 57:11 'Who is it that would loan Allah a goodly loan so He will multiply it for him and he will have a noble reward?' and 64:17 'If you loan Allah a goodly loan, He will multiply it for you and forgive you. And Allah is Most Appreciative and Forbearing'. The importance of contract fulfilment is given in 5.1. 'O you who have believed, fulfil [all] contracts'.

⁷⁰² Foster (n 14) 28.

⁷⁰³ *ibid*.

There are also similarities in the reasoning enveloping the legal models of both the *Shariah* and Western company law. For example, early justification of the *mudarabah* by Al-Sarakhsi resembles the modern Western description of a limited corporation⁷⁰⁴:

‘people have a need for this contract. The owner of capital may not find his way to profitable trading activity, and the person who can find his way to that activity may not have the capital. And profit cannot be attained except by means of both of these, that is, capital and trading activity. By permitting this contract, the goal of both parties is attained’.

The same kind of legal thinking can be traced in both jurisdictions with respect to agency, property, contract and fiduciary concepts: in the West these concepts are derived from the rules of equity, and in the *Shariah* from the notion of *amana* (meaning ‘trust/fidelity’)⁷⁰⁵. Trust, on the other hand, may be considered in Western law as an obligation governed by equity, which brings the two concepts very close. Therefore, to some extent, it can be considered that the sources of such legal thinking are quite similar in England and Saudi Arabia. There are also similarities between the rules of a partnership: as in Western law, *mudarabah* and *sharikah* under the *Shariah* cease to exist when one of the partners withdraws, passes away, or become incapacitated (it should be noted, however, that under the *Shariah* no exceptions have been granted to this rule, unlike in Western law)⁷⁰⁶. On a more technical level, Cizakca⁷⁰⁷ noted a number of similar mechanisms between *sharikah* and *mudarabah* and Western forms, such as an English partnership and French *société*.

6.2.2.2 Differences between the *Shariah* and Western Company Law

Having discussed the existing similarities between the *Shariah* and contemporary Western company law, it is necessary to consider the numerous differences existing between these two legal systems. These differences encompass various aspects of the legal framework, from the defined business entities and the underlying governance theories to the guiding moral principles and ethics.

⁷⁰⁴ *ibid* 28.

⁷⁰⁵ See the discussion on *amana* in Abraham Udovitch, *Partnership and profit in Medieval Islam* (New Jersey, Princeton University Press 1970) 88-89.

⁷⁰⁶ Foster (n 14) 28.

⁷⁰⁷ Murat Cizakca, *A Comparative Evolution of Business Partnerships: The Islamic World and Europe, with Specific Reference to the Ottoman Archives* (Danvers, MA, EJ Brill 1996): see Chapter 2 for a detailed analysis of practical convergences.

The first primary difference between the legal systems under consideration has already been mentioned above: it is the absence of corporations as legal entities, and the presence of only partnerships, which do not possess either legal personality or limited liability⁷⁰⁸. These concepts (legal personality, corporation, limited liability) are inherent in Western law, and their absence in the *Shariah* can be explained by the specifics of social environment and the needs of society, within which the Islamic law has evolved. According to Foster, the *Shariah* legal system has historically functioned in a much simpler environment than Western law: this environment has not been affected by such factors as vast trading systems of colonialism, industrial revolutions, development of capital markets, and the creation of complicated banking systems⁷⁰⁹. Consequently, commercial activities in the Arab world were conducted on a small scale or in form of joint ventures. Kuran went even further to identify various religious, social and political impediments to the development of a corporation as a legal entity in Islam⁷¹⁰.

Another significant point of distinction is the dominant underlying theoretical model. As was discussed in earlier chapters of this thesis, the English model of corporate governance stands upon the theory of agency. The major premise of this theory is that corporate directors act as self-interested agents, who may not have the same goals as the company owners (shareholders)⁷¹¹. As a result, the creation of mechanisms ensuring protection from directors' abuse of power has become necessary. However, the principles of *Shariah* law reject the agency theory. Instead, company directors are considered faithful keepers and managers of the assets entrusted to them (much like the trustee theory envisions⁷¹²), and the demonstration of devotion and faithfulness to the interests of the company is equated to an act of worship⁷¹³. Therefore, the *Shariah* considers directors as having a diametrically different role to that in

⁷⁰⁸ See n 697 above. Whether these concepts are recognised in Islamic law today is discussed later in the chapter.

⁷⁰⁹ Foster (n 14) 30.

⁷¹⁰ Timur Kuran, 'The Absence of the Corporation in Islamic Law: Origins and Persistence' (2005) 53 *American Journal of Comparative Law* 785.

⁷¹¹ See Jensen and Meckling (n 241); also see Ross (n 365) 134–39.

⁷¹² See James Davis, David Schoorman and Lex Donaldson, 'Towards a Stewardship Theory of Management', (1997) 22 (1) *Academy of Management Review* 20.

⁷¹³ Miles and Goulding (n 18).

Western law: it does not assume that directors' powers have to be controlled and/or curbed; rather, there is an a priori assumption that each Muslim lives and acts by the word of Allah.

It is commonly implied that the Western model of economy focuses on fulfilling the needs and wishes of human beings⁷¹⁴. Hence, an individual and his/her desires are the central theme of capitalism. Consequently, for as long as the rights and freedoms of the other members of the society are not infringed, an individual is free to pursue these desires. In contrast to that, Islam attributes the right to satisfy man's desires as belonging to God only. Although the *Shariah* does not deny the needs and desires of men, it sets clear guidelines as to how these can be fulfilled⁷¹⁵. Since one of the main goals of Islam is to achieve justice and equal opportunities, and ensure that the basic needs of all are satisfied, and it disallows such activities as exploitation, waste or indulgence. Within the Western law tradition, to which English law belongs, any lawful activity is permitted (even though it could be harmful to society at large). An example here could be the case of *Adams v Cape Industries plc*⁷¹⁶, where the English court had to decide whether a British corporation was liable for breach of duty of care and negligence when its subsidiary sold asbestos to a company in the US, thereby making the company employees sick with asbestosis. By holding the company not liable, the English Court of Appeal generally established that the corporate veil should not be pierced if a group of companies operated as one business entity. As such, the decision opened the door to corporate structure manipulations to divert certain rights and responsibilities, especially in relation to third parties.

Following the discussion above, the Islamic tradition promotes the 'value maximisation' approach, which requires consideration of the interests of other stakeholders, beyond the company and its shareholders. For quite a long period of time, Anglo-American corporate governance model has been following the 'shareholder wealth maximisation' model⁷¹⁷. This approach, however, has been increasingly questioned, especially in the light of, and as a consequence of cases like *Adams*. A number of stakeholder-focused initiatives have been

⁷¹⁴ *ibid* 136.

⁷¹⁵ *ibid*.

⁷¹⁶ [1990] Ch 433.

⁷¹⁷ Mervyn Lewis, 'Accountability in Islam' (Fourth International Conference on Accounting and Finance in Transition, Adelaide, Australia)
<<http://www.unisa.edu.au/commerce/docs/Accountability%20and%20Islam.pdf>> accessed 9 August 2011.

implemented by the UK government in recent years, among which the CA 2006 is, perhaps, the most important one. Section 172 of the Act introduced some significant changes to the way that company directors in England should act and the interests they should take into account. Section 172(1) is the most prolific in this regard: it imposes a duty to act in a way that a director, in good faith, considers best for the company and its members as a whole, while taking into account, at the same time, the consequences of such acts in the long term, employee interests, fostering relationships with the suppliers and customers, and considering the impact of the acts on the community and the environment. As such, the CA 2006 attempted to introduce a wider context of social responsibility into the framework of directors' decisions and acts. While suggesting that shareholders' interests are still superior⁷¹⁸, the Act suggests that they should not be the cause of disregarding other parties' interests in the process.

Still, whether the effects of the new provisions in the CA 2006 will represent a move toward the stakeholder oriented model remains to be seen. After the passage of the Act, many scholars, commenting on provision 172(1) predicted that directors would eventually be more cautious during the decision making process because of the potential censures and derivative claims by company shareholders. However, there is little evidence to suggest that it has been really so in practice. For example, a study conducted by Loughrey, Key and Cerioni suggests that there has not been a significant increase in derivative claims since the passage of the CA 2006, and that lawyers, in general, discourage shareholders from filing such claims due to the apparent difficulties of succeeding with them⁷¹⁹. Similarly, some scholars have argued that employee groups could be even worse off after the Act's passage since they have no enforceable rights mentioned in the Act and their interests might be de-emphasised when considered alongside the interests of other stakeholder groups mentioned in Section 172(1) of the CA 2006⁷²⁰. Therefore, while the recent changes to company law in England introduced a certain shift toward recognition of the stakeholder model, the implications of the changes remain largely theoretical, due to the apparent difficulties of bringing an action against directors' misdeeds in relation to the third parties' interests.

⁷¹⁸ CA 2006, s 172(2).

⁷¹⁹ Joan Loughrey, Andrew Key and Luca Cerioni, 'Legal Practitioners, Enlightened Shareholder Value and the Shaping of Corporate Governance' (2008) 8 *Journal of Corporate Law Studies* 79, 111.

⁷²⁰ Charles Wynn-Evans, 'The Companies Act 2006 and the Interests of Employees' (2007) 36 *Industrial Law Journal* 188, 192.

As seen, in many aspects the *Shariah* legal regime is more different than similar to Western law. Primarily, this has been dictated by the significant differences in the historic context within which the compared legal systems evolved. While the Western legal system has been influenced by structural economic shifts that brought an intensification of trade and commerce, Islamic businesses have existed in a much simpler environment. As a result, the *Shariah* system historically has not considered such fundamental concepts of Western law as corporation, ownership and limited liability. Still, to say that the *Shariah* represents an inferior legal system for the contemporary business environment would be wrong. Indeed, the *Shariah* does not prohibit the major concepts of internationally accepted business principles and practices such as wealth creation, competition and contracts. What the *Shariah* does, however, is increase the level of corporate responsibility and accountancy. The religious duties emphasised by the *Shariah* transcend the required legal obligations typical for Western law practices and add moral obligations toward all stakeholders and the society at large. In this sense, the *Shariah* can even be considered superior to Anglo-American law, which only emphasises the duties of directors owed toward shareholders, while the obligations to company stakeholders are quite loose and often not legally enforceable⁷²¹.

6.2.4 The *Shariah* and Contemporary Business Associations

As already mentioned, the inability of the Islamic tradition to provide a comprehensive legal basis for managing new forms of business, such as corporations, has led to the widespread adoption of Western style company law across the majority of the Middle East countries. Saudi Arabia was no exception in this case, as it borrowed a French-based company regime previously adopted in Egypt. As a result, the traditional Islamic rules embodied within the *Shariah* became added to by the new set of rules defining new business associations and corporate governance as prescribed by Western style law⁷²². In justifying the introduction of Western-style law to the Kingdom's legal system, the Explanatory Memorandum to the CL 1965 states:

⁷²¹ For a good discussion in this regard see Abdussalam Abu-Tapanjeh, 'Corporate Governance from the Islamic Perspective: A Comparative Analysis with OECD Principles' (2009) 20 *Critical Perspectives on Accounting*, 556. In Anglo-American law, directors owe the duties to their companies, while they are encouraged to consider the interests of the related groups (third parties). This, however, carries an advisory, non-enforceable character.

⁷²² The new laws replaced the rules of business governance. While the Kingdom still maintains *Hanbali* forms, the Ministry of Trade only registers the entities created in accordance with the CL 1965. See Koraytem (n 229) 66.

[...] companies created by mutual agreement where one or more partners agree to conduct business for profit with a view to sharing profits and losses as agreed [are] sanctioned by the *Sunnah* (traditions of the Prophet) and *Ijma'* (the consensus of the authorities in Islam). In the *Sunnah*, it is supported by the holy tradition (ascribed to God), stating: 'I am the third (partner) of every two partners, unless one of them deceives the other, in which case I shall dissociate Myself from them'; and by the tradition that Usamah ibn Shurayk came to the Prophet, God bless him and grant him salvation, asking: 'Do you know me?' The Prophet answered: 'How can I not know you, when you were my partner and the best partner, never deceiving nor quarrelsome!' Moreover the Prophet was sent to the people at a time when they formed companies and he consented to what they were doing without any prohibition or objection. This consent constitutes one of the aspects of *Sunnah*. As for the consensus (of authorities in Islam), it is evidenced by Muslims' engaging in trade as partners from the advent of Islam to date without anyone objecting thereto⁷²³.

By accepting the new rules of business governance, the legal environment of Saudi Arabia had to also consider the application of the major principles that come with it. Islamic scholars have questioned whether Western corporate law can be compatible with the principles of *Shariah*, and specifically, whether Islamic law accepts the notions of legal personality and limited liability. Indeed, the legal reasoning for the acceptance of corporation in the *Shariah* should come from the fact that both of these main corporate terms are compatible with it. In the absence in the *Shariah* of such a form of business as a corporation, it is necessary to examine the classical *Shariah* mechanisms and basic principles to search for possible analogies of legal personality and limited liability.

6.2.4.1 Legal Personality in the *Shariah*

Since the *Shariah* does not provide explicit explanations regarding the term 'legal personality', jurists had to look into interpretations of *Shariah* principles and draw analogies from other concepts in an attempt to justify the acceptance of the term. However, up until now, there is no clear agreement among the scholars regarding this issue. Zuhairah Ariff pointed out that some modern Islamic law scholars justify the existence of legal personality in the *Shariah*, based on the *al dimmah* theory of *fiqh*⁷²⁴. *Al dhimmah*, which means

⁷²³ See Nabih Saleh *The General Principles of Saudi Arabian and Omani Company Laws (Statutes and Shari'a)* (London, Namara Publications 1981) 248.

⁷²⁴ Zuhairah Ariff, 'The Myth of Corporate Personality: An Overview from the Common Law and the Islamic Law Perspective' (International Conference on Harmonisation of *Shariah* and Civil Law, International Islamic University Malaysia 2003), cited in Zuriati Z, Yusoff M and Azrae A, 'Separate Legal Entity under *Shariah* Law and Its Application on Islamic Banking in Malaysia' (2009) 6 (2) *International Journal of Banking and Finance* 145.

‘accountability’ and ‘guarantee,’ is sometimes linked to the term *al-ahliyyah* (meaning ‘capacity’) and *iltizamat* (meaning ‘obligation’)⁷²⁵ Therefore, if an entity is recognised as having existence, either real or artificial, then it will have a capacity and certain obligations, which creates, in theory, a separate legal entity. This position, however, is criticised by other Islamic law researchers who claim that the very nature of *al dhimmah* assumes its applicability to real persons, for whom the *Qur’an* and the *Sunnah* have been written⁷²⁶.

Another line of argument has evolved around the rules of analogy. Some scholars seem to support the idea that legal personality has historically existed in Islam in such concepts as the *waqf*, the *bayt al-mal*, and the mosque⁷²⁷. The *waqf* refers to holding and preserving property for philanthropic purposes with the prohibition of using that property for any purpose outside these objectives. It is functionally similar to trusts under common law. According to Usmani, after contributing the properties to the *waqf*, individuals no longer own them, but the entity does: the fact that Usmani considered to prove that the *waqf* is a separate legal entity⁷²⁸. Any property acquired by the proceeds of the *waqf* becomes the property of the *waqf* as an institution, and not that of the *waqf* contributors⁷²⁹. In a similar manner, donations to the mosque (*masjid*) including bequests, become the property of the mosque as an institution, and this is not prohibited in Islam⁷³⁰. Finally, Islamic scholars who support the idea of legal personality in Islam refer to *bayt al-mal*, which is the Islamic financial institution administering taxes and paying state salaries. Usmani, with reference to Al-Sarakhsi, noted that *bayt al-mal* as an institution was allowed to lend money or borrow it from other state departments, an activity which is attributed to a separate legal entity⁷³¹. However, other scholars openly disagree with these ideas. Nyazee, for example, explicitly states that Islamic jurists did not assign *al dhimmah* to either the *bayt al-mal* or the *waqf*⁷³². The Mujlisul Ulama

⁷²⁵ Mahdi Zahraa, ‘Legal Personality in Islamic Law’ (1995) 10 (3) *Arab Law Quarterly* 195.

⁷²⁶ Zuriati and others (n 724) 145.

⁷²⁷ See, for example, Nabil Saleh, ‘Arab International Corporations: The Impact of the Shariah’ (1993) 8 *Arab Law Quarterly* 180.

⁷²⁸ Muhammad Usmani, *An Introduction to Islamic Finance* (Kluwer Law International 2002) 158.

⁷²⁹ *ibid* 105.

⁷³⁰ Zuriati and others (n 724) 146.

⁷³¹ Usmani (n 728) 105-106.

⁷³² Nyazee (n 697) 278; see also Kuran (n 710) 822-823.

(Council of Islamic Scholars) refuted the claim of legal personality in the *Shariah* based on the *waqf* and *masjid* for the following reasons: 1) the property purchased with the *waqf* income cannot be the property of the *waqf* institution because it requires a human person (*waaqf*) for this purpose; 2) all properties possessed by the *masjid* are in the hands of Allah, who is not fictitious⁷³³.

6.2.4.2 Limited Liability in *Shariah* Law

The concept of limited liability in *Shariah* law should be given special attention. The absence of the concept of corporation in the *Shariah* prompts the review of basic *Shariah* principles and the use of analogies to find the answer to the question of whether Islam accepts the notion of limited liability. The main principle of relevance in this case is *al-kharaj bi al-daman*, which links profits to the liability for losses⁷³⁴. Based on this principle, Islamic law scholars argued that a contributor of capital in a business entity has full liability resulting from the entity's transactions, which renders limited liability unacceptable⁷³⁵.

In terms of analogy, liability in Islamic law is generally understood through the description of the major forms of partnership, which are *sharikahs* and *mudarabahs*. *Sharikahs* have historically been trade partnerships, and in all forms of *sharikah*, unlimited liability has been out of the question⁷³⁶. The situation with *mudarabahs* is more complicated. Under a *mudarabah* contract, there is a capital provider (*rabb al-mal*) and a work provider (*mudarib*), who manages the capital on a limited or absolute basis. In general, the capital provider is not jointly liable, except for 'special circumstances,' with the *mudarib* in transactions arranged with third parties⁷³⁷. Consequently, it has been the *mudarib* who acted as the defendant or the plaintiff in all cases regarding *mudarabah*⁷³⁸. The separation of asset management from asset ownership in *mudarabah* has led some Islamic scholars to consider this fact as justification of

⁷³³ Mujlisul Ulama of South Africa 'The Concept of Limited Liability: Untenable in the Shariah' (South Africa: Young Men's Muslim Association 2007) <<http://books.themajlis.net/node/251>> accessed 15 September, 2011.

⁷³⁴ Frank Vogel and Samuel Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Cambridge, MA: Kluwer Law International 1998) 300.

⁷³⁵ Nyazee (n 697) 54; also see Syed Hasanuzzaman, 'Limited Liability of Shareholders: An Islamic Perspective' (1996) 28 *Islamic Studies* 354.

⁷³⁶ See Foster (n 14) 15-19.

⁷³⁷ Udovitch (n 705) 239.

⁷³⁸ Nyazee (n 697) 278.

the compliance of Western corporations with the Islamic principles. In this regard, Abdul Rahman wrote⁷³⁹:

‘the structure of a modern joint stock company is more or less a variation of the Islamic concept of *mudarabah* [in which] one or more persons supply capital and others run the business on their behalf at an agreed rate of profit. The modern corporation has many similarities with the *mudarabah*. The notion of separation of ownership and control can also be found in the principles of *mudarabah*’.

However, in cases when the *mudarib* acquires something on credit and the acquired property is destroyed, then the *rabb al-mal* would have to cover the expenses⁷⁴⁰. Therefore, *mudarabah* does not completely correspond to the principle of limited liability as it is understood in the West. Developing this idea, Foster also noted that *mudarabah* cannot justify the applicability within *Shariah* of the limited liability concept as understood in Western company law⁷⁴¹. Nevertheless, the Council of the Islamic *Fiqh* Academy generally accepted the notion of limited liability under Islamic law, stating that *Shariah* does not object to the creation of a business entity which has liabilities limited to its capital⁷⁴². However, Islamic scholars have argued that the concept of limited liability is only acceptable in the case of publicly held companies, where the large numbers of shareholders makes it impossible to hold any of them liable for the company affairs⁷⁴³. In this regard, Usmani noted that in public companies the number of shareholders can be so large that none of them can be responsible for the business affairs on a daily basis and for company liabilities exceeding the assets⁷⁴⁴. He generally dismissed the possibility of limited liability for privately held corporations and all forms of partnerships⁷⁴⁵.

⁷³⁹ Abdul Rahman (n 697) 60-61.

⁷⁴⁰ Al-Sarakhsi, cited in Nyazee (n 697) 169.

⁷⁴¹ Foster (n 14) 281. Specifically, Foster mentions that the notion of limited liability in Islamic law under a *mudarabah* contract has been considered from the perspective of their relationship to each other and not for the reasons of risk reduction and investor protection, which apply in Western law.

⁷⁴² The Islamic Fiqh Academy. Resolution 63/1/7, para. 12, 1992: ‘There is no objection in Shari’a to setting up a company whose liability is limited to its capital for that is known to the company clientele and such awareness on their part precludes deception’. <<http://www.fiqhacademy.org.sa>> accessed 14 September 2011.

⁷⁴³ See, for example, Usmani (n 728) 158 and 160; also in Hasanuzzaman (n 735), 353.

⁷⁴⁴ Usmani (n 728).

⁷⁴⁵ *ibid.*

6.2.4.3 Modern Trends in the Saudi Legal Business Context

Despite the apparent divergence of Islamic scholars' opinions regarding legal personality and limited liability in the *Shariah*, Saudi Arabian law has been steadily moving in the direction of accepting Western style business forms. Article 2 of the CL 1965 mentions limited liability partnerships and limited by shares companies among the major business forms acceptable in the country (along with mutual partnerships, joint ventures and joint-stock companies). The Article mentions that these types of businesses are *Shariah* compliant. Furthermore, the CL 1965 accepts the notion of legal personality for three types of business entities: limited partnerships, limited by shares companies, and joint stock companies⁷⁴⁶. Therefore, despite the ongoing debate among Islamic scholars on the presence of limited liability and legal personality in the *Shariah*, the Saudi government seems to support the existence of these concepts, or, at least, that they do not contradict the *Shariah* principles.

The acceptance of Western style forms of business in Islamic law has occurred gradually, but the major reasons for the 'acceptance mentality,' as Foster puts it⁷⁴⁷, can be explained as the expected difficulties in developing a comprehensive legal code based on the *Shariah* principles and the popularity of Western style corporations as forms of business elsewhere in the world. The first reason for the acceptance of Western style corporations in Saudi Arabia is based on the notion that Western corporations, as legal entities, are well established. At the same time, developing an alternative well defined entity based on Islamic law seems problematic in view of the absence of a clearly defined term in the *Shariah*. Therefore, the creation of *Shariah* defined business associations fit for modern practices would require considerable time and resources⁷⁴⁸. In this regard, accepting the existing forms of business entities seems like a reasonable choice. Second, it is an established fact that the majority of foreign businesses dealing with Saudi counterparts are incorporated, which inevitably raises the issue of effective transaction regulation.

⁷⁴⁶ Clifford Chance LLP, 'Corporate Law Project. Jurisdiction: Saudi Arabia' (The United Nations Mandate of the Special Representative of the Secretary-General (SRSG) on the Issue of Human Rights and Transnational Corporations and other Business Enterprises 2011), 10
<<http://www.businesshumanrights.org/media/documents/ruggie/corp-law-saudi-arabia-clifford-chance-for-ruggie-feb-2011.pdf>> accessed 14 September 2011.

⁷⁴⁷ Foster (n 14) 279.

⁷⁴⁸ *ibid* 281.

It can be said that the *Shariah* is more suitable for governing the aspects of human life, which are not prone to quick and fundamental changes⁷⁴⁹. These include family law, criminal law, property law, endowments, and trusts. Business activities, on the other hand, represent an area of regulation where rapid changes have occurred over the course of recent decades as Saudi Arabia has firmly entered the global business arena. Because the *Shariah* does not provide clear answers to many questions posed by the modern business environment, the Saudi legislator has had to search for quick and reliable solutions for the welfare of the society as a whole. This principle is known as *almasalih almursalah* (public interest), and it assumes that the governing body of the country can establish new laws and regulations for which there are no clear answers in the Holy Texts, if these are dictated by the pressing needs of society. Still, by accepting the notion of limited liability and corporations, the law of Saudi Arabia in no way diverges from the principles of *Shariah*. Article 2 of the CL 1965 explicitly states any rules and regulations mentioned in it are *Shariah* compliant.

6.2.4.4. The *Shariah* and the New Business Concepts

As the new concepts of corporation, limited liability and corporate governance have steadily entered the legal plane of Saudi Arabia, it is worthwhile to determine the kind of relationship that exists between the *Shariah*, which still remains the superior law of the Kingdom, and these new concepts, which encompass the majority of the contemporary business entities in Saudi Arabia. It is obvious that the classical approach to the definition of a corporation and its governance, as identified in Western law, would be affected by the principles of the *Shariah* due to its focus on somewhat different values than those that Western company law propagates. This inevitably leads to a differently conceived concept of corporation and its goals.

The first important influence of the *Shariah* is on the function of capital exploitation, which is one of the main aspects of Western (Anglo-American) company law. This function is determined by the ability of those who have expertise (company directors) to use the capital of those who invest in a corporation (shareholders). As discussed in the previous chapters, English law, which is based on the principles of separated ownership and control and principal-agent relationships between shareholders and directors, recognises this problem and creates various mechanisms to counter it. In contrast, property exploitation is inherently alien

⁷⁴⁹ Almajid (n 275) 175.

to the *Shariah*. The basis for this is the principle of *al-kharaj bi al-daman* (profit through risk), which links responsibility to the revenue entitlement⁷⁵⁰. Foster also noted that any capital contributed on a basis different from *al-kharaj bi al-daman* can be regarded as a loan, and in this case the *Shariah* prohibits the lender from receiving more than the amount of capital lent (*riba*)⁷⁵¹. Therefore, the *Shariah* requires responsible treatment of the corporate capital and prohibits its risky use (exploitation).

Another conventional aspect of a corporation as defined in Western company law is the primacy of the shareholders. This means that the board of company directors is expected to pursue the goals which are first of all in the interests of the company shareholders, while the goals of the other groups of stakeholders are pushed aside⁷⁵². Lewis outlined several assumptions that follow as a consequence of this: emphasis on the financial welfare of one specific group of stakeholders (shareholders in this case); rational self-interest of the main actors (the agency problem); and irrelevance of morality and religious principles⁷⁵³. Arguably, this model of corporate governance assumes the pursuit of purely materialistic goals, the primary of which is wealth maximisation of the company shareholders. Granted, this model has not gone unchallenged. Some European countries, like Germany, Austria, the Netherlands and Switzerland have developed corporate governance models that seek to create a socially responsive corporation, where the interests of all relevant parties are considered⁷⁵⁴. In such a corporation, supervisory roles are separated from executive roles, and the presence of company supervisory committees ensures that the actions of the long term interests of shareholders, employees, customers, suppliers and society as a whole are considered⁷⁵⁵. Even within the ‘managed corporation’ Anglo-American model of corporate governance, institutional investors are starting to play a stronger role in regulating the acts of directors.

⁷⁵⁰ Abdulkader Thomas, Stella Cox and Brian Kraty, *Structuring Islamic Finance Transactions* (London, Euromoney Books 2005) 226. See Section 6.2.4.2. for the discussion of *al-kharaj bi al-daman*.

⁷⁵¹ Nicholas Foster, ‘Islamic perspectives on the law of business organisations: Part 2: the *Shariah* and Western-style business organizations’ (2010) 11 (2) *European Business Organisation Law Review* 273.

⁷⁵² The *OECD Principles of Corporate Governance* (2004) 11 state that the main objective of good corporate governance is to provide good incentives for the board to pursue the objectives in the interests of the company and its shareholders. <www.oecd.org/dataoecd/32/18/31557724.pdf> accessed 9 August 2011.

⁷⁵³ Lewis (n 18) 11.

⁷⁵⁴ *ibid* 11-12.

⁷⁵⁵ Ellen Schneider-Lenne, ‘Corporate Control in Germany’ (1992) 8 *Oxford Review of Economic Policy* 16.

Moreover, many researchers have been calling for the development of a ‘stakeholder approach’ in corporate governance, which would have the objective of protecting the interests of all related parties⁷⁵⁶. Yet these theories, although widely popular, are still called ‘alternative’ theories of corporate governance. The traditional approach based on shareholder wealth maximisation still prevails in Anglo-American company law, while the interests of other parties are recommended to be considered within legislative accounts of these countries.

The *Shariah*-based approach is contrary to this. One of the fundamental principles of the *Shariah* is justice, which does not allow one group’s interests to be placed above those of the others. Consequently, the corporate resources have to be distributed on a fair basis among all stakeholders for the overall benefit of the community⁷⁵⁷. This approach resembles the Western approach of corporate social responsibility, which was described above. The difference is that the *Shariah* essentially brings together this approach with the notion of effective corporate governance. They are, in effect, inseparable under the *Shariah* law. As was demonstrated above, the Western school of corporate governance thought might not be, as a whole, concentrated on strictly maximising the value of shareholders. Indeed, leading Western management gurus, like Peter Drucker and Charles Handy, have been actively advocating governance approaches based on the long-term overall prosperity of society and treating businesses more like communities and not properties⁷⁵⁸. Consequently, a range of ethical and moral principles have been embedded in the suggested best practices of corporate governance. Still, despite these endeavours, there are a number of issues with the Western approach to corporate governance from the Islamic point of view.

First, business ethics within the Islamic tradition has deep roots in the Holy *Qur’an* and the *Sunnah*, which outline general principles of behaviour that are considered desirable. These rules, founded on faith, are starkly different from Western ideas of ethics, which have

⁷⁵⁶ Nada Kakabadse, Cecile Rozuel and Linda Lee-Davis, ‘Corporate Social Responsibility and Stakeholder Approach: A Conceptual Overview’ (2005) 1 (4) *International Journal of Business Governance* 277; Dima Jamali, ‘A Stakeholder Approach to Corporate Social Responsibility: A Fresh Perspective into Theory and Practice’ (2008) 82 (1) *Journal of Business Ethics* 213; Bannerjee (n 25); David Hawkins, *Corporate Social Responsibility: Balancing Tomorrow’s Sustainability and Today’s Profitability* (New York, NY, Palgrave MacMillan 2006).

⁷⁵⁷ See Choudhary Slahudin, ‘OECD Principles and the Islamic Perspective on Corporate Governance’ (2008) 12 *Review of Islamic Economics* 29, 33.

⁷⁵⁸ Charles Handy, *The Hungry Spirit* (New York, NY: Broadway Books 1999); Drucker P, *Management Challenges in the 21st Century* (2nd edn, New York, NY: Harper Collins 2007).

evolved on the basis of secular humanist values as the society progressed and where the fragmentation of ethical ideologies is such that it is difficult to establish a unified view⁷⁵⁹. A general view on the *Shariah*-based business ethics was expressed by Slahudin⁷⁶⁰:

‘The hallmark of Islamic business ethics lies in the high values that underpin the business operations and transactions. Islam stresses the practice of justice and equality, truthfulness and transparency, and protection of minorities, accountability and adequate disclosure, just as it prohibits all forms of exploitation, in all walks of life, including business dealings [...]. The three underlying principles (transparency, accountability and adequate disclosure) of the OECD code, developed after a series of reports and researches, also underlie good practice in Islam, as known since the religion was consolidated 1400 years ago’.

Second, despite the recent development of the principles of corporate governance based on social responsibility, the entire Anglo-American business culture is rooted in self-interest. As a result, even if the system is eventually modified, it will still lack the overarching requirement to consider the interests of society. Finally, as was demonstrated in Chapter 4 of this thesis, the Anglo-American system of corporate governance is based on the theory of agency. Therefore, the main parties of the corporate governance process are not considered as stewards who are either motivated to act in the wider interests of the society or observed and guided to do so⁷⁶¹. This approach is alien to Islam, which demands authority over totality and does not admit the divergence between what is sacred and what is secular. Therefore, each and every act of a Muslim has to conform to the standards and principles defined within the *Shariah*, and business activities are not excluded from this.

As seen, *Shariah* regime significantly deviates from some traditionally accepted aspects of business law as developed in the West. It requires a more diligent approach to corporate governance and places more responsibilities on the corporate governing body, which has to

⁷⁵⁹ See Lewis (n 18) 14 for a general distinction between secular and religious beliefs and ethics; also see Foster (n 751) 299.

⁷⁶⁰ Slahudin (n 757).

⁷⁶¹ As mentioned before, the structure described, known as the stewardship approach, is well developed and applied in some European countries, like Germany, Austria, Switzerland and the Netherlands. See discussion above. This theory is still being juxtaposed with the Anglo-American approach, which is widely regarded as an agency relationship. See, for example, Zulkifli Hasan, ‘Corporate Governance: Western and Islamic Perspective’ (2009) 5 (1) *International Review of Business Research Papers* 277; Lucian Cernat, ‘The Emerging European Corporate Governance Model: Anglo-Saxon, Continental, or Still a Century of Diversity?’ In Clark T and Chanlat J-F (eds) *European Corporate Governance: Readings and Perspectives* (Abingdon, Routledge 2009) 144-157; Ruth Aguilera and Gregory Jackson, ‘The Cross-National Diversity of Corporate Governance: Dimensions and Determinants’ (2003) 28 (3) *Academy of Management Review* 447.

consider traditional Islamic values and rules of behaviour. In Saudi Arabia, where the *Shariah* is the supreme law of the land, more than in any other Muslim country, these rules have to be abided by all, including the company directors. These, however, represent what should be the ideal situation. Whether, in fact, *Shariah* laws are strictly followed in Saudi corporate settings is debatable.

Following the discussion above, an ideal from the *Shariah* perspective is that an Islamic corporation would focus on the creation of wealth for the entire Islamic community, avoid taking excessive risks, be transparent, and its directors would avoid any temptation to self-interest. In reality, large distortions from the written *Shariah* rules exist. Ali coined the term ‘sheikocracy’ to define the corporate reality in the Arabic world⁷⁶². The main features of sheikocracy, according to Ali, are strict hierarchical authority, subordination on the basis of personal relationships and authority, the dependency of rules and regulations on the personal powers of those who create them, and the overall patriarchal approach in the decision making process⁷⁶³. Following these statements, it becomes clear that connections and social status determine the role in corporations and those whose interests normally prevail. This idea was expressed by Muna, who wrote that

‘The Arab executive lives in a society where family and friendship remain important and prevalent factors even in the functioning of formal institutions and groups. Consequently ... the Arab executive relies upon family and friendship ties for getting things done within his organization and society’⁷⁶⁴.

Further, any claims for a high moral ground in the case of Saudi corporate executives and a high level of transparency in Saudi organisations are overshadowed by the country’s relatively poor place in the Corruption Perceptions Index, which is annually published by Transparency International. According to the 2010 list⁷⁶⁵, Saudi Arabia ranked only 50th in the world. Such divergence between the theoretical and practical execution of the *Shariah* principles in Saudi corporate governance has been explained by researchers as the presence

⁷⁶² Abbas Ali, *Islamic Perspectives on Management and Organisation* (Cheltenham, Edward Elgar 2005) 192.

⁷⁶³ *ibid.*

⁷⁶⁴ Farid Muna, *The Arab Executive* (London, MacMillan 1980) 12.

⁷⁶⁵ Transparency International, ‘Corruption Perceptions Index 2010 Results’ (2010) <http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results> accessed 9 August 2011.

of two identity forms in Arabs⁷⁶⁶. The first type of identity is historically determined, cultural and global: it epitomises the ideal devout Muslim⁷⁶⁷. The second type of identity is immediate and particular to everyday situations⁷⁶⁸. The presence of these two identities often leads to strong beliefs in the former, but following the latter in practice. Within the realm of corporate governance, the selective, authoritarian management, which is based on relationships and status, often only creates an illusion of such concepts as consensus, transparency and common interest⁷⁶⁹. Therefore, to say that the *Shariah* rules are strictly and undeniably followed within the context of Saudi corporations is, perhaps, an overstatement. The question is, however, whether the discrepancies between the *Shariah*-stated rules and actual behaviour of Saudi corporate executives are the results of imperfect human nature or the loopholes provided within the adopted company codes. This chapter attempts to provide at least a partial answer to this question by looking into the codification of directors' duties towards company property and the major principles of the *Shariah* law to identify possible gaps between the two.

6.3 Property in *Sharia* Law

In order to acquire a full understanding of the various aspects in Saudi law covering the fiduciary duties of directors towards company property, it is necessary to first discuss the concept of property itself, because it is different from what is commonly understood in the West (including English company law). The Islamic concept of property is based on the *Shariah* law, which treats it in a sacred manner⁷⁷⁰. The primary difference from Western law is the belief that, ultimately, all property is owned by Allah, which is clearly implied in the *Qur'an* and the *Sunnah*⁷⁷¹. All forms of property which are assigned to human beings are

⁷⁶⁶ See Ali (n 762); also see Eqbal Ahmad, 'Islam and Politics' in Haddam Y, Haines B and Findley E (eds) *The Islamic Impact* (New York, Syracuse University Press 1984).

⁷⁶⁷ Ahmad (n 766).

⁷⁶⁸ Ali (n 762).

⁷⁶⁹ *ibid.*

⁷⁷⁰ Joseph Brand, 'Aspects of Saudi Arabian Law and Practice' (1986) 9 *Boston College International and Comparative Law Review* 1.

⁷⁷¹ See, for example, *Qur'an* 5:120 'To Allah belongs the dominion of the heavens and the earth and whatever is within them. And He is over all things competent' and *Quran* 3:26 'Say, 'O Allah , Owner of Sovereignty, You give sovereignty to whom You will and You take sovereignty away from whom You will. You honor whom You will and You humble whom You will. In Your hand is [all] good. Indeed, You are over all things competent'.

therefore given on the basis of trusteeship (*amanat*)⁷⁷². Consequently, property in Islam is not an end in itself; rather, it is a means of effective distribution of wealth which Allah assigns to his trustees. This makes people accountable for appropriately managing property in this universal trust under the rules prescribed by the *Shariah*⁷⁷³. In relation to company property, this rule posits that directors are the trustees of God, who are accountable for their rightful management of the company assets. Importantly, no restrictions on property and wealth accumulation are given by the *Shariah* for as long as this is conducted by legal means, such as work, contracts, inheritance, transfer or exchange⁷⁷⁴.

While the *Shariah* attributes all property to Allah, it does not forbid human beings from owning thereof: the possession is simply considered within a different context than in Western jurisdiction. Contemporary Islamic jurists consider private property one of the three major property types, the other two being public and state properties⁷⁷⁵. Justifications for private property can be found throughout the *Qur'an* and the *Sunnah*, which discuss taxes, legality of ownership, inheritance, and prohibition of stealing. The Prophet also implied the importance of private property⁷⁷⁶ and even stated that protection of one's property makes one a martyr⁷⁷⁷. Consequently, a well known *Hanbali*⁷⁷⁸ jurist, Ibn Taimiya, acknowledged that respect for private property is one of the fundamental duties of Islamic state⁷⁷⁹.

⁷⁷² Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (Singapore, John Wiley & Sons (Asia) 2007).

⁷⁷³ See *Qur'an* 24:33 'Give to them from the property of Allah which he has bestowed upon you'.

⁷⁷⁴ Mohammed Alsanosi, 'The Concept of Corporate Governance in *Shariah*' (2009) 20 (2) *European Business Law Review* 343. Alsanosi contrasts these with the illegal forms of acquisition of property, such as gambling, cheating, bribery, forgery, illegal trading, and coercion, which are banned by the *Shariah*.

⁷⁷⁵ Farhad Nomani and Ali Ranhema, '*Islamic Economic Systems*' (London, Zed Press 1994) 66-70. Public property includes natural resources, such as water, forests, ocean, mines, and pastures: everyone has equal rights to these and can use them for as long as other citizens' rights are not infringed by these actions. State property refers to those natural resources that cannot be immediately privatised. This generally includes unclaimed properties such as uncultivated land.

⁷⁷⁶ The Book of Pilgrimage (Kitab Al-Hajj) Chapter 17, No: 2803 'Verily your blood, your property are as sacred and inviolable as the sacredness of this day of yours, in this month of yours, in this town of yours'. <<http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/muslim/007.smt.htm>> accessed 9 August 2011.

⁷⁷⁷ 'Kitab Al-Iman' (Online version). Chapter 63. http://www.msapubli.com/hadiths/muslim/001_smt_0063.htm accessed 9 August 2011.

⁷⁷⁸ *Hanbali* is the predominant Islamic school of thought in Saudi Arabia.

⁷⁷⁹ Saba Habachy, 'Property, Right, and Contract in Muslim Law' (1962) 62 (3) *Columbia Law Review* 453.

As seen, the *Shariah*, in general, recognises human rights to property; although it is not considered ultimately as possession by man. But what can be considered private property in Islam? The concept of property (*mal*) in the *Shariah* is viewed differently according to each school of Islamic thought. Of relevance to the current discussion is the definition provided within the *Hanbali* school, which considers *mal* as ‘something in which there exists a lawfully permissible benefit without resulting from pressing need or necessity’⁷⁸⁰. Al-Buhuti⁷⁸¹ further explained the principle of *mal* by saying that it included everything except for 1) things in which there is no benefit in essence; 2) things that are legally prohibited; 3) things permissible only in a situation of pressing need; and 4) things permissible only in a situation of necessity. Following the definition of property in the *Shariah*, there are several key characteristics that qualify for this definition. According to Muhammad Islam⁷⁸², Islamic tradition defines five key aspects of property: 1) it has to be desired by man, or, in contemporary meaning, have some commercial value; 2) it can be possessed and owned; 3) it can be stored; 4) it is beneficial in the eyes of the *Shariah*; and 5) its ownership can be assignable and transferable.

What about intangible things? In Western law, certain intangibles are considered to be property in the form of intellectual capital and, as was have seen in the previous chapter, English law treats corporate opportunities as if they were property. In general, the *Hanbali* definition of *mal* seems not to pose any obstacles. However, if we look at the key characteristics of property defined above, some of them (for instance, the ability to be stored) cannot be easily met by intangibles. Perhaps for these reasons the *Hanbali* school allows certain intangibles to be regarded as *mal*, but only if they are somehow linked to material objects and items⁷⁸³. This is a significant allowance on the side of what is, in other legal senses, a very strict legal framework that exists in Saudi Arabia. It should be mentioned that intangible forms of property are nowhere mentioned in the Holy Texts⁷⁸⁴, which are

⁷⁸⁰ Al-Kharqi, *Matan al-Iqna*, cited in Muhammad Islam ‘The Concept of Property in Islamic Legal Thought’ (1999) 14 (4) *Arab Law Quarterly* 365.

⁷⁸¹ Al-Buhuti (Mansur Ibn Yunus) *Kashshaf al-Qana' Matan al-Iqna'* (1983) in *Alam al-Kutub* vol 3 152.

⁷⁸² Islam (n 780) 365.

⁷⁸³ See Amir Khoury, ‘Ancient and Islamic Source of Intellectual Property protection in the Middle East: A focus on Trademarks’ (2003) 151 *The Journal of Law and Technology* 172.

⁷⁸⁴ Silvia Beltrametti, ‘The Legality of Intellectual Property Rights in Islamic Law’ in Mach T and others (eds) *The Prague Yearbook of Comparative Law* 2009 (Prague 2010) 55-94.

rigorously followed by the *Shariah* scholars in the Kingdom. Therefore, the support for intangible forms of property in Saudi Arabia is derived from various forms of *ijma* and *qiyas*⁷⁸⁵. In statutory company law, certain forms of intangibles are equated to company assets. What exactly can be attributed to intangible assets is defined by the Board of the Capital Market Authority⁷⁸⁶:

‘non cash assets, without physical substance, capable of providing the firm with services or benefits in the future, and in which the firm has acquired the right as a result of events that have occurred or operations that have been completed in the past. Intangible assets could be separately identifiable (could be separated from other assets), such as formation costs, trademarks, copyrights, industrial samples and designs, franchises and licenses. Intangible assets could also be unidentifiable in a separate manner such as goodwill, management skills and qualifications, and other factors which constitute the reputation [of the company]’.

Therefore, Saudi company law formally accepts the notion of intangible property, which can be beneficial to business. Importantly, the definition does not include either opportunities or information about opportunities. Within the interpretation of property provided by the *Hanbali* law, it is unlikely that these could be considered as property either, because they are not attached to the company’s tangible assets. However, as will be demonstrated later, one of the Articles of the CL 1965 considers secret information as something that belongs to a company, thus prohibiting its exploitation in the same manner as for tangible assets.

An important and unique attribute of private property in the *Shariah* is the notion of its rightful use. Starting from the traditions attributed to the Prophet, when private property is used in such way that it is harmful to the others, Islam has the right to curtail the rights to it⁷⁸⁷. This view is supported by a number of prominent scholars in *Shariah* law. For example, Naqvi believed that property ownership has strong links to the good of the community: those who do not understand this notion can have the property removed from them⁷⁸⁸. Similarly,

⁷⁸⁵ See Chapter 3 of this thesis for the discussion of the main sources of the *Shariah*.

⁷⁸⁶ The Board of the Capital Market Authority (2007) ‘Glossary of Defined Terms Used in the Regulations and Rules of the Capital Market Authority’.

⁷⁸⁷ This belief is attributable to Hanbali school of thought, which argues that the state has the right to bound individual’s property rights, if private ownership endangers community interests. Other schools of Islamic thought debate this proposition. For discussion, see Nomani and Ranhema (n 775) 71-77.

⁷⁸⁸ Syed Nawab and Haider Naqvi, *Ethics and Economics: An Islamic Perspective* (London, The Islamic Foundation 1981). The justification for stripping of property rights is that the property is owned by God, and men are serving as His trustees.

Haneef considered that ineffective use of land justifies its confiscation by the state for redistribution to those who would be able to use it for the public good⁷⁸⁹. The reason for such a strict (and it may seem harsh) attitude toward personal property in the *Shariah* stems from the fact of self-interest, on which property rests. However, as follows from the discussion above, self-interest should not prevail in managing God's property on trust. Therefore, all actions involving private property have to be tested on the basis of *Shariah rules* and serve to fulfil, among other things, ethical obligations to society⁷⁹⁰.

The analysis conducted above shows that the *Hanbali* school of Islamic law recognises both tangible and intangible types of property. While the Holy Texts provide a clear indication of personal ownership only of tangible objects, the concept of *mal* has been extended to include some forms of intangible property, which indicates the *Shariah's* adaptability to the contemporary economics and business environment. In this view, the traditionally emphasised religious fundamentalism in Saudi Arabia seems to partially give way to the modern tendencies in an attempt to justify them on the basis of a re-interpretation of the traditional Islamic principles. Nevertheless, the strictness of the *Shariah* is still reflected in the rules of rightful property use, which provide the Islamic state with powers to reject property rights in a case when the property is not used in an effective and responsible manner.

6.4 Directors' Duties with Respect to Company Property in Saudi Arabia

Codification of directors' duties in Saudi Arabian legislation has been introduced as part of the overall corporate governance framework established in response to the needs of the market and the creation of the new business environment in the country. As discussed in the previous chapters, the primary secular piece of legislation governing directors' duties is the CL 1965 (CL 1965). The major provisions defining the nature of directorship and the directors' duties in Saudi companies are listed in Articles 66 to 82. Not all of these Articles deal with the fiduciary duties towards company property. Of particular interest to this study are Articles 69 para 1 (avoiding conflict of interest), 69 para 2 (declaring interest in

⁷⁸⁹ Mohamed Haneef, *Contemporary Islamic Economic Thought: A Selected Comparative Analysis*, (Kuala Lumpur, Iqraq Books 1995) 124.

⁷⁹⁰ See Ahmad (n 699) 195; also see Muhamad Arif, 'Towards Establishing the Microfoundations of Islamic Economics: The Basis of the Basics' in Ghazali A and Omar S (eds) *Readings in the Concept and Methodology of Islamic Economics* (Selangor Darull Ehsan, Pelanduk Publications 1989) 86.

transactions), 70 (not competing with the company), 72 (not disclosing company secrets), and 71 with 73 para 2, which deal directly with the prohibition of property exploitation. These Articles provide the legal treatment of the fiduciary duties of company directors towards company property in Saudi Arabia.

While the CL 1965 provides a list of the codified duties of company directors, the *Shariah* provides a set of rules and behaviour that all company directors have to follow. As discussed above, these duties are based on the principles of general morality and ethics that Islam imposes on its followers. Unlike the government-issued laws regulating business affairs, *Shariah* rules are neither codified nor organised into a single comprehensive list that is easy to comprehend and follow. Instead, the Holy Texts are studied and interpreted by religious scholars to provide what is right in different situations. Despite the lack of codification and organisation, *Shariah* principles are strictly applied and followed in Saudi Arabia, where the *Hanbali* school of thought interprets the Holy Texts' teachings very close to their classic form, with few modifications⁷⁹¹. Therefore, at least in theory, Saudi company directors have to follow both the rules prescribed in the Articles within the CL 1965 and the teachings of the *Shariah*. In situations where the *Shariah* comes into conflict with the secular law, it is the *Shariah*, as the supreme law of divine nature in the Kingdom, that prevails. Consequently, the laws, rules, and regulations that come into conflict with the *Shariah* are rendered invalid in Saudi Arabia⁷⁹². Therefore, an understanding of the underlying principles of the *Shariah* that might be relevant to a particular suggestion in relation to the law is required to ensure that it will be accepted from the perspective of Islamic law. The following sections follow this logic by considering directors' fiduciary duties towards company property from the perspective of the company law epitomised in the CL 1965 and from the perspective of the applicable rules of the *Shariah*. However, before delving into a discussion of the duties, it is necessary to identify the subjects to whom Saudi company directors owe their duties.

6.4.1 To Whom Are the Duties Owed?

Directors' duties in Saudi company law are determined both by the laws enacted by the government (including the CL 1965 and, to some extent, the Listing Rules issued by the

⁷⁹¹ Beltrametti (n 784).

⁷⁹² In relation to company law, this is explicitly mentioned in the CL 1965 Article 2.

Capital Market Authority)⁷⁹³ and by the divine laws that are put forward by the *Shariah*. Quite surprisingly, there is no clear consistency among the pieces of Saudi law pertaining to this matter. The directors' duties under the CL 1965 go beyond the company and extend to the company shareholders and other entities, as formulated in Article 76:

‘Directors shall be jointly responsible for damage to the company, or the stockholders, or third parties, arising from their maladministration of the affairs of the company or their violation of the provisions of these Regulations or of the company’s bylaws⁷⁹⁴. Any stipulation contrary to this one shall be considered nonexistent’.

Nevertheless, the term ‘third parties’ is nowhere clarified in the Act. As such, the CL 1965 fails to either name the other entities to which directors might owe their duties or to define the scope of this term. Besides, the LRs for the joint stock companies that are issued by the Capital Market Authority (CMA) seem to ignore the third parties in this sense overall. In this regard, Article 28 of the LRs provides:

‘Directors of an issuer [meaning the joint stock company] must exercise their powers and carry out their duties in such a way as to serve the interests of the issuer’.

It can be assumed that the ‘third parties’ defined within the CL 1965 may refer to the stakeholders named in the CGR 2006, who are ‘Any person who has an interest in the company, such as shareholders, employees, creditors, customers, suppliers, community’⁷⁹⁵. However, two important issues arise here. First, both the LRs and the CGR have been issued by the CMA. In this regard, it becomes unclear why the Authority would explicitly state that

⁷⁹³ See Section 3.2.2. for the discussion on the legislative developments and legal authorities in Saudi Arabia.

⁷⁹⁴ In Saudi Arabia, company by-laws are the primary documents setting forth the rules of corporate governance. Their purpose and functionality resemble those of the articles of association used in England. In general, the bylaws establish such things as the number of directors and their remuneration, the way that shareholder meetings are conducted, how consent and approval are achieved at the meeting, and other important issues.

Bylaws are mentioned in many provisions of the CL 1965 as the tools to regulate various company affairs. This proves the intent of Saudi legislators to transfer the responsibility for managing some of the company governance affairs to companies themselves. Company bylaws in this sense play an important role in the regulation of directors’ duties, but many large companies use them as a tool to circumvent the rules established by the CL 1965. A typical example here is the bylaws of Alahsa Development Company, a Saudi company with a market capitalization of nearly £133 million, whose bylaws clearly establish the ability of the board to grant loans for the terms exceeding three years, to buy, sell and mortgage the property and assets of the company and to release the debtors of the company from their liabilities. These are exceptions to Article 73 of the CL 1965.

⁷⁹⁵ CGR 2006, Article 2(b). Article 1(a) also clearly assumes the protection of stakeholders’ rights: ‘These Regulations include the rules and standards that regulate the management of joint stock companies listed in the Exchange to ensure their compliance with the best governance practices that would ensure the protection of shareholders’ rights as well as the rights of stakeholders’.

the duties are owed to the company only, and in the other include all the stakeholders. One explanation is possible: the documents imply that the duties are owed to the company, but there is also an obligation to protect the rights of the stakeholders. This is in line with the wording of the Articles provided in both documents. However, in this case, it is unclear which one of these documents ties in better with the CL 1965: on the one hand, Article 76 of the CL 1965 mentions some ‘third parties’, which could be stakeholders; on the other hand, the CGR, unlike the LRs, has a recommendatory character, which means that its Articles are not binding.

This brings us to the second issue, which is the recognition of the duty to other parties beyond the company. To the best of the researcher’s knowledge, neither incorporation nor listing on Saudi Stock Exchange explicitly requires the recognition of duties to anything or anyone other than the company. Besides, Article 1 of the CL 1965 provides that a company is a ‘contract pursuant to which each of two or more persons undertake to participate, in an enterprise aiming at profit, by offering in specie or as work a share, for sharing in the profits or losses resulting from such enterprise’. Granted, an introductory part of the CL 1965 does recognise social responsibility (that is, an obligation to act so as to benefit society at large, not only specific entities) as a consequence of incorporation⁷⁹⁶; however, this part of the Act does not impose any specific obligation upon company directors. Furthermore, the CL 1965 does not give a right for any ‘third parties’ to sue the directors for breach of their duties, although such a right is clearly given to the shareholders on behalf of the company by Article 78⁷⁹⁷. As a result, it can be observed that the duties or responsibilities that directors might owe to any entity besides the company are given mostly advisory character in government-issued pieces of legislation. This explains why the majority of the actions pertaining to the stakeholders (or ‘third parties’ for this matter) are described in the CGR 2006⁷⁹⁸, which does not have a legal binding power.

⁷⁹⁶ CL 1965 Explanatory Introduction: ‘The number of companies has risen by leaps and bounds in a few years from a few score to several hundred, and is still constantly increasing due to the great benefits that such companies have in actual practice achieved in furtherance of the public interests and of the private interests of the people, individually as well as collectively’.

⁷⁹⁷ CL 1965, article 78: ‘Every stockholder shall have the right to institute the action liability against directors on behalf of the company if the wrongful act committed by them is of a nature to cause him personal prejudice’.

⁷⁹⁸ For example, in addition to defining the stakeholders and emphasising the responsibility of directors to respect their rights, the CGR 2006 Article 10(e) suggests that the company board of directors should create a written policy defining the nature of their relationships with the stakeholders and protection of their interests. The article requires, among other things, mechanisms for indemnifying the stakeholders for infringement of

Following the discussion above, it is logical to conclude that Saudi company laws and regulations put the emphasis on the company (and to some degree on the shareholders) as the main entities to whom directors owe their duties. Even if we assume that the term ‘third parties’ extensively covers the company stakeholders as described in the CGR 2006, it is still unclear what practices would trigger a breach of duty to these parties. The point is that the only explicit mentioning of such a trigger is provided in Article 76 of the CL 1965, which mentions ‘maladministration of the company affairs’ as a case for liability to the third parties. Again, however, this term is neither clarified, nor defined. This leaves too much room for interpretation of the term, which in turn gives the courts considerable flexibility when such issues arise. The provision in Article 76 of the CL 1965 is similar to misfeasance covered by Section 212 of the IA 1986 in England. In England, however, the definition of the term and its applicability is determined based on the precedents in case law, which is not a common practice in Saudi Arabia. Consequently, on the basis of the existing government issued laws the only clear case when directors will owe the same duties to stakeholders seem to be when failure to consider them also affects the company.

While the state-issued company legislation gives clear priority to the company in terms of directors’ duties, the rules of *Shariah* are applicable on a wider basis, as they prioritise the welfare of society and place a duty of care to the third parties and to society in general on those who find themselves in the position of authority. As such, the duties imposed on directors under the *Shariah* can be compared to the general duty of care, which is owed to the company, its shareholders and other interested parties. This can be regarded as placing additional responsibilities on the company directors to act in a way which is not harmful to others and society as a whole. From the *Shariah* standpoint, directors are entrusted with the company, business and property from God, who is the only and ultimate owner of all things. Therefore, they have to follow the rules and principles of the *Shariah* and be accountable before God for this⁷⁹⁹.

As seen, there is some divergence between the government-issued laws and the *Shariah* in terms of views on directors’ duties. Whether the reason to this is the absence of codification of *Shariah* rules, or because legislators feel that the *Shariah* imposes duties on each

their rights, a code of conduct and ethics that directors should follow in relationships with the stakeholders, and the company’s social contributions.

⁷⁹⁹ Lewis (n 18).

individual regardless of their position and therefore the law does not have to be specific, or because making the law too specific could bring apparent tensions with the *Shariah* principles, is not clear. However, the fact is that the CL 1965 does not provide clear answers to many legal questions, which seems to undermine its very purpose of filling the legal gaps in the areas which are not effectively explained by the *Shariah*.

The binding legal documents that govern corporate governance issues in Saudi Arabia give preference to the company, to which directors owe duties, while the *Shariah* emphasises general duties owed to society at large. While *Shariah* concepts are not codified in Saudi company law, it should be remembered that all man-made laws are only supplementary to the *Shariah*, which are considered the laws of God⁸⁰⁰. Still, there is a clear need for the *Shariah* to be codified in the form of laws and regulations to ensure their widespread compliance⁸⁰¹. Nevertheless, it is clear that each of the Articles present in the company law statutes of Saudi Arabia has to be in compliance with the rules of *Shariah*. Consequently, each of the Articles dealing with the duties of directors towards company property has to be considered within the scope of both the government-issued legislation and the Islamic tradition laid out by the *Shariah*.

6.4.2 Article 69: Conflict of Interest and Declaration of Interest

6.4.2.1 Purpose and Codification

Unlike English company law, which distinguishes the duty to avoid conflict of interest from the duty of declaring interest in transactions involving the company (Sections 175 and 177 of the CA 2006), the Saudi CL 1965 has one Article to cover both. Article 69 of the CL 1965 includes three paragraphs that oblige the directors not to have interests in company transactions and to declare such interest whenever it might be present. We shall consider the two parts of the Article on a separate basis.

The first paragraph of Article 69 of the CL 1965 reads:

⁸⁰⁰ Chapter 3 provides a detailed discussion on this.

⁸⁰¹ See Fadi Dahar, 'Directors' Duties Under Saudi Law' (2011) <<http://www.mondaq.com/x/133486/Corporate+Governance/Directors+Duties+Under+Saudi+Law>> accessed 10 August 2011.

‘A director may not have any interest, directly or indirectly, in the transactions or contracts made for the account of the company except with an authorisation from the regular general meeting, to be renewed annually. Transactions made by way of public bidding shall, however, be excluded from this restraint if the director has submitted the best offer’.

In the absence of other mentions of the possible conflicts of interest between a director and the company in the CL 1965 or other government issued laws⁸⁰², it is logical to assume that this is the provision that has the exact purpose of regulating such conflicts. By reading the provision, however, it becomes obvious that it is rather narrow in scope and open to a wide range of interpretation. In essence, the entire complex aspect of conflicts of interest is explained in just two lines, while the other two lines describe the exceptions to the rule. The wording of the provision strongly implies that the rule applies specifically to the transactions or contracts for the account of the company. This is a serious deviation from Section 175(a) of the English Companies Act 2006 discussed in the previous chapter, which provides that directors should avoid situations where a conflict of interest may arise. In fact, the provision of Article 69 of the CL 1965 does not literally address the conflicts of interest. Instead, it seems to prohibit directors from having interests in the transactions of the company. This makes it unclear whether potential conflicts of interest are included in the provision⁸⁰³.

Further, the paragraph does not clarify the idea of ‘indirect’ interest. This is important, because nowhere else in the Act is it defined either. Theoretically, indirect interest can be related to the ‘related parties’ connected to a director having an interest in the transactions. In this case, however, such parties have to be clearly identified. For example, the English CA 2006 lists the following parties connected to a director: family members, a body corporate to which the director is connected, a person acting in his capacity as trustee of a trust, a person acting as a partner of the director, or firms in which the director has interest and/or stake. The Saudi CL 1965 does not elucidate this point. A simple example where the CL 1965 may find it difficult to provide a clear answer is: if a spouse was involved in a company which was tendering for a contract with the director’s company, under CL 1965 would the director be

⁸⁰² Article 18 of the CGR 2006, basically, restates the provisions of Articles 69 and 70 of the CL 1965. As such, it simply duplicates rather than clarifies the position of Saudi company law regarding conflicts of interest.

⁸⁰³ As noted in the previous chapter, English company law recognises situations where a director has or can have a potential conflict of interest with the company. This includes the actual transactions of the company that a director may divert for his own benefit, or potential transactions in which a company may hypothetically engage. The CA 2006 clearly indicates that both present and potential conflicts are covered by the statute. The CL 1965 applied in Saudi Arabia fails to clarify whether all types of transactions or only potential ones are covered.

deemed to have an interest? Therefore, it is necessary to define indirect connections and interest in order to create the boundaries within which the transactions mentioned in Article 69 paragraph 1 are permissible by law.

Another serious omission of paragraph 1 is the absence of clarification regarding the nature of the transactions that are covered by the Article. Specifically, there is no indication of whether the transactions include real property, intellectual property, information or opportunity. As noted in Chapter 5 of this thesis, English company law places information and opportunities in the same context as company property. It does not consider information and opportunity as property in the full meaning of the term: the existing case law in England dismissed this idea in *Boardman v Phipps*⁸⁰⁴ and *Bhullar v Bhullar*⁸⁰⁵, while the CA 2006 regards property, information and opportunity as separate constructs⁸⁰⁶. However, within the corporate opportunities framework, both can be as if they were property in order to define the nature of the rights and duties existing between the company and the director. This was demonstrated in *Island Export Finance Ltd v Umunna*⁸⁰⁷ and *CMS Dolphin v Simonet*⁸⁰⁸. Finally, for the purposes of law, the CA 2006 included information and opportunities in Section 175 dealing with the directors' duties to avoid interest. The Saudi CL 1965 does not clarify this point, despite the fact that the concept of mal (property) in the *Shariah*, as discussed above, includes intangible objects in its modern interpretation. Moreover, Article 72 of the CL 1965 includes intangible objects (company secrets) in the category protected from directors' exploitation. Therefore, it seems surprising that Article 69 of the CL 1965 did not mention what types of transaction are covered. In the absence of clear guidelines as to what can cause the conflicts of interest, the provision of Article 69 is likely to be a serious cause of confusion with regard to cases where it can be applied.

Article 69 also leaves a wide lacuna in a number of related corporate governance aspects. For example, the Article (and the entire CL 1965 for this matter) does not specify whether engaging in a transaction for the benefit of the company members and managers can be

⁸⁰⁴ [1967] 2 AC 46. It should be noted, however, that in their opinions Viscount Dilhorne and Lord Cohen admitted that in some cases information could be considered company property.

⁸⁰⁵ [2003] BCC 711 720.

⁸⁰⁶ CA 2006, s 175 (2)(a).

⁸⁰⁷ [1986] BCLC 460.

⁸⁰⁸ [2001] 2 BCLC 704.

considered a breach of duty to avoid conflicts of interest. Nothing is said regarding the transactions or agreements that directors may enter into with the company itself, for the benefit of both parties. The wording of the Article also seems to prohibit directors from engaging in a transaction with the third party where both the director and his company are likely to acquire benefits. Finally, neither the Article, nor the other provisions of the CL 1965 explain whether the conflict of interest duty is extended to the directors who resign from their position and to what extent this duty could be applied. Once again, all these matters arise as a result of a provision that is too vague and broad regarding the duty to avoid conflicts of interest, and it is clear that additional details could make the position of Saudi company law much clearer in this regard.

Another omission of Article 69 paragraph 1 is that it does not include the conflict of duties as a situation where its provisions should apply. As discussed in Chapter 4, ownership in the majority of Saudi corporations is much more concentrated than in Western countries. Moreover, family ownership and block shareholding normally determine who will be placed on the board of directors. As a result, even though nominee directors are not separately recognised in Saudi company law, they are a common occurrence. Consequently, nominee directors can be naturally put under pressure to behave in the interests of block shareholders. As was mentioned above, Article 28 of the LRs provides that directors' duties are owed to the company or to other parties⁸⁰⁹. However, the case when the duties to large shareholders may not be in line with the duties to the company in general is not considered by Article 69⁸¹⁰. Granted, the provisions of Articles 76, 77, and 78 of the CL 1965 allow shareholders of public companies to bring legal actions for mismanagement of company property; however, this can be regarded as a measure dealing with the consequences of a breach of the fiduciary duty to avoid conflict of interest (as described by the provisions of Article 69 of the CL 1965), not with the root of the problem itself.

Article 69 also includes two exceptions to the conflict of interest rule. These are authorisation by the regular general meeting and public bidding for a transaction. Notably, Saudi company law does not allow the board to grant permission for some specific transactions to be carried out by a director. This can be explained by the fact that it is typical for a Saudi company

⁸⁰⁹ As Article 76 of the CL 1965 implies.

⁸¹⁰ Nor is it clarified where to look for legal explanation of such situations.

board to include large shareholders or their nominees⁸¹¹; therefore, for the board to forfeit its right of authorisation can be considered as a protecting measure for the company shareholders in general. Still, the Article does not outline the procedure for granting permission at the shareholder meeting, nor does it indicate whether such permission is granted by a simple majority of votes or by a specific quorum. The power of large shareholders is likely to make it easier for directors to obtain permission for acts bordering on the conflict of interest premise, while it could also easily block the transaction in question. In either case, it would be helpful to determine who can be allowed to vote on the issue and what the procedure for the approval involves.

The second protection from the conflict of interest rule is also worth noting. According to Article 69, a director can be exempt from liability if he submits a winning bid for the transactions made as a public offer. Interestingly, this provision seems to allow direct competition with the company, even though it is only in specific cases. However, Article 70 of the CL 1965 explicitly prohibits directors' participation in business activities carried out by the company. As such, there is an obvious tension between the two Articles, which breeds a lack of clarity regarding the overall notion of competing with the company. This issue will be discussed later, in the section devoted to Article 70 and the duties attached to it.

The second and third paragraphs of Article 69 deal with the declaration of interest by directors. The paragraphs oblige the company directors to declare any interest and they outline the correct procedure for doing this. The paragraphs read⁸¹²:

‘The director must declare to the board of directors any personal interest that he may have in transactions or contracts made for the account of the company. Such declaration must be recorded in the minutes of the board meeting, and the interested director shall not participate in voting on the resolution to be adopted in this respect.

The chairman of the board of directors shall communicate to the regular general meeting when it convenes the transactions and contracts in which any director has a personal interest. Such communications shall be accompanied by a special report from the auditor’.

As seen, these paragraphs supplement the first provision of the Article that deals with an interest in related transactions. Declaration of interest is to be made to the board of directors,

⁸¹¹ See Chapter 4 of this thesis for the discussion on this point.

⁸¹² CL 1965, Article 69 para 2-3.

which, in turn, presents it through the chairman to the general meeting. This two-step process of declaration seems logical: on the one hand, the board of directors needs to know about the interest in order to ensure fair voting on the resolutions related to such transactions; on the other hand, the shareholders have to be aware of the interest, because it is they who ultimately decide whether the director may have an interest in the transaction. However, the provision does not require a declaration of interest before the transaction takes place. In other words, a director with an interest in the transaction is not prohibited from waiting until the company considers the transaction or the corresponding arrangement and only then declaring the existing interest. Nor does the Article require the directors to explain the nature and extent of their interest in the transaction, which could, potentially, have a significant impact on the outcome of the resolution related to the matter. It might be argued that such issues can be addressed by shareholders themselves: the provision of Article 96 of the CL 1965 states that shareholders are allowed to ask questions related to the matters raised at the General Assembly meeting and demand answers from both the board of directors and the external auditor. This provision, however, is of a limited scope: it only allows questions to be asked within the agenda presented by the board and ‘in a manner that does not prejudice the company’s interest’⁸¹³.

As seen above, the provisions of Article 69 of the CL 1965 leave quite a few questions unanswered and many points not clarified. This, in turn, means that the courts are given a significant degree of freedom in interpreting these provisions⁸¹⁴. However, for the purposes of the discussion, one of the core fiduciary duties of directors in Saudi companies seems to remain largely unresolved by the provisions of the CL 1965. A very broad definition of the conflict of interest provided by Article 69 leaves too much room for interpretation, and uncertainty regarding several key issues, such as the types of interest and transactions covered by the Article or the appropriate procedure in declaring interest, still persist.

6.4.2.2 Duty in *Shariah* Law

Following the discussion of the general *Shariah* perspectives on commerce and business, it is impossible to distinguish any rules that could apply specifically to corporate governance.

⁸¹³ CL 1965, article 96.

⁸¹⁴ The courts in Saudi Arabia have to yet develop a comprehensive and consistent approach to regulating various issues of corporate governance and directors’ duties. See for discussion Al-Jeber (n 345) cited in Almajid (275).

This is because in the times when the Holy Texts were written, there was no such thing as incorporation in the Middle East; instead, partnership was the main type of business entity⁸¹⁵. As noted earlier in this chapter, the contemporary Saudi company law recognises both corporation and its two key features: legal personality and limited liability. However, the traditional *Shariah* principles were built upon and applied to partnerships, while its acceptance of the main features of modern corporations is still debated among Islamic scholars⁸¹⁶. Foster⁸¹⁷ warned about some dangers in linking the classical *Shariah* concepts to modern corporations: ‘The concepts of the corporation, legal personality and limited liability belong to Western-style law. It follows that asking whether the *Shariah* had these concepts is an analysis of one system in the terms of reference of another system. This is dangerous because, unless the systems compared are very similar indeed, the second system's terms of reference will not fit the first, resulting in a distorted view of the first system’. Foster’s solution involves considering the main differences between the systems and the context within which different forms of business entities emerged and developed. Considering the differences that exist between Western style corporations and partnerships described in the *Shariah*, it is necessary to look at the general provisions that can be applied in the context of both corporations and partnerships.

The general principle of declaring personal interest in a transaction can be linked to the notions of honesty and promise keeping. As the directors become appointed to govern the company, they can be considered as entering a contract, which obliges them to behave in a certain manner and to act in the best interests of the company under *Shariah* law. Therefore, the promise to act in the best interests of the company is inherent in an Islamic directorship contract. Keeping a promise, on the other hand, is one of the key aspects of Islamic teachings. The *Qur’an* teaches⁸¹⁸: ‘O you who have believed, fulfil [all] contracts’. Consequently, a contract is considered to be one of the major bonds that exist between people⁸¹⁹. By entering

⁸¹⁵ Foster (n 14) 29.

⁸¹⁶ Section 6.2.4.4 provides an overview of this issue.

⁸¹⁷ *ibid.*

⁸¹⁸ The *Qur’an*, 5:1.

⁸¹⁹ Consider in this regard Cherif Bassiouni, ‘Business ethics in Islam’ in Minus P (ed) *The Ethics of Business in a Global Economy* (Norwell, MS: Kluwer Academics 1993) 121: ‘the fulfilment of obligations in good faith and in accordance with [the] principles of ‘business ethics’ is not only required; it is inseparable from the general obligation of piety’.

the position of a director, an individual is obliged to act in the interests of the company, while being prohibited from pursuing self-interest, including in related transactions. Therefore, the duty not to pursue a personal interest in company transactions is fully compliant with the *Shariah*.

Another important aspect in the *Shariah* that justifies the provision of Article 69 is honesty. This aspect primarily refers to the declaration of interest in relevant transactions. The *Shariah* not only treats honesty as a virtue; it expects it as a trait of every devout Muslim: ‘And those who are to their trusts and their promises attentive, [...], those are the inheritors’⁸²⁰. Similarly, dishonesty is rejected by the *Qur’an*: ‘Woe to those who give less than due. Who, when they take a measure from people, take in full. But if they give by measure or by weight to them, they cause loss. Do they not think that they will be resurrected for a tremendous Day - The Day when mankind will stand before the Lord of the worlds?’⁸²¹. The general interpretation of these verses can be that truthfulness and honesty are expected, and that Allah punishes those who are dishonest in their deeds with others. Dishonesty can also be linked to cheating, and any gains of property, money or opportunity by cheating are prohibited by secondary *Shariah* sources through the notions of *ghabn* and *gharar*⁸²². Therefore, a director attempting to advance his personal interests at the expense of the company will be considered as a cheat and a dishonest man with all the applicable consequences, which are expropriation of any profits and properties, with their consequent transfer to the company.

6.4.3 Article 70: Competing with the Company

6.4.3.1 Purpose and Codification

The issues related to directors’ competition with the company in Saudi Arabia are regulated by Article 70 of the CL 1965. The Article outlines both the rule and the consequences of its breach. According to Article 70:

‘A director may not, without authorisation from the regular general meeting, to be renewed annually, participate in any business competitive with that of the company, or engage in any of the commercial activities

⁸²⁰ The *Qur’an*: 23: 8-10.

⁸²¹ The *Qur’an*: 83: 1-6.

⁸²² Mahmoud Almadani, ‘The Role Of *Shariah* Law In Protecting Minority Shareholders In Private Companies’ (2010) 21 (12) International Company and Commercial Law Review 398.

carried on by the company; otherwise, the company shall have the right either to claim damages from him or to consider the operations he has conducted for his own account as having been conducted for the account of the company’.

The text of the Article clearly and explicitly prevents directors from participating in a competing business or engaging in any commercial activities that a company carries. In this sense, Saudi company law differs from English law, reviewed in the previous chapter, which recognises the non competition duty as a part of the conflict of interest rule within Section 175(7). The codification of the principle in Saudi law hints at the strict approach of dealing with the issue in such a way that it prohibits any business activity, a restriction that can only be lifted by the authorisation of the general meeting. In this regard, the English Companies Act 2006 treats competing directorships as a conflict of duties within the no conflict framework. Consequently, the same rules and provisions are applied as to the conflict of duties, which can be avoided if there is an authorisation issued by the board of directors and where the situation cannot reasonably be regarded as likely to give rise to a conflict of interest⁸²³. English law does not generally prevent directors from establishing a directorship in a company competing with their former business⁸²⁴, even in cases where new business connections are a product of previous directorship⁸²⁵. Even in the case of an existing directorship, English case law somewhat relaxed the application of the conflict of duty rule, as in the case *Plus Group Ltd. v Pyke*⁸²⁶. The Article being considered here, in Saudi Arabia’s CL 1965, leaves much less room for interpretation of the conflict of duties rules and provides only one acceptable exception, authorisation by the general meeting, which can be much harder to achieve than the permission from the board.

Article 70 seems to complement Article 69 discussed earlier, which prohibits directors from pursuing benefits on their own account at the expense of the company. However, Article 70 also leaves many blank spaces and much room for interpretation of its provisions. The first issue with the provisions of Article 70 is that it does not elucidate the issue of current and past directorships. From the wording of the Article, which is given in the present tense, it

⁸²³ CA 2006, s 175 (4).

⁸²⁴ See *British Midland Tool Ltd v Midland International Tooling Ltd* (n 605).

⁸²⁵ See *Hunter Kane Ltd v Watkins* (n 596); *In Plus Group Ltd v Pyke* (n 535); *Foster Bryant Surveying Ltd v Bryant* (n 596).

⁸²⁶ [2002] EWCA Civ 370

may follow that it covers the instances of current directorship. However, even if this is so, it remains unclear what the legal status of past directorships are in relationship to the provisions of the Article. Unfortunately, neither the CL 1965 nor any other main pieces of government issued legislations are enlightening in this regard⁸²⁷. These are, however, important issues. As discussed in Chapter 5, competition with the company is one of the key issues considered in the English legal system with respect to the duty to avoid conflicts of interest. Even though it cannot be said that the issue has been successfully resolved by English courts, there is, nevertheless, a wide body of case law related to the matter, which specifically considers situations of former directorship. Not recognising the issue per se can arguably lead to such problems as resigning with the intention of usurping corporate opportunities, engaging in preparatory activities with the goal of resigning and taking the opportunity, and not acting in good faith if the possibility of diverting a very profitable transaction may come.

The second issue with Article 70 of the CL 1965 is that it specifically refers to competition with the directors' companies. As such, the Article does not recognise the act of competing as a conflict of duty. Consequently, it becomes very difficult to determine which duties prevail in cases when a person occupies a director's chair in more than one company. Surprisingly, the CL 1965 nowhere considers such a possibility. At the same time, practice shows that multiple directorships are quite common in the Saudi business landscape where large cross-holdings in companies are not uncommon⁸²⁸. Therefore, the absence of company law provisions regulating duties of directors who hold positions in more than one company is striking. Importantly, the resolutions regarding multiple directorships cannot be easily regulated by means of corporate articles, because it would require that the articles address the issue in a similar manner across all the companies in which the position of a director is held. Therefore, the issue of multiple directorships represents one of the main unregulated aspects of competing directorships in Saudi law.

Finally, it should be made clear that the provisions of Article 70 (as well as any other Article of CL 1965) refer to joint stock companies only. At the same time, Saudi company law remains generally silent in respect of competition as related to directors of limited liability companies. This area of corporate governance and applicability of directors' duties, therefore, remains largely self-regulated by means of the articles of association.

⁸²⁷ Again, the provisions of Article 11 of the CGR 2006 simply restate what is said in Article 70 of the CL 1965.

⁸²⁸ See Section 4.3.2. of this thesis.

6.4.3.2 Duty in *Shariah* Law

While the *Shariah* lacks specific insights into the nature of director-company relationships, it has a number of provisions that have been applied historically to the most popular form of business in the Middle East – partnership. The concept of a partnership bond is defined in the *Sunnah*⁸²⁹:

‘Abu Hurayrah said that: The Prophet [PBUH] said: Allah says: I am the third [partner] of the two partners as long as they do not deceive each other. When one of them deceives the other, I depart from them’.

This concept can be also applied within the modern corporate setting, meaning that if a director betrays the company (by competing with it), God Himself turns away from such business. Based on this *hadith*, *fiqh* within the Islamic tradition has interpreted as breach of fiduciary duty the situation where one of the parties acts in a way which is harmful to another, unless he has received permission to do so⁸³⁰. Consequently, on the same basis, the *Hanbali* school of Islam acknowledged that a partner should not compete with the entity formed with the other partners if competition is harmful to the association⁸³¹.

Notably, the rules outlined in the *Hanbali* school only prohibits harmful competition, while allowing it when no harm to the business is present. This contrasts with the all-encompassing prohibition rule outlined in Article 70 of the CL 1965, which disallows any kind of competition, no matter whether it is harmful or not. Therefore, the *Shariah* rules covering competition with the company seem closer to the position taken by the English legislature, where there is some legal relaxation of the rule, to allow competing with the company in specific circumstances⁸³². Still, it should be remembered that the *Shariah* principles in this regard apply generally to partnerships, not to modern corporations. Therefore, it would not be entirely correct to state that company law and the *Shariah* diverge from each other in this case. In the researcher’s opinion, the fact that both recognise competing with the company (or partnership) as a breach of fiduciary duty, represents a positive direction in protecting the

⁸²⁹ Sunan Abu Daud, ‘Draft of *Shariah* Parameter Reference 4: Musharaka Contract’, Cited in Bank Negara Malaysia (2010) 4 <http://www.bnm.gov.my/guidelines/05_shariah/04_draft_shariah%20parameter_spr4.pdf> accessed 15 August 2011.

⁸³⁰ Saleh (n 723) 97. In cases when such behaviour takes place, the party committing the wrong must compensate for the damage resulting from its actions.

⁸³¹ Al Moghni, vol 5 46, cited in Saleh (n 723) 41.

⁸³² See Section 5.3.2.2.2.4. of this thesis.

weaker parties (such as minority shareholders) and a step towards a more organised approach to managing directors' duties. More clarity, however, is needed in terms of codification of this duty in the CL 1965. This is especially important in view of the fact that the *Shariah* does not provide a definitive guide to this matter.

6.4.5 Article 72: Disclosure of the Company Secrets

6.4.5.1 Purpose and Codification

Article 72 of the CL 1965 is somewhat unique because it deals explicitly with the intangible form of company property. Specifically, the article prohibits directors from disclosing important information. The wording of Article 72 proceeds as follows⁸³³:

‘Directors may not disclose to the stockholders outside of a general meeting, or to third parties, such secrets of the company as may have come to their knowledge by reason of their directorship; otherwise, they must be removed and held liable for damages’.

As seen, the Article imposes the duty to maintain confidentiality and avoid disclosure of company secrets to other parties. While the term ‘secrets’ is not defined in the Article, it can be generally understood as involving information in one form or another. In fact, the existing legal literature does not recognise the concept as ‘secrets of a company,’ preferring either ‘confidential information’ or ‘trade secrets’ instead. In either case, the term ‘information’ is at the core of the definition. For example, MacQueen, Waelde, and Laurie wrote that ‘trade secrets [...] provide [...] alternative means to protect valuable knowledge, for by definition, trade secret’s protection [...] is concerned with keeping valuable information from [the] public domain’⁸³⁴. In relation to a director’s duty to not disclose company trade secrets, in *Facenda Chicken v Fowler*⁸³⁵ the English court defined what makes information a trade secret: whether information was provided by the terms of confidentiality, whether information indicates a high level of secrecy, whether there was an implied confidentiality in the information disclosed, and whether the information in question can be easily separated from what can be easily circulated, used, and disclosed. Consequent cases further refined the

⁸³³ CL 1965.

⁸³⁴ Hector MacQueen, Charlotte Waelde Graeme Laurie and Abby Brown, *Contemporary Intellectual Property: Law and Policy* (Oxford University Press 2011, 2nd ed.) 5.

⁸³⁵ [1986] ICR 297.

dominion of trade secrets and the situations where the protection of company information may apply. None of these are present in Saudi company law at the moment. Although secret information is clearly listed as something protected from directors' exploitation, neither the nature of such information, nor the cases where the protection would apply, are mentioned in the CL 1965.

Therefore, Article 72 formally recognises information as something that belongs to the company and can be considered as the company's property. At the same time, it seems that the courts are given a substantial amount of freedom to interpret the meaning of the term. Nevertheless, the strict liability imposed by the provisions of the Article makes the breach of this duty a very serious matter in Saudi law⁸³⁶. Because of this fact, the absence of explanation regarding two of the key aspects involved in the breach of duty (the definition of 'secrets' and the definition of 'third parties') is a very serious legal oversight that can potentially lead to negative consequences. On the one hand, too wide an interpretation of the law may impose unduly hard punishments for rather minor misconduct, such as accidental disclosure of information that can be potentially regarded as belonging to the public domain. On the other hand, a lack of clear guidance regarding the actions that trigger liability may impose behaviour that is too cautious on the directors' side and thus inhibit the process of communication.

The importance of clarifying Article 72 also comes from the fact that some of the 'company secrets' may carry a negative character. For example, if a company engages in unethical market behaviour, and the information comes to the surface during the board meeting, can this be considered a company secret coming to a director's knowledge in the course of his directorship? If this is so, then revealing the fact will legally cost a director his position in the company and impose additional liabilities based on Article 72 provisions, which do not distinguish company secrets from negative, concealed information. Consequently, a director may find himself in a difficult situation where fear of losing his position with the company may prevent him from revealing certain facts in respect of the company's inappropriate actions. This could be harmful to the company stakeholders and society as a whole.

⁸³⁶ No other Article of the CL 1965 pertaining to directors' duties includes removal from the office as part of the liability for the breach of duty. Article 72, however, mentions removal as a definite, not merely possible, measure of punishment.

6.4.5.2 Duty in *Shariah* Law

Before considering the duty of non-disclosing company secrets under the *Shariah*, it is first necessary to make the case for inclusion of intangible objects (which company secrets represent) in the concept of property as the *Shariah* explains it. Intangible property rights are not specifically regulated by Islamic law. However, the concept of intangible property does not contradict the provisions of the *Shariah* developed within the *Qur'an* and *Sunnah*, which justifies its inclusion in the category of *mal*⁸³⁷. Unlike the *Hanafi* school of legal Islamic thought which links the concept of property strictly to tangible objects, the *Hanbali* school (prevalent in Saudi Arabia) recognises intangible objects as possible pieces of property for as long as they are related to tangible property⁸³⁸. Company secrets, therefore, can be considered acceptable as recognised pieces of company property, if they can be attributed to some material objects, such as company products. Examples may include product manufacturing (process know-how, design pattern, or product formula), sales of goods (market information), or product delivery (logistics plans). Since the CL 1965 fails to define the term ‘company secrets,’ and the *Shariah* does not contain any specific provisions that may pinpoint the definition, it remains up to the courts to interpret the term. However, by following the major rule prescribed by *Hanbali* school (regarding the link to material objects), there is a possibility that the list of potential objects falling under the scope of the term can be limited to some extent.

The duty of non-disclosure of the company secrets can be traced to the notions of honesty and trust in the *Shariah*, which have been explored above in the section dealing with Articles 69 and 70 of the CL 1965. Obviously, if directors become entrusted with the information that belongs to the company, they are obliged by the *Shariah* to be honest and maintain faithfulness to the company by not disclosing the information to the others. The problems, however, arise where the information in question is harmful to other parties and society. In this case, a clash of the concepts of honesty and trust on the one hand, and the responsibility before other parties and society, becomes apparent. Both duties are clearly implied in the *Shariah*, but following one of them automatically breaches the other. This dilemma, however, seems to exist merely based on the fact that Article 72 does not define the term ‘company secret’, and so allows within its definition a broad range of information and opportunity

⁸³⁷ Beltrametti (n 784).

⁸³⁸ Islam (n 780).

concepts, including those which are good for the company but harmful to other parties involved. Therefore, clarification of the terms provided by Article 72 of the CL 1965 is needed, not only for the purposes of legal consistency, but also to establish harmony with *Shariah* law.

6.4.6 Articles 71 and 73 (para 2): Property Exploitation through Loans

6.4.6.1 Purpose and Codification

In addition to the restrictions that the CL 1965 has imposed on directors in terms of diverting company transactions for personal interest, competing with the company, and disclosing company secrets, there are also the provisions that directly prohibit exploitation of the company property and assets. These provisions are outlined in Article 71 and Article 73 paragraph 2. They cover directors' personal transactions with the company and prohibit certain actions related to the company property.

Article 71 of the CL 1965 provides:

‘A corporation may not grant any cash loan whatsoever to any of its directors; nor may it guarantee any loan contracted by a director with a third party. Banks and other credit companies shall be excepted from this provision, for these may, within the limits of their objectives and under the same terms and conditions as they apply to their transactions with the public, grant loans to or open credits for their directors or guarantee loans contracted by them with third parties.

Any contract concluded in violation of the provisions of this Article shall be considered null and void’.

As seen, this Article prevents directors from taking loans from the company or obtaining guarantees from it in order to receive a loan from other parties. While company property is nowhere mentioned in the provisions of the Article, its relevance is implied indirectly: a director is prohibited from receiving and using property in the form of money and using company property as a form of guarantee for personal loans from third parties. Article 71 is analogous to the provision of Section 175 in English Companies Act 2006, which addresses the exploitation of all forms of property as well as information and opportunities. The primary reason for inclusion of the Article in the CL 1965 seems to be an attempt to prevent the usurping of a position of directorship for personal gain at the expense of the company and, ultimately, its shareholders.

The very first thing which is evident from the phrasing of the Article is the absence of the possibility of ratifying any loan by means of a shareholders' meeting. This differs from the other Articles dealing with directors' duties under the CL 1965, which were discussed above. In the absence of a ratification provision, the rule of the Article is made absolute: it provides no exceptions for non-financial companies in terms of granting loans to company directors. There can be two possible explanations for making the rule under Article 71 absolute. From one perspective, it simply provides additional protection for the stakeholders involved against possible directors' misconduct: by granting personal loans to directors the shareholders might be putting at risk not only the company's assets, but also the company employees and customers, who could eventually feel the adverse financial impacts of directors not repaying the loan. From another perspective, the absolute prohibition of loan granting averts blatant and direct company property exploitation by directors. Since *Shariah* law prohibits *riba* (charging interest)⁸³⁹, company loans are likely to be provided interest-free, thereby allowing directors to use their position to obtain free personal financing by diverting the funds from the company. In either case, the absolute prohibition of loans by the company seems fully justified from both legal and religious perspectives.

In terms of clarity, Article 71 represents perhaps the best worded paragraph related to directors' duties within the CL 1965. The Article is free from ambiguous definitions and leaves little room for interpretation of its meaning. The functional application of the Article is also fully justified: in the absence of other direct regulation of directors' behaviour in relation to various forms of corporate property, the Article's provisions lay out clear guidelines related to the prohibition of corporate property abuse by means of directorship.

Another set of duties prohibiting exploitation of corporate property in Saudi company law is provided in Article 73 paragraph 2 of the CL 1965, which reads:

‘[...] the board of directors may not contract loans for terms exceeding three years, or sell or mortgage the real property or the place of business of the company, or release the debtors of the company from their liabilities, unless so authorised in the bylaws of the company and subject to the terms set forth therein’.

As seen, the provision regulates the actions of the entire board of directors, not its single members. This is logical, considering that the actions described (and prohibited) by the

⁸³⁹ See, for example, the *Qur'an* 2: 275-276.

Article can be potentially ratified only within the overall scope of the board of directors' decisions. This is also a novel approach to treating directors' duties compared to English jurisdiction, whose legal provisions focus on regulating the duties of individual directors. The provisions of Article 73 should be considered in concert with Articles 75 and 76, which define the scope of the board's collective duties and liabilities. Article 75 provides that the company is bound by all the decisions and acts of its directors within the limits of their competence. In the absence of the balancing Article 73, the company would be, therefore, obliged to follow the collective decisions of the board, which could be exploitive to its property. Such acts could be a release of the company debtors from their liability to pay or the sale of company property to, for example, pay for losses or debts incurred as the result of the board's actions. Obviously, the company position and especially the position of the shareholders in this situation would be vulnerable. From this standpoint, Article 73 serves as a safeguard against certain actions of the board that can cause unnecessary burden to the company through directors' exploitation of its property.

At the same time, it can be argued that such a blanket prohibition as Article 73 imposes on directors is somewhat restrictive in respect of raising capital to develop the company. Perhaps, in order to avoid excessive restrictions, paragraph 3 of the Article also provides that the board may perform such acts if authorised by the general meeting or if 'such acts fall by virtue of their nature within the scope of the company's objects'⁸⁴⁰. However, the wording of this sentence is too vague to be interpreted conclusively. It is, for example, very unclear what is within the 'scope of company's objects' or what the 'virtue of their nature' means: it does not clearly establish what acts can be considered as falling within this scope. Granted, this could have been eventually refined within an active case law. However, as discussed in Chapter 1, the court decisions in Saudi jurisprudence are not made available to the public, nor can they serve as precedents for future cases, since the legal system of the country is one of civil law. Unfortunately, in this particular case, the inability of the court decisions to refine the meaning of the statute does more harm, since the provision of the Article fails in terms of clarity and precision.

Another important link with Article 73 is Article 76 of the CL 1965, which secures the collective responsibility of the board of directors for any maladministration. While the term 'maladministration' is nowhere defined in the statute, it is likely that the courts will pay

⁸⁴⁰ CL 1965, Article 73 para 3.

attention to the provisions of Article 73 in deciding which acts of the board can be categorised as giving rise to liability before the company and the shareholders. From this perspective, Article 73 also plays an advisory role to the courts. At the same time, Article 73 cannot be regarded as an all-encompassing guide to potential acts of maladministration. It does not include, for example, such important acts as negligent business dealings, failure to take action, or failure to follow procedures outlined by law. For these reasons, the term ‘maladministration’ needs definition, either in Article 76 or somewhere else in the statute.

Article 73 considers the primary mechanism of exempting the board of the duties by means of authorisation in the company articles (by-laws). This is probably done to avoid the situations where directors, who can be large blockholders of shares themselves or appointees of large shareholders, could easily pass the resolution through the shareholders’ meeting. Nevertheless, paragraph 3 of the Article still leaves ratification by shareholders as a means of exemption from the duties outlined in paragraph 2. This, on the one hand, prevents the board from exempting themselves from the duties implied by the Article. At the same time, in a situation such as the one described above, it can serve as little protection from this. However, in the absence of any other regulating authority except for the board and the general meeting of shareholders, the safeguards provided by Article 73 may be the only possible legal way to ensure the board’s compliance with the rules outlined in paragraph 2.

While Article 71 prohibits loans and loan guarantees to directors in relation to third parties, Article 73 is less restrictive: loans may be granted if they are allowed by the company bylaws, approved by company shareholders, or conducted within the scope of the company objects. This brings the possibility of granting loans to the parties connected to directors. In its current form, Article 73 does not distinguish between other third parties and those third parties that can be connected to a director by means of business, family or friendship. Consequently, a distinction between these groups of potential debtors is not drawn. This is an omission in the statute that needs to be addressed in order to avoid potential property exploitation by directors with the help of such ‘related’ parties. Consequently, appropriate procedures have to be established to provide the company members with the requisite information regarding such transactions. These suggestions are made in the last chapter of the thesis.

6.4.6.2 Duty in *Shariah* Law

Articles 71 and 73 of the CL 1965 both deal with the direct exploitation of company property, although in different forms and on a different scale. We first consider the *Shariah* approach to treating possible company loans to directors (the provision of Article 71 of the CL 1965) and then discuss the exploitation of company property, such as the sale of company property and relieving company debtors from liability (the provisions of Article 73 of the CL 1965).

Loans under the *Shariah* are treated as a form of social service where those who are wealthy reach out to the poor to provide financial assistance. In general, Islamic law allows issue of loans under two conditions: the loan has to be repaid, and the loan should be gratuitous, i.e. free from interest⁸⁴¹. This is best described by the following verse from the *Qur'an*⁸⁴²:

‘And whatever you give for interest to increase within the wealth of people will not increase with Allah. But what you give in *zakat*, desiring the countenance of Allah - those are the multipliers’.

At the same time, the *Shariah* does not encourage asking for loans or any form of financial assistance even in hard times. The Prophet was quoted saying that:

‘The inmates of Paradise are of three types: one who wields authority and is just and fair; one who is truthful and has been endowed with power to do good deeds, and the person who is merciful and kind-hearted towards his relatives and to every pious Muslim, and who does not stretch out of his hand in spite of having a large family to support’⁸⁴³.

From this perspective, a director asking for a loan from his company would not be considered as worthy. Besides, the very purpose of the loan, as identified above, is to provide financial assistance to the needy. A director of a company can be hardly considered as such. At the same time, the issue of loans to directors can also fall under the concept of *gharar* (uncertainty), which is also prohibited in *Shariah* law. The uncertainty in this case would increase for the other parties (stakeholders), who may financially suffer if the director fails to repay the loan.

⁸⁴¹ Interest (*riba*) is strictly prohibited by the Holy Texts. See, for example, the *Qur'an* 2: 275, 2: 276; 2:278, 3: 130.

⁸⁴² The *Qur'an*: 30: 39.

⁸⁴³ Mohammad Hossain, ‘Al-Qard al-Hasan: A Practical Approach’ (2004) <http://www.witness-pioneer.org/vil/Articles/shariah/al_qard_al_hasan_A_Practical_Approach.htm> accessed 20 August 2011.

Protection of property from unjustified use is also a well established practice in the *Shariah*. Although, according to the Holy Scripture, all property is in the possession of Allah, it does not prevent humans from having rights over it⁸⁴⁴. As mentioned above, the Holy Texts' mentioning of property in a commercial context is often cited with reference to partnerships. In this context, the usurping of partnership property and its use for self benefit is strictly prohibited in Islam. As *Hanbali fiqh* established, it is prohibited for a partner to use the property of the partnership for personal purposes or for the benefit of third parties⁸⁴⁵. At the same time, however, partners are allowed, under authorisation, to enter into contracts with their partnerships for their own merit⁸⁴⁶. For example, *Hanbali fiqh* does not prohibit an individual from buying some partnership property on his own account, if such an action is authorised by his partners⁸⁴⁷. Therefore, with respect to the using of company property, the *Shariah* provides more relaxed rules than are codified in the CL 1965. However, the rules of *Shariah* are based on partnerships, where the number of individuals involved in business is much smaller than in publicly owned companies. In partnerships, therefore, it can be much easier to communicate specific business arrangements, including those relating to the partnership property, and to ensure that none of the involved parties is hurt in the process. This logic, however, is much harder to apply to public companies, where protection of every company member would be a rather difficult endeavour. In this sense, putting restrictions on directors' dealings with the company property is justified⁸⁴⁸.

6.5 Chapter Summary

This chapter provided an extensive review of the present situation in Saudi law with regard to a director's fiduciary duties related to company property, including information and opportunities. As noted, all human laws in the Kingdom have to be in compliance with the superior law of the land, which is the *Shariah*. Based on the provisions of the CL 1965, the CGR 2006, and the corresponding ethical principles outlined in the *Shariah*, ideally company

⁸⁴⁴ Islam (n 780). Numerous mentions of property in the *Qur'an* and *Sunnah* refer to it as 'your property.'

⁸⁴⁵ Al Moghni vol 5 18 and 45, cited in Saleh (n 723) 41.

⁸⁴⁶ *ibid.*

⁸⁴⁷ *ibid.*

⁸⁴⁸ This also does not contradict the principles of the *Shariah*, which do not prohibit restrictions on dealings with business properties. In addition, Article 73 para 2 and 3 duly provide mechanisms to authorise property dealings by the board.

directors in Saudi companies would take care of the interests of their company and its stakeholders, be righteous and considerate in managing the company property, and pursue high moral standards to ensure that the best traditional values of Islam are applied in their companies.

Unfortunately, practice shows that not all directors of Saudi corporations behave in the manner described above. According to Grais and Pellegrini⁸⁴⁹, full commitment to the core Islamic values and traditions cannot be taken for granted. Consequently, not all business owners and directors willingly comply with these principles and choose instead to pursue their own interests⁸⁵⁰. This, in turn, results in the gap between what the laws prescribe and actual behaviour in practice. Hirschman noted that such inconsistencies between rational, law-abiding behaviour and behaviour in reality are common to any social, political or economic system⁸⁵¹. Therefore, it is no surprise that breaches of fiduciary duties by directors occur in the Saudi corporate landscape as well. Even with the company codes in place, effective governance of directors' duties in Saudi jurisdiction remains problematic. The problematic areas of the Companies statute identified in this chapter will be addressed again in the final chapter of the thesis, where suggestions for improvements of the statutory code will be provided.

⁸⁴⁹ Wafik Grais and Matteo Pellegrini, 'Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options' (World Bank Policy Research Working Thesis No.4052 2006) 6 <www.kantakji.com/fiqh/Files/Companies/1111.pdf> accessed 20 August 2011.

⁸⁵⁰ Almadani (n 822) 399.

⁸⁵¹ Grais and Pellegrini (n 849) 6.

Chapter Seven: Functional Comparison of the Treatment of Directors' Fiduciary Duties towards Company's Property in England and Saudi Arabia

7.1. Introduction

Up until now, this thesis has discussed different aspects of the treatment of fiduciary duties of company directors toward corporate property in England and Saudi Arabia. Applying the functionalist approach to the research, the study started by reviewing the two legal systems and determined how the systems are similar and how they are different. The socio-cultural environment was considered in this step due to its tremendous impact on the way that the law operates in both countries. The second step involved the introduction of the common problem that the systems in both countries have to address by legal means: directors' exploitation of corporate property. The third step in the research process presented the means that English and Saudi legal systems employ to regulate fiduciary duties of company directors toward corporate property. The fourth step introduced a comparative analysis of the approaches that both systems use to regulate the fiduciary duties of directors towards corporate property and the assessment of their effectiveness. The final step in the analysis is a critical evaluation of the findings and building the proposals for improving the ways to treat the issue in both legal systems.

The purpose of this chapter, therefore, is to outline the major similarities, differences and outcomes of the existing legal treatment of directors' fiduciary duties toward company property in England and Saudi Arabia. Another important task is to elucidate the factors that can help explain the differences between the two systems' approaches and suggest possible improvements to both systems as they can borrow from each other the best practices in this area. Following the structure of the thesis, this chapter starts with the discussion of the legal macro environments pertaining to the topic of the study. The first part of the chapter compares the English and Saudi legal systems in terms of property definition. The second part of the chapter deals specifically with the regulations of directors' fiduciary duties in the context of the law within both countries. Besides analysing the differences in codification of duties and the applicable equity rules, this part will also consider such issues as clarity of the existing regulations, their legal impact, and the degrees of consistency that exists between various sources of law regulating the fiduciary duties of company directors towards property. The final part of the chapter provides major conclusions and recommendations based on the research conducted. These include both academic and practical suggestions.

7.2 Definition of Property

The comparative analysis of the ways that the English and Saudi legal systems regulate the fiduciary duties of company directors toward property should rightfully start with the comparison of how property itself is understood in each legal system. In terms of the context within which the concept of property has been evolving, significant differences can be noted between England and Saudi Arabia. In England, the concept of property has developed from the foundations of land ownership and created an entire system of property rights defined within secular law. Private property is a cornerstone of the capitalist market that has developed in England over the course of history, and it is one of the major legal rights protected by law. Company property can be considered as something that can be bought, sold and legally protected from unpermitted usage by other parties.

The concept of property (*mal*) in Saudi Arabia is somewhat different. The primary difference lies in the perceived nature of property ownership. The *Shariah* attributes all property to Allah. However, it does not forbid human beings from ownership thereof: the possession of property is simply considered within a different context to that in the English jurisdiction. Islamic law allows private property on the basis of trust between men and God, which implies taking care of the property and using it in a righteous way. This is, perhaps, the most striking difference in the treatment of property between the English and Saudi legal systems: in England, private property cannot be confiscated for what may be ‘improper use’ that is harmful to the public. Saudi jurists, however, justify this rule on the basis that, ultimately, human beings are not the owners of property: it belongs to God. Therefore, all actions involving private property have to be tested on the basis of the *Shariah* rules and serve to fulfil, among other things, ethical obligations to society⁸⁵².

In terms of applicable types of property, both countries recognise tangible (real assets) and intangible (intellectual capital) forms. Intangible forms of property are nowhere mentioned in the *Qur’an* and *Sunnah*; therefore, their acceptance in Saudi legislation comes primarily from secondary sources, the *ijma* and *qiyas*, which accept intangible forms of property for as long as they are connected to the real property of the company. Consequently, the company law in the Kingdom secures the protection of company intellectual capital in the form of formation

⁸⁵² See Ahmad (n 699) 195; also see Arif (n 790) 86.

costs, trademarks, copyrights, industrial samples and designs, franchises and licences⁸⁵³. Difficulties, however, arise in both countries when the question of misusing corporate opportunity and information emerges. The heart of the problem here lies in the much more subtle nature of opportunities and information, which are not so evident from a legal perspective as being suitable for protection as a piece of property.

It can be argued that both England and Saudi Arabia recognise information as something that should be protected from exploitation. This is provided by Section 175(2) of the CA 2006 in England and Article 72 of the CL 1965 in Saudi Arabia. In England, Section 175(2) of the CA 2006 distinguishes information and opportunities from property for the purposes of the fiduciary obligations of directors. In many respects, this echoes the court decision in *Boardman v Phipps*⁸⁵⁴, where the majority of the judges held that information and opportunities are not to be considered as company property. Importantly, however, English jurisdiction has been treating information and opportunities *as if* they were company property. This treatment provides no absolute rights of property to information and opportunities, but reflects the nature of the relationship thereof to directors and the company. This notion has been developing in English company law within the corporate opportunities doctrine, which emerged in North American legal systems, specifically from the famous decision in *Canadian Aero v. O'Malley* in the Canadian Supreme Court⁸⁵⁵. Based on the corporate opportunity framework, a number of notable case decisions treated corporate information and opportunities as if they were property⁸⁵⁶. A notable exception was the decision in *Bhullar v Bhullar*⁸⁵⁷, where the court explicitly rejected the idea that an opportunity might 'belong' to a company or that a company may have a beneficial interest in it. However, as was noted in chapter 5, the ruling in *Bhullar* was based on the possible misinterpretation of opportunity in the purely proprietary context. The issue of treating information and opportunities *as* or *as if* company property has been particularly acute in the court decisions dealing with former directors in England.

⁸⁵³ Capital Market Authority (n 786).

⁸⁵⁴ [1967] 2 AC 46

⁸⁵⁵ [1974] SCR 592.

⁸⁵⁶ See *Island Export Finance Ltd. v Umunna* [1986] BCLC 460, *CMS Dolphin v Simonet* (n 500), and *Foster v Bryant* [2007] (n 596).

⁸⁵⁷ [2003] BCC 711, at 720.

Company law in Saudi Arabia recognises the concept of information, although it does not provide any mentioning of opportunities as subject to protection from exploitation by company directors. The term ‘company secrets’ is unlikely to include corporate opportunities, because many such opportunities cannot be regarded as secret. Moreover, *Hanbali fiqh* in Saudi Arabia is unlikely to recognise opportunities as *mal* because they cannot be directly attached to tangible corporate assets. Neither information nor opportunities are included in the list of what can be considered intangible property of a company, as provided by the Capital Market Authority⁸⁵⁸. In the absence of available relevant case law, it is hard to say whether information is treated in Saudi Arabia as if it were property in a similar manner to the English courts. However, the fact that secret information is covered by one of the Articles of the CL 1965 and granted protection by it seems to confirm the idea that Saudi company law may treat information as property in the same manner as tangible assets on the basis of the prohibited exploitation thereof.

Another important point that emerges from the comparative analysis of the two legal systems is that the application of legal rules of property to information and opportunities remains an open issue, although for different reasons. English company law, being in a constant process of amendments and improvements to the existing rules to better adapt them to new economic and social realities, has been testing the applicability of the corporate opportunity doctrine in the country’s legal context. As the analysis showed, the doctrine has been accepted by the courts with mixed results. In Saudi Arabia, on the other hand, it is the lack of active case law that does not allow information and opportunities to be defined clearly in the context of company law, since the applicable provisions of the statutes are vague in this regard.

7.3 Statutory Recognition of Directorship Forms

7.3.1 The Legal Concept of Company Director

Recognition of the legal definition of directorship and identifying the differences in the approaches to it legally and in practice is a major step in determining what kind of duties the directors owe and how they are applied in different countries. Therefore, it becomes essential to compare the types of directors, and their powers and roles in corporate governance in England and Saudi Arabia in order to effectively realize what duties they owe (if any) to the company and how those duties are applied in practice.

⁸⁵⁸ Capital Market Authority (n 786)

In terms of the legal definition of ‘director,’ legislation in both countries is rather vague. Somewhat surprisingly, the primary legislation in both England and Saudi Arabia leaves too many unclear areas in relation to this. Neither legislation defines directors’ rights and obligations, or distinguishes between different types of directors. This fact has led to the identification of directors’ rights and obligations within the company’s by-laws, which are guided by soft law introduced in both countries, and which clarifies certain points related to directorship, types of directors, and their roles. As in any common law country, the English courts have played a significant role in interpreting ambiguities in legislation and clarifying certain points omitted by it, while in Saudi Arabia strict government control and corporate self-regulation have been common.

Despite the different origins of the two countries’ legal systems, both England and Saudi Arabia have adopted a single-tiered board structure. This fact points to the legislative focus on shareholders, rather than stakeholders. Although such an approach is, arguably, not common for a civil law country, as Saudi Arabia is, it was demonstrated that large blockholders (the government and the rich families) play too significant a role in business and have too much influence over the process of corporate governance to allow other groups to interfere with their interests. In terms of board composition, both countries have applied the ‘one size does not fit all’ approach, allowing companies the flexibility to determine the right size of the board for themselves. As such, only the minimum number of board members is established by law, while no upper cap is present⁸⁵⁹.

Perhaps the major difference between the two countries in terms of their approach to directorship is in the legal separation of the different types of directors. While neither country has legislation explicitly defining legal types of directors, business realities have led to their establishing such definitions, although to a differing extent. In England, the CA 2006 recognises de jure and shadow directors, while non-executive directors are recognised in the CGR 2010. The courts, and to some extent the legislation⁸⁶⁰, have identified these types in order to apply different forms of responsibilities and liabilities to individuals who are appointed directors or act as such. However, while the courts have had seemingly no problems in applying full scale liabilities and duties for de jure (legally appointed) directors

⁸⁵⁹ Although it should be noted that both countries have soft laws recommending certain limits to the number of directors. These are not mandatory, however.

⁸⁶⁰ The CA 2006 does recognise the term ‘shadow director.’

and their varieties⁸⁶¹, the situation is more complicated with the shadow directors. While the CA 2006 states that shadow directors owe the same duties and responsibilities as the general directors, the courts have not been convinced of this. The only duty owed by shadow directors that seems widely accepted by English courts today is the duty of care and skill. Therefore, in terms of shadow directorship, there is no agreement in English law either on the application of the term, or on the duties that it assumes.

The situation with regard to the legal definition of directorship is, at least theoretically, easier in Saudi Arabia. Unlike in England, Saudi law does not distinguish between different types of directors. The non-binding CGR 2006 in the Kingdom recognise non-executive directors and apply good corporate practices to them. However, all binding statutory provisions and laws in the country assume only one type of directorship, a general one. While that type is not defined as being *de jure* or shadow, it is logical to think of it as the first one. This assumption is based on the fact that the appointment of directors in the Kingdom is a more linear process than in the England, largely due to the former's dominant shareholding patterns. Blockholders have no need for engaging in other types of governance rather than the direct one simply because they have such power of appointing the directors as they deem appropriate. At the same time, the appointed *de jure* directors are almost fully controlled by their appointors, who, however, are not recognised as directors anywhere in Saudi law. Finally, the definition of a director to whom the duties apply in Saudi law is very narrow, since it only includes individuals who are members of the board of directors. As argued in Chapter 4, the absence of controlling mechanisms for outside influences on the board may be detrimental to the issue of property exploitation. Therefore, suggested amendments to the CL 1965 provided in Appendix B include specific provisions recognising shadow directors as having the same duties as their *de jure* counterparts.

As for non-executive directors, both legal systems recognise the importance of having them on companies' boards, although in both cases, this recognition only goes as far as recommendations within the corporate governance regulations, which are not binding. The legislation of both countries also recognises the importance of the independence of NEDs and identifies their primary functions as monitoring and advising the executive directors. In practice, however, these goals are hardly met in either England or Saudi Arabia, although for different reasons. In England, the NEDs' involvement in corporate affairs is typically low due

⁸⁶¹ The nominees and alternative directors.

to lack of incentives and time, the selection process (potentially ‘non-active’ members are preferred), and the control exerted by the executives. Less influential, but still important, is ‘insider’ non-executive directorship based on business connections and relationships. In Saudi Arabia, the NEDs’ involvement is theoretically higher; however, their independence is questioned. This stems from the fact that NEDs are commonly appointed by large shareholders and therefore serve their interests. Further, corporate boards in the Kingdom tend to include representatives of the same families, appointees by the government, or cross-directors from friendly businesses. As a result, the effectiveness of NEDs in both countries is doubtful: their involvement in companies’ affairs is such that their main purposes do not surface. Therefore, the very idea of introducing more NEDs onto corporate boards becomes questionable.

Until recently, English law equated NEDs to executives in terms of their duties and responsibilities. However, as in the case of shadow directors, there has been a shift toward limiting these, as demonstrated in recent cases. The primary responsibility of NEDs in Saudi Arabia, by law, is to act in favour of the shareholders, who are, in most cases, their appointors. Therefore, even though the law assumes full responsibility for NEDs, it is highly unlikely that their acts can deviate from the direct orders of their appointors and disagree with the executives. Therefore, in both countries, there is a clear tendency towards the limited effect and limited liability of NEDs on the corporate board.

7.3.2 Legal Position of a Company Director

The discussion on the approaches to directorship definitions and types within the legal systems of England and Saudi Arabia has shown some important similarities and differences between the two. However, in order to complete the discussion on the role of directors, it is important to identify the legal position of a company director as seen in both jurisdictions. Depending on the definition (agent or trustee), it will be easier to determine what duties directors owe and to whom.

In England, the nature of the director’s office evolved historically, and today directors are widely considered as agents of a company. However, they are more than that, because, as practice shows, directors are not strictly controlled by shareholders, especially in large public companies. Further, directors in England possess certain features of trustees, taking into account the fiduciary duties laid upon them, which are very close to the constructive trust

relationship with beneficiaries. On the other hand, English directors are not trustees in the full sense, because they are not entitled to the company property and are certainly more able to take risks than regular trustees can. Overall, the dual nature of English directors can be summarized by the expression ‘fiduciary agents’.

The dual nature of the directorship office is also evident in Saudi Arabia. On the one hand, the company laws adopted in the Kingdom, coupled with the strong control of shareholders over the board, suggest a principal-agent type of relationship. However, the nature of the Saudi director office is such that it has to not only follow the rules outlined by the company laws, but also make sure that the director’s conduct is in line with the *Shariah* laws, which are considered supreme in Saudi Arabia. In this sense, obligations imposed on Saudi directors by the *Qur’an* suggest a form of relationship which is closer to the beneficiary-trustee relationship. Nevertheless, the current statutory legislation in the Kingdom only applies to those individuals who directly govern the company. The statutory law has excluded outside parties who can influence companies (like shadow directors) from owing the same fiduciary duties as the company directors themselves. This seems like a serious omission in the law, considering the potentially harmful effect of not holding influential outside parties responsible in the same manner as de jure directors. Again, for these reasons, recommended amendments presented in Appendix B address this issue.

7.4 To Whom Are the Duties Owed?

As discussed, English and Saudi company laws are the products of different legal systems: common law and Islamic law (with the elements of civil law). Therefore, it could seem that these systems would establish very different rules regarding those to whom company directors owe their duties. The analysis of the two legal systems, however, has revealed that the expected differences are largely theoretical, while in practice, English and Saudi company laws have much in common⁸⁶².

The English Companies Act 2006 makes it clear that directors owe duties to their company⁸⁶³. Almost the same formulation is found in Saudi company law, where Article 28 of the LRs issued by the CMA obliges company directors to exercise their duties for the

⁸⁶² Arguably, this practical resemblance is yet another factor that makes the systems comparable from the point of view of a functional law analysis.

⁸⁶³ CA 2006, s 170(1).

benefit of the company. Therefore, statutes in both countries establish the company as the major claimant with regards to directors' duties. Further, in both jurisdictions companies are treated as separate legal entities which may have interests other than those of the shareholders⁸⁶⁴. What about the other parties? Theoretically, company directors would owe the duty of care to society as a whole under the *Shariah*, while in England the concept of the socially responsible corporation, which has emerged recently, would imply at least consideration of the interests of the other parties besides the company. Again, seemingly different jurisdictions of England and Saudi Arabia provide nearly identical responses to this question.

Both English and Saudi company law codes formally recognise the importance of considering the interests of parties other than the company. The CA 2006 in Section 172(1) obliges directors to promote the success of their companies in a manner that has regard for employees, customers, suppliers, the community and the environment. As such, the CA 2006 attempted to introduce a wider context of social responsibility into the framework of directors' decisions and acts. Still, the extent and efficacy of Section 172(1) are questionable because none of these parties is capable of suing directors for specific breaches of duty. It can be argued that Saudi company law attributes more power to the relevant groups of stakeholders, especially in view of Article 76 of the CL 1965, which imposes liability on the board of directors for acts of 'maladministration' toward 'third parties'. However, in the absence of clear definitions of either term, it is very unclear who the receivers of the fiduciary duties might be, and what specific acts are equated to the board's wrongdoing towards them⁸⁶⁵. Consequently, Saudi company law does not grant the assumed 'third parties'⁸⁶⁶ the right to sue the directors nor does it establish the procedures for filing any claims resulting from the directors' 'maladministration'. Drawing the parallels to English company law, the provision of Article 76 of the CL 1965 is similar to the 'misfeasance' covered by Section 212

⁸⁶⁴ As was noted in Chapter 6, there is no agreement among Islamic scholars as to whether the concept of corporate personality is *Shariah* compliant. Nevertheless, the Saudi government included this concept, along with limited liability, into the context of modern company law in the Kingdom. Limited partnerships, companies limited by stock companies, and joint stock companies, according to Article 2 of the CL 1965, enjoy the statuses of both corporate personality and limited liability.

⁸⁶⁵ As was noted, the CGR 2006 in Article 2(b) mentions the term stakeholders, whose rights have to be protected within the corporate governance framework. The term includes 'any person who has an interest in the company, such as shareholders, employees, creditors, customers, suppliers, community.' However, since the same authority issued the CL 1965 and the CGR 2006, it is unclear why two separate concepts would be used to define the same subjects. In addition, the CGR 2006 has a recommendatory, non-binding character.

⁸⁶⁶ The exception is company shareholders. See discussion below.

of the Insolvency Act 1986 in England. In England, however, the definition of the term and its applicability is determined based on the precedents in case law, which is not a common practice in Saudi Arabia. Consequently, on the basis of the existing government-issued laws the only clear case when directors will owe the same duties to stakeholders seem to be when failure to consider them also affects the company.

None of the other sources of Saudi company law provides an explanation of these concepts either, which leaves it up to the courts to define them. However, given the wide range of possible legal interpretations of the Articles based on these terms, it is recommended that they should be clarified in statutory law. This would ensure consistency of legal applications and decrease the amount of speculation regarding the nature of duties outlined in the corresponding Articles of the CL 1965. The definitions of the terms can be provided either within the corresponding Articles themselves or in a separate Article that can outline the terms and link them either to the Articles related to fiduciary duties only or to the entire code, since these terms can be used in other Articles as well. Appendix B provides a set of recommended definitions.

In terms of liability claims, both English and Saudi jurisdictions seem to grant more powers to shareholders than to other stakeholders. The statutory codes in both countries have provisions that allow shareholders to bring claims against the directors either as a group or individually⁸⁶⁷. The English Act is, however, more precise and comprehensive in this regard: it outlines specific misdeeds (negligence, default, breach of duty, and breach of trust) that may trigger the filing of the claim and the procedures for doing so. Article 78 of the CL 1965, on the other hand, remains unclear regarding this matter by mentioning the misdeeds in general terms ('wrongful acts') and providing no clear guidelines as to how the claim should proceed. However, detailed or not, derivative claims by shareholders, as outlined in both jurisdictions, have not seen much success recently. This is proved by the fact that English case law has still seen a dearth of derivative claims even after the passage of the CA 2006⁸⁶⁸, while in Saudi Arabia, the only provision dealing with recitative claims is unclear and

⁸⁶⁷ CA 2006, ss 261-264; CL 1965, article 78.

⁸⁶⁸ Yates and Hinchliffe (n 491) 332; Loughrey, Keay and Cerioni (n 719) 111.

confusing, which makes it extremely hard for such claims to succeed, especially when brought by minority shareholders⁸⁶⁹.

Following the discussion above, it is logical to conclude that English and Saudi company laws and regulations put the emphasis on the company (and to some degree the shareholders) as the main entities to which directors owe their duties. The legal systems are also similar in that they allow shareholders to file derivative claims against the directors, although the effectiveness of this remains questionable. In relation to other stakeholders (such as employees, customers, suppliers, the environment, and society as a whole), statutory laws mostly assign the responsibility of ‘having regard’ for their interests, while no duties are imposed that could be similar to those owed to the company.

7.5 Conflicts of Interest

The duty to avoid conflicts of interest is directly recognised and dealt with in both English and Saudi jurisdictions, although the degree of depth of the law and the comprehensiveness of the applicable legal rules is quite different. In English law, the duty to avoid conflicts of interest is codified in Section 175 of the CA 2006, which includes a number of provisions clarifying the scope of the duty, exceptions to the duty, and the procedures for obtaining exceptions where appropriate. The section is largely a product of the long history of related case law, which has been dealing with the issue of conflicts of interest for quite a long time. Saudi company law, however, provides a very limited overview of the conflicts of interest issue by confining the entire complex issue to only two lines of text within Article 69 of the CL 1965. The comparative analysis of how English and Saudi company law treat the conflicts of interest issue is provided below by reviewing the underlying rationale for the duty in law, the wording of the duty in the statutes, the scope of the duty, and the exceptions provided in each jurisdiction.

7.5.1 Rationale and Wording

The need for regulating conflicts of interest in both England and Saudi Arabia has been determined historically, although based on different rationales. In England, the rationale for avoiding a conflict of interests has evolved from the concept of the constructive trust, where

⁸⁶⁹ Even though the Article allows derivative complaints, it restricts them to being made prior to the completion of the conduct that is impugned; otherwise the right to complain is denied. It could be claimed that the purpose of this provision is to keep power and control over the company’s affairs in the hands of the majority shareholders.

profiting from the position of trust was established as illegal in *Keech v Sandford*⁸⁷⁰, which formed the basis for future conflicts of interest cases. The modern understanding of the need to manage the conflicts of interest in company law is to prevent situations where directors might exploit opportunities for personal benefit⁸⁷¹. Parker LJ in *Murad v Al-Saraj*⁸⁷² noted that one of the reasons for enforcing the policy of avoiding a conflict of interest is ‘the perceived difficulty in determining what might have happened but for the fact that the fiduciary had placed himself in a position of conflict.’ This view is also shared in scholarly work on English law⁸⁷³. While a corporate form of ownership did not exist in the traditional forms of business treated within the *Shariah*, the links to the modern treatment of the issue of conflicts of interest can be found in Islamic law. Any property, money or opportunity gained by usurping the position of power is prohibited by secondary *Shariah* sources through the notions of *ghabn* and *gharar*⁸⁷⁴. Therefore, as mentioned earlier, a director attempting to advance his personal interests at the expense of the company will be considered as a cheat and a dishonest man, with all the applicable consequences, which are the expropriation of any profits and properties, and their consequent transfer to the company. Therefore, despite the distinctively different traditional legal systems of England and Saudi Arabia, both countries established their own rationales for legal treatment of the duty to avoid conflicts of interest.

The contemporary legal systems in England and Saudi Arabia have codified the duty of avoiding such conflicts of interest in their major company law statutes. Interestingly, while the provisions of both Section 175 of the CA 2006 and Article 69 of the CL 1965 prohibit conflicts of interest, neither statute actually defines what an ‘interest’ may entail⁸⁷⁵. This, in the opinion of the researcher, is a serious omission in both cases, although the consequences of such omission are, arguably, different.

⁸⁷⁰ [1726] EWHC Ch J76.

⁸⁷¹ See, for example, *Kingsley Consulting Ltd v McIntosh* [2006] EWHC 1288 (Ch); [2006] BCC 875 at 55.

⁸⁷² [2005] EWCA Civ 959, at 107.

⁸⁷³ See, for example, Davies (n 435) 392-394: the courts would face difficulties in assessing a transaction’s fairness if a director claimed that the same transaction would take place in a situation where there was no conflict.

⁸⁷⁴ Almadani (n 822) 398.

⁸⁷⁵ No explanations are provided in the explanatory notes to the statutes or any other statutory code used in the company law of either country.

In England, the absence of a definition of ‘interest’ creates issues regarding the breadth of the rule’s application. Specifically, it leads to difficulties with the interpretation of the rule regarding the corporate opportunities which can be used by directors. Earlier case law traditions took quite a wide view of such opportunities, considering anything of possible interest to the company as a ‘corporate opportunity’ (even where impossible to pursue, in practice or legally), while more recent case decisions seem to have followed a narrower view. The introduction of section 175(4)(a) into the CA 2006, too, seems to serve the purpose of relaxing the strict application of the conflicts of interest rule. Still, the section is not sufficiently well defined to clarify the extent of the exceptional situations in which the conflict of interest would not arise. From this standpoint, the lack of clarification in the CA 2006 is likely to prolong the legal debates regarding the scope of the conflicts of interest rule. It could be easier for the courts if the statutory code made it clearer.

In Saudi Arabia, the issue of conflicts of interest within the context of modern corporations is a relatively new legal area. The introduction of the CL 1965 was, in fact, the first attempt to govern many areas of company law which have not been clearly defined within the traditional concepts of the *Shariah*. As such, the main issue with the absence of definition of ‘interest’ is not so much related to the necessity of clarifying the breadth of the rule’s application, but, with the absence of explanation, what exactly may fall under the provision of Article 69. The Article even distinguishes between direct and indirect interests, but it never makes clear how each of them is defined. Based on this, it becomes difficult, if not impossible⁸⁷⁶, for the courts to consider all aspects within which the rule of the conflicts of interest would apply.

7.5.2 Scope and Application

The scope of the rule provided by the statutes of English and Saudi company laws vary significantly. In England, the application of the rule is quite broad, which follows from statutory provisions of the CA 2006. The English statute provides that avoiding the conflicts of interest involves exploitation of the company’s property, information or opportunities even if the company could not take advantage of them⁸⁷⁷. Exploitation is mentioned as a specific way of applying the rule, and it is implied that the term exploitation extends to any use of

⁸⁷⁶ Since the previous court decisions are not binding in Saudi Arabia, the scope of the term ‘interest’ as defined within particular court decisions cannot be readily applied in subsequent case law.

⁸⁷⁷ CA 2006, s 175(2).

property, not simply its abuse⁸⁷⁸. The broad application of the rule is further enforced by the fact that ‘it is immaterial whether the company could take advantage of the property, information or opportunity.’ Finally, the duty to avoid conflicts of interest relates not only to current, but also to former directors⁸⁷⁹.

Article 69 of the CL 1965 is the only provision that deals with the conflicts of interest in Saudi company law. It provides that the rule applies specifically to transactions or contracts on behalf of the company. As such, the scope of the rule is limited by the statute to interests in the transactions of the company. This, however, leaves out many potential situations of the conflicts of interest rule that have to be considered. Following the discussion on the scope of the duty in English law, Saudi company statute fails to address such important issues as exploitation, in relation to what leads to triggering the rule or whether former directors are subject to it. Nor does the scope of the rule in Saudi statutory law consider whether information and opportunity can be pursued by the company. However, as was previously discussed, opportunities are not given the same protection in Saudi law as property, and protection of information is mentioned in another Article of the CL 1965⁸⁸⁰. Still, the scope of Article 69 is very obscure. In addition to the issues mentioned above, the Article does not mention the nature of the transactions covered and whether potential conflicts of interest are included in the provision.

In terms of the application of the rule, English law has been somewhat divisive, as two approaches in the case law have emerged: no-profit and no-conflict rules. Under the no-profit rule, company directors are not allowed to make a profit while serving in their positions, and it becomes irrelevant whether directors might have acted in good faith and whether the company profited from their actions⁸⁸¹. Under the no-conflict rule, however, a broader view on the conflict of interest is provided: if a director made a profit, the court would consider whether a conflict of interest with the company took place⁸⁸². Case authority exists in favour

⁸⁷⁸ CA 2006, s 175 (2).

⁸⁷⁹ CA 2006, s 170(2) (a).

⁸⁸⁰ CL 1965, article 72.

⁸⁸¹ The approach was applied in *Regal (Hastings) Ltd v Gulliver* (n 432).

⁸⁸² The approach was applied in *Boardmann v Phipps* (n 457).

of both the no-profit approach as a separate rule⁸⁸³ and within the broader no-conflict rule⁸⁸⁴. As demonstrated in Chapter 5, the CA 2006 did not manage to completely resolve the matter, although it can be argued that Section 175(4)(a) has been a step towards accepting the no-conflict rule in English company law. Within this approach, the application of the duty to avoid conflicts of interest is more flexible: it does not dismiss the possibility of earning profit per se; rather, each case is considered on a factual basis that determines whether an actual conflict of interest with the company was present.

Unlike England, the application of the duty to avoid a conflict of interest is not certain in Saudi company law. In the absence of public access to case law, it is impossible to determine how Saudi courts treat ambiguities and blank spaces left by Article 69 of the CL 1965. Article 69 leaves a wide lacuna in a number of related corporate governance aspects. For example, the Article (and the entire CL 1965 for this matter) does not provide whether engaging in a transaction for the benefit of the company members and managers can be considered a breach of the duty to avoid a conflict of interest. Nothing is said regarding the transactions or agreements that directors may enter into with the company itself, for the benefit of both parties⁸⁸⁵. Finally, neither the Article nor the other provisions of the CL 1965 explain whether the conflicts of interest duty is extended to the directors who resign from their position and to what extent this duty could be applied. The fact is that the courts' decisions in Saudi Arabia do not contribute to the further development of company law as a whole and to refining the application of Article 69 specifically. Therefore, clarification of the law in this regard can be done by extending the provisions of Article 69 and eliminating any ambiguities that the Article has in its current form.

An important aspect of the duty to avoid conflicts of interest is the situation of directors competing with their companies. Both the English and Saudi legal systems have created statutory arrangements that regulate these matters. In England, the corresponding provision is found in Section 175(7), which prohibits the conflict of duties between directors and their companies. This indicates that the issue is considered within the conflicts of interest framework. Saudi Companies Law 1965 attributes a separate section to govern the conflict of

⁸⁸³ *Ultraframe (UK) Ltd v Fielding* (n 400); *In Plus Group Ltd. v Pyke* (n 535); *Wilkinson v West Coast Capital* (n 535); *Don King Productions Inc v Warren* (n 535).

⁸⁸⁴ *Boardman v Phipps* (n 457); *Item Software v Fassihi* (n 412).

⁸⁸⁵ This is an exception to the conflicts of interest rule in England. See CA 2006, s 175(3).

duties: Article 70 prohibits company directors from participating in competitive businesses and/or engaging in any of the commercial activities carried on by their companies.

From the formulations of the statutory provisions that regulate competing with the company, it is obvious that Saudi law takes a much stricter stance on the issue. It establishes clear barriers to competing, from two standpoints: personal competition (participating in the same commercial activities as the company) and involved competition (being part of a competing business). English law, on the other hand, treats competing with the company in the same manner as the conflict of interest, which means that it provides the same exceptions to the rule. As a matter of fact, up until the CA 2006, there were no statutory provisions in English law regulating directors' competition with their companies. For quite a long time, the only authority in this regard was over a century old, in *Mashonaland Exploration Co v New Mashonaland Exploration Co*,⁸⁸⁶ where the court held that a director cannot be generally restrained from competition with his company⁸⁸⁷. Only recently, in *Plus Group Ltd. v Pyke*,⁸⁸⁸ did the court cast doubt on the applicability of *Mashonaland* to modern economic realities, although it did not go on to amend the rule.

The issue of competing directors has indeed been a very hard one for the English legal system to handle. Granted, significant hurdles established by the statutory law have made it difficult for directors to serve on boards of competing companies. The major point of concern for the courts, however, has been the case when directors planned to compete with the company after resignation. In this regard, the courts have generally considered such aspects as preparatory steps⁸⁸⁹, the circumstances leading to resignation⁸⁹⁰, and the time passed before engaging in

⁸⁸⁶ [1891] WN 165

⁸⁸⁷ With some restrictions, the rule was later upheld in *Bell v Lever Bros* [1932] AC 161. The restrictions imposed by the decision included the absence of concern in the contracts of the original company and not using property or information belonging to the original company. For the complete analysis, see Lord Blainsburgh's opinion. Later cases followed suit by establishing that being engaged in a competitive company is not a breach of fiduciary duty. See, for example, *Hivac Ltd v Park Royal Scientific Instruments Ltd* [1946] Ch. 169, CA; also see connection to executive director per Lord Denning in *Scottish Co-op Wholesale Society Ltd v Meyer* [1959] AC 324, HL.

⁸⁸⁸ [2002] 2 BCLC 201.

⁸⁸⁹ Planning by itself is not considered a breach of duty in English case law: see *Island Export Finance Ltd. v Umunna* (n 856); *CMS Dolphin v Simonet* (n 500); *IDC v Cooley* (n 506). However, actual preparatory steps while being a director constitute a breach: *Coleman Taymar Ltd v Oakes* (n 604); *British Midland Tool Ltd v Midland International Tooling Ltd* (n 605).

⁸⁹⁰ In *Plus Group Ltd v Pyke* (n 535); *Foster v Bryant* (n 596). Informing the board of the intention to pursue an opportunity was linked to the duty of loyalty in *O'Donnell v Shanahan* (n 507).

competing activities⁸⁹¹. All these factors lead to the conclusion that the English legal system still has issues in regulating competing directorships.

In this regard, the clear and unambiguous provision of Article 70 of the CL 1965 may seem superior to the uncertainty of English company law. However, Article 70 leaves many blank spaces and much room for interpretation of its provisions as well. For example, it does not make a distinction between present and past directorships. In fact, the issue of directors who have resigned is nowhere addressed in the CL 1965 at all. Therefore, issues such as resigning with the intention to usurp corporate opportunities, engaging in preparatory activities with the goal of resigning and taking the opportunity, and not acting in good faith if the possibility of diverting a very profitable transaction may come, remain open. Secondly, the degree of competition between the companies for possible directorship is not clarified. This is, however, a serious issue in Saudi Arabia, where multiple directorships are quite common in the Saudi business landscape as large cross-holdings in companies are not rare⁸⁹². Finally, the code goes further than the established *Shariah* rules, which only condemn competitive activity if it harms the company⁸⁹³. In this regard, the *Shariah* rules seem closer to the position taken by the English legislature, where competition is allowed in specific circumstances⁸⁹⁴.

There is a rule in both legal systems that provides an exemption from the conflict of duties. In both legal systems, authorisation is required. However, the types of authorisation are different: English law considers it sufficient for the board of directors to exempt one of the directors from the conflict of duties liability, while Saudi company law only allows authorisation by the general meeting of shareholders. Whether one of these approaches is superior to another is hard to judge. On the one hand, allowing the board to grant protection from liability allows the tedious process of shareholder's approval to be avoided; on the other hand, shareholders' approval provides a higher degree of protection. It can be said, however, that the chosen approaches of both jurisdictions fit the legal realities of both countries. The board's approval seems suitable for England, where dispersed shareholding and consequent

⁸⁹¹ *Southern Real Estate Pty Ltd v Dellow and Arnold* [2003] SASC 318; [2003] 87 SASR 1. Discussion on the passing of 'reasonable time,' although there was no indication of what this may consist.

⁸⁹² See Section 4.3.2. of this thesis.

⁸⁹³ Saleh (n 723) 97.

⁸⁹⁴ See Section 5.3.2.2.2. of this thesis.

low involvement of shareholders may create the rather tedious process of granting an approval. At the same time, for the strict purposes of law that are strongly implied in Article 70 of the CL 1965, to relax the rule by allowing the board of directors to approve competition by one of the directors would be illogical.

Another difference between the two legal systems with regard to authorisation is the presence of guidelines for the authorisation process. The English CA 2006 outlines the procedure in Sections 175(5) and 175(6), while the Saudi CL 1965 remains silent in this regard. As a matter of fact, shareholders' approval is nowhere clarified in Saudi statutory law. Therefore, it remains unclear whether the authorisation is provided by a simple majority and whether a specific number of participant shareholders is required for the authorisation. However, despite the guidelines provided for the process of authorisation by the board, the CA 2006 is not without its flaws. Two main issues in this regard are: the absence of a definition of an 'interested director', who, along with the director in question, should be excluded from voting; and allowing the related director (and 'interested directors') to participate in the discussion of the meeting prior to voting on the matter.

Finally, and this is extremely important, English law makes the rule applicable to both public and private companies. It even establishes different approaches to the process of granting directors permission to avoid a conflict of duties. In contrast, Saudi CL 1965 applies, in general, to joint stock companies only. In other words, any of the provisions of the statute, including Article 70, do not cover governance issues related to private companies. The absence of statutory regulations for private companies is, however, a serious detrimental feature in the overall legal fabric of Saudi company law. While the discussion on this matter is beyond the scope of this study, it is, nevertheless, strongly suggested that statutory provisions to regulate corporate governance in private companies are developed in Saudi Arabia.

7.5.3 Exceptions

English and Saudi company statutes contain a number of provisions that may deem the duty to avoid conflicts of interest not infringed. Here, again, the legal systems significantly diverge from each other. The exceptions to the rule provided by the CA 2006 in England include: transactions or arrangements with the company; situations which cannot reasonably be regarded as likely to give rise to a conflict of interest; and when an authorisation is obtained

from the board of directors⁸⁹⁵. Article 70 of the CL 1965, in turn, provides two forms of protection: authorisation by shareholders and public bidding. The issues related to the authorisation process have been reviewed above on the basis of competing directorships. Therefore, the discussion proceeds by focusing on the remaining types of protection.

Section 175(4)(a) of the CA 2006 provides that the duty to avoid a conflict of interest in English law is not infringed if ‘the situation cannot reasonably be regarded as likely to give rise to a conflict of interest.’ The introduction of this section in the statute was possibly aimed to relax the traditional strict approach in regulating conflicts of interest in England. However, the extent to which this rule could and would be accepted by the courts remains questionable. The provision itself does not contain any specific terms, which makes it widely interpretable. Chapter 5 considered possible applications of the rule based on a company’s rejection of opportunity and the ‘line of business’ test. Neither of these, however, was well received by English courts in the pre-Act era⁸⁹⁶. Therefore, despite the intention of the English legislator to relax the traditional strict approach of the courts in relation to the conflicts of interest rule, it yet remains to be seen whether it will succeed.

Unlike English company law, which has demonstrated an intention to relax some its rules in regulating conflicts of interest, Saudi Arabia remains somewhat conservative in this regard. Neither the CL 1965 nor recent statutes such as the LRs 2004 provide many exceptions to the rule of conflict of duties except for the authorisation by shareholders. In fact, the only other exception to Article 69 of the CL 1965 is public bidding. Specifically, the Article provides that if a director submits a winning bid, he is not considered liable for breach of the duty to avoid a conflict of interest. However, the provision seems to be in clear conflict with what Article 70 says, since the latter prohibits any type of competition with the company. Article 70 does not provide an exception like public bidding, which makes the situation rather confusing and generates a lack of clarity regarding the overall notion of competing with the company. Further, Article 69 also fails to clarify such issues as a resigning director’s transactions with the company or for the benefit of the company. While the absence of a test similar to Section 175(4)(a) can be explained by the intention to preserve a strict approach to

⁸⁹⁵ CA 2006, ss 175(3)-175(4).

⁸⁹⁶ See *Bhullar v Bhullar* (n 507) where rejection of opportunity by the company was not considered sufficient to grant protection from liability. See *O’Donnell v Shanahan* (n 507) for rejection of the ‘line of business’ test.

regulation of the duty to avoid a conflict of interest, the issues raised above have to be addressed in order to provide full clarity in relation to the duty in Saudi company law.

7.5.4 Suggested Changes to the Statutes

7.5.4.1 The CA 2006

The very first problem identified in the course of the review of Section 175 was the unnecessary specificity that might be considered a limitation of the scope of the no-conflict rule. Specifically, section 175(2) provides a particular definition of the scope of the rule, stating that it is not permitted to exploit the company's property, information or opportunities even if the company could not take advantage of these. The primary issue raised in the section seems to be not when the conflict emerged, but whether the conflict related to the exploitation of property, information or opportunity and whether the director was 'aware at a time when he was director' of the company. The wording of the corresponding section in this sense seems to require that exploitation, not the presence of a conflict of interest, be within the director's consideration. This is a strange limitation, in that it concentrates on the director's avoidance of exploitation, not all kinds of possible conflicts of interest. It seems that the main idea behind the section was to emphasise the avoidance of all kinds of such conflicts, not specific ones. Not that the exploitation of company property is unimportant for this matter, but clarification on what exploitation entails and to what degree it can be applied under the section would be helpful. Otherwise, the introduction of other types of conflicts of interest in the section is desirable.

Second, too vague a definition of the reasonability defence leaves it up to the courts to look into specific cases of the taking of corporate opportunities by directors. However, as the recent cases demonstrate, traditionally conservative English courts are not likely to diverge from the comfortable absolute rule shaping conflict of interests, as formulated in *Keetch v Sandford*⁸⁹⁷ and later approved in *Regal (Hastings) Ltd v Gulliver*⁸⁹⁸ and *Boardman v Phipps*⁸⁹⁹. This makes the intended changes to the strict rules very difficult to implement in practice. In order to shift the process, it is submitted that statutory clarification of section 175(4)(a) should be provided. What situations should be included here? Following from the

⁸⁹⁷ [1726] EWHC Ch J76.

⁸⁹⁸ [1942] 1 All ER 378.

⁸⁹⁹ [1967] AC 46.

analysis above, such situations could be when the opportunity is out of the scope of the company business and where there is no legal possibility for a company to pursue an opportunity (but there is a legal possibility for the director to do so). This would represent a partial adoption of the Guth-Broz corollary, while not threatening the integrity and foundations of the strict approach used within English equity⁹⁰⁰.

Finally, issues were noted in section 175(6). It seems that by limiting the number of required individuals to approve of taking corporate opportunities only increases the likelihood of these opportunities being exploited by directors⁹⁰¹. On the other hand, it cannot be denied that the requirement of shareholders' approval can be very hard to meet, especially in public companies. This was possibly the main reason for introducing the provision of the board's approval in the first place. However, leaving the section in the way it is formulated decreases the security that the company shareholders may have with regard to company property. For these reasons, reformulation of the section is required. According to the Act, the process of authorisation is conducted by means of a quorum, during which the director in question, as well as any other interested director, is excluded from voting⁹⁰². While the position of the director seeking exclusion from exploitation of the opportunity rule is clear, the case of the 'interested director' is somewhat confusing, because it is nowhere clarified who can potentially fall in this category. Further, the Act only disallows the director in question to vote on the matter of authorisation, while he can freely participate in the discussion regarding authorisation, thus having an opportunity to influence the board's decision-making process. This is an undesirable omission that can lead to an increased risk of property exploitation, especially when a director has a very strong influence over the board. Granted, the position of the director seeking authorisation has to be clearly explained in order to make a case for authorisation. However, this can be conducted by means of presenting a report in the due manner. The presence at the meeting of the director whose proposal for exclusion from exploitation of opportunity is likely to cause a potential conflict of interest is simply not

⁹⁰⁰ Indeed, this thesis does not submit that any capability facts should be taken into account to allow the seizing of the opportunity by directors. The thesis does not, for example, suggest the inclusion of a financial capacity test or the rejection of opportunity by the company. When a company cannot legally pursue an opportunity, it cannot be considered as a capability fact and, therefore, cannot be regarded as immaterial.

⁹⁰¹ See a good discussion on why section 175(4)(b) could increase the likelihood of property exploitation, in Davies (n 405) 567-570.

⁹⁰² By means of section 175(6) of the CA 2006.

appropriate. An appropriate change to the statutory law is, therefore, required in order for the company shareholders to be duly notified about any relevant board authorisations.

Suggested amendments to Sections 175(2), 175(4)(a) and 175(6) are provided in Appendix A.

One of the serious issues within the no-conflict framework remains that of competing after resignation. Considering the significant difficulties that individuals might face under English law when serving as directors in competing companies, such cases are rarely met with in practice. It is much more likely that competing directorships in modern English companies emerge within the paradigm of resignation and the subsequent launch of that individual's own company⁹⁰³. Therefore, modern English company law focuses more on the situation where a director who plans to compete with the company after resignation takes certain steps to prepare for this while still being the director. In this regard, two conflicting approaches have emerged in English case law: one that considers the preparatory activities for competition to be an outright breach of fiduciary duties⁹⁰⁴, and the other that takes a case sensitive approach in deciding whether it is so⁹⁰⁵. Considering these approaches from the perspective of consistency with the other fiduciary duties and protection of the company property, the first approach is preferable. However, in order to provide more clarity in this matter, it seems that an entire section on fiduciary duties related to resigning directors should be introduced⁹⁰⁶. This is quite a complicated task, which leaves the issue most likely to remain in the hands of the courts to decide.

7.5.4.2 The CL 1965

Much criticism has been voiced regarding the way that Article 69 of the CL 1965 treats the issue of the conflicts of interest and declaration of interests. Inconsistencies and lack of clarity are, in fact, evident throughout the entire provision of the Article, which, in the opinion of the researcher, needs serious rethinking and reconstruction. To sum up, the following problems were noted in the course of reviewing the Article:

⁹⁰³ The cases of *Umunna*, *CMS Dolphin*, *Bryant*, and *IDC* confirm this notion.

⁹⁰⁴ *British Midland Tool Ltd v Midland International Tooling Ltd* (n 605); *CMS Dolphin v Simonet* (n 500).

⁹⁰⁵ *Balston Ltd v Headline Filters Ltd* (no 506); *Item Software v Fassihi* (n 412).

⁹⁰⁶ Section 170(2) applies to directors who have already resigned, thus extending fiduciary duties to where directors leave the company. The issue reviewed here is different, because directors still remain in a directorship capacity when preparations for competition are initiated.

In relation to paragraph 1:

- The Article only deals with interest in the company transactions and contracts, while leaving out what potentially can be beneficial to the company;
- The Article does not clarify what is covered within the transactions in question;
- The Article leaves unanswered the question of whether engaging in transactions for the benefit of both the company and the director is acceptable;
- The Article does not clarify whether directors can engage in transactions with the company for mutual benefit;
- The Article does not include provisions related to former directors or to directors sitting on the boards of more than one company;
- There is a conflict between this section, which allows directors to publicly bid against the company, and Article 70, which prohibits any form of competition with the company;

It is obvious that the introduction of all these amendments in the Article would require substantial rewriting of its provisions. However, each of these amendments has been explained and justified above, and their introduction will, it is believed, make the provisions under Article 69 more comprehensible and easier to enforce, thus leaving much less ambiguity than is currently in the Article. Finally, none of the suggested amendments go against the *Shariah* principles, and therefore they would be totally legitimate within the Saudi jurisdiction.

The text of the original Article 70 of the CL 1965 clearly and explicitly prevents directors from participating in a competing business or engaging in any commercial activities that a company undertakes. The main criticisms regarding the Article were the absence of consideration regarding past directorships and occupation of director positions in more than one company. The Article was found unable to provide clear guidance regarding such issues as intentional resignation to compete with the company and the situation where a directorship was held in two competing companies. Therefore, the amendments to Article 70 are aimed at resolving these issues specifically. The proposed amendments (Appendix B) prohibit intentional resignation for the purposes of competing with the company, prohibit directorship in competing companies, and oblige the directors not to participate in board meetings whenever a conflict situation unexpectedly arises.

The following amendments are suggested to deal with the issues for Article 69 and Article 70 as noted above:

- 1) Replacing the duty to avoid interest in company transactions and contracts by the duty to avoid conflicts of interest per se, existing or potential;
- 2) Extending the nature of the definition of transaction by including real property, intellectual property, information and opportunities;
- 3) Disallowing transactions with third parties for the benefit of both the company and director as well as transactions between the company and director, so as to avoid situations where only these kinds of opportunities are pursued;
- 4) Introducing provisions regulating situations of resignation and multiple directorship in the context of the conflict of interest;
- 5) Introducing the required minimum number of votes to allow directors to pursue the opportunities and transactions when there may be a conflict of interest with the company;
- 6) Resolving the conflict between Article 69 and Article 70 by allowing directors to engage in public bidding only if there is no bidding on the side of the company and thus no competition with the company.

7.6 Declaration of Interest

Within the context of conflicts of duty, both the English and Saudi legal systems have introduced statutory provisions that oblige directors to declare their interest in company transactions. In both countries, the duty serves as complementary to the general duty to avoid conflicts of interest. In Saudi Arabia, it is presented in the same Article as the general duty to avoid conflicts of interest⁹⁰⁷. In England, the duty is codified in a separate provision, Section 177 of the CA 2006, but the nature of its provisions directly point out to the general duty to avoid conflicts of interest. The treatment of this duty in both jurisdictions has more parallels than the duty to avoid conflicts of interest, although certain fundamental differences still persist.

⁹⁰⁷ CL 1965, Article 69 para 2-3.

7.6.1 Rationale and Wording

As mentioned above, both the English and Saudi jurisdictions consider the duty to declare an interest in the transactions of the company within the broader context of the application of the general duty to avoid conflicts of interest. Again, however, the rationale for the introduction of the duty is somewhat different. In English law, Section 177 of the CA 2006 serves primarily a preventive function, because it requires a declaration to be made of a director's personal interest in a transaction before it is initiated. It may be recollected that the equity of the self-dealing principle, which in English law strongly relies on *Keech v Sandford*⁹⁰⁸, entitles the company to avoid any transactions where a director's interests are likely to come into conflict with the company's, and that even the possibility of bad faith or fraud can be opposed and rejected⁹⁰⁹. Therefore, Section 177 allows companies to avoid undesired transactions in this regard. In Saudi Arabia, the main rationale for the duty rests upon some fundamental principles of the *Shariah*, which are fulfilment of contract and honesty. Seizing a transaction for oneself would be considered a breach of the former, while failure to declare a personal interest in such a transaction would be a breach of the latter.

In terms of the wording of the duty in the statutory laws of both countries, the primary issue of not defining 'interest' still remains. Once again, the absence of this term leads to certain confusion as to what could fall within the scope of the statutory rules. In addition, an interesting point can be observed in the Saudi statute: while the provision relating to the conflicts of interest mentions direct and indirect interest in the transactions, the provision dealing with declaration of interest mentions 'personal interest' as the main subject of the duty. This, in turn, means a difference in the scope of the duty application⁹¹⁰, as noted in the next section. However, it is still unclear why the Saudi legislator decided to limit the scope of the rule's application⁹¹¹.

⁹⁰⁸ [1726] EWHC Ch J76

⁹⁰⁹ *Ex p Lacey* (n 662).

⁹¹⁰ English law considers both direct and indirect interest for the purposes of Section 177 of the CA 2006.

⁹¹¹ Although, truth be told, the absence of a clear definition of the term 'interest' makes this concern somewhat irrelevant.

7.6.2 Scope and Application

The scope of the duty to declare transactions remains unclear within statutory law in both jurisdictions due to the absence of a definition for the term ‘interest.’ Consequently, even though English law mentions direct and indirect interest for the purposes of the duty, it is hard to determine how far it goes beyond ‘any personal’ interest as defined in the statutory code of Saudi Arabia. It has been, largely, up to the courts in England to decide how far the term ‘interest’ may be extended. *Cowan de Groot Properties Ltd v Eagle Trust*⁹¹² was one such case, where the court had to decide whether a sales contract between two parties, where the defendant was a director in one and a shareholder in another, was an interest to be disclosed. The court was inconclusive on this, claiming that the interest would not be disclosable in most cases, but acknowledging that there could be exceptions, thereby informally addressing the reasonable likelihood of a conflict. Later, in *Runciman v Walter Runciman plc*, the court held that even in cases where the interest of a director was blatantly obvious, there is a need to disclose it⁹¹³.

Unlike Saudi company law, which, apparently, does not distinguish between type and levels of interest for the purposes of their declaration, the English legal system has distinguished between technical and substantive breaches of disclosure. Technical non-disclosure, in general, can be defined as the failure to disclose an interest in situations where it is clear and obvious. This point was addressed in *Lee Panavision v Lee Lighting*⁹¹⁴ and codified in Section 177(6)(b) of the CA 2006, which states that in cases where company directors are aware of personal interest, it does not have to be disclosed. Therefore, the English approach to a declaration of interest seems more flexible than in Saudi Arabia. However, whether such an approach is preferable is questionable.

The main issue with the separation of secret disclosure between technical and substantive is that in the absence of a requirement to report an interest under technical non-disclosure, information regarding directors’ interests remains with the board only. It is not, however, recorded in the minutes of the board meeting and is not be available to shareholders. The importance of the information in the minutes cannot be underestimated, because it helps

⁹¹² [1991] BCLC 1045.

⁹¹³ [1992] BCLC 1084. The same idea was expressed in *Re Neptune (Vehicle Washing Equipment) Ltd (No. 1)* (n 675).

⁹¹⁴ [1991] BCLC 575; [1992] BCLC 22 CA.

avoid suspicions of secret dealings and some potential abuses from shadow directors. Indeed, a director or a group of directors may engage in beneficial transactions for themselves without due disclosure because the board apparently knows about their interest in the transactions. In other words, the rule of technical non-disclosure declared in *Lee Panavision* and codified in Section 177(6)(b) of the CA 2006 leads to a much lower degree of transparency, which favours directors, but downplays the interests of shareholders. While a number of recent cases addressed the need for a more formal disclosure of interests⁹¹⁵, the active provision of the CA 2006 that provides protection from non-disclosure on the technical basis is likely to determine future decisions of the court in this regard.

Another point of difference between the laws related to the duty to declare transactions may be speculative, since no clear definitions of the terms in this regard are provided in either jurisdiction. However, the English courts seem to take a broader view of the scope of the duty by applying it to directors' related parties (if this is what meant by 'indirect interest'). As noted above, Article 69 of the CL 1965 in Saudi Arabia only treats personal interests as subject to the duty application. Therefore, while English law provides more freedom to directors in terms of declaring interests, it seems to be more inclusive than its Saudi counterpart by reason of the introduction of related parties.

7.6.3 Process of Declaration

The duty to declare an interest in the transaction implies that there has to be some procedure for doing so correctly. The English and Saudi legal systems developed their own approaches in this regard, with some of the elements being similar and some of them being drastically different. Both legal systems oblige directors to declare an interest in relevant transactions to the board of directors. English jurisdiction provides two possibilities for this: either in writing or by means of a general declaration, while Saudi law does not provide clarification on the matter, nor does it require such important details as the nature and extent of interest. Finally, Saudi legislation does not have a provision that requires the interest to be declared prior to the transaction taking place⁹¹⁶. This last point is, perhaps, the main weakness of the Saudi legislation, since the entire purpose of the duty to declare interest is based on timely provision of information in this regard.

⁹¹⁵ *Gwembe Valley Development Co Ltd v Koshy (No 3)* (n 681); see also *Re MDA Investment Management Ltd* (n 681).

⁹¹⁶ All these issues are covered in Section 177 of the CA 2006 in English law.

At the same time, the procedure for declaring interest in a transaction outlined in Saudi company law does have its advantages. Unlike English jurisdiction, Article 69 paragraph 3 of the CL 1965 requires that any expressed interest in a transaction by directors should be recorded in the company minutes and presented to the shareholders in due manner. Moreover, the Article also provides that such communication has to be accompanied by a report from the auditor. It can be argued that these procedures provide an additional degree of protection to the company shareholders by providing vital information about the transactions involving company board members. Compared to the shareholders in English companies, who may remain uninformed about some dealings involving company directors under the rule of non-technical disclosure, shareholders in Saudi companies enjoy a higher degree of board transparency.

7.6.4 Legal Defences

While English law provides a number of possible legal defences to a declaration of interest in company transactions, Saudi law offers none. It remains unclear whether this is dictated by the attempt of the Saudi legislator to create an all-encompassing strict rule for a higher degree of shareholder protection or whether it is a product of reliance on the *Shariah* duty of honesty, but the fact is that in the absence of exceptions to the rule, Article 69 of the CL 1965 seems to be a very strict piece of legislation. In contrast, English law provides a whole list of protections from the main provisions of Article 177: 1) director not being aware of the interest; 2) director not being aware of the transaction which involved interest; 3) situations that cannot reasonably be regarded as likely to give rise to a conflict of interest; 4) if other directors are aware of the interest; and 5) if the situation concerns terms of his service contract that have been or are to be considered by a meeting of the directors or by a committee of the directors appointed for the purpose under the company's constitution⁹¹⁷. In addition, section 177 of the CA 2006 provides some leeway in this regard: directors are allowed to proceed with the transaction if all the requirements under the section are met. Consequently, no defence can be applied in a situation where the parties entered the transactional terms as though acting at arm's length. Similar provisions in English case law are valid in relation to a director's purchases from other companies⁹¹⁸. Importantly, English

⁹¹⁷ Sections 177(5)-177(6) of the CA 2006.

⁹¹⁸ However, articles of association in general give permission to such transactions. In this regard, see *Ireland Alloys Ltd v Dingwall* (n 663): the requirements for disclosure were listed in the articles, but not followed, which invalidated the board's decisions.

case law recognises that if the beneficiary allows the transaction, he cannot later demand it be set aside⁹¹⁹. Based on these facts, the treatment of the duty to declare an interest in transactions is more relaxed in English jurisdiction.

To some extent, relaxation of the rules within the English legal system in terms of declaration of interest may be regarded as corresponding to the requirements of time. Indeed, due to the ever more complex nature of company transactions, it is, for example, becoming increasingly difficult for directors to keep track of all transactions so as to avoid liability. In this regard, protection from liability seems justified. However, for the reasons outlined above, in the absence of well-defined liability for technical non-disclosure, the directors are given, perhaps, too much freedom and, hence, an incentive to breach their fiduciary duties. At the same time, in the absence of information to shareholders regarding such omissions, it becomes much harder to bring a case against mischievous behaviour of company directors. In this regard, it is surprising that in the predominantly strict English company law there is such an evident fiduciary loophole.

7.6.5 Suggested Statutory Changes

7.6.5.1 The CA 2006

As was discussed above, breach of fiduciary duty under section 177 of the CA 2006 is interpreted as either substantive or technical⁹²⁰. While the substantive breach of duty carries full liability for the breach of fiduciary duty, the courts seem to refuse its application to technical breaches. As such, technical breaches, for example, are not commonly subject to a transaction being declared voidable. The courts are normally guided by the fact that section 177(6)(b) does not require a declaration of an interest if other directors are aware of it. The primary issue with this approach is that formal declaration of an interest at the meeting discloses the interest not only to directors but also to shareholders because of its inclusion in the board meeting minutes. As mentioned earlier, the importance of these notes should not be underestimated, because these help avoid suspicions of secret dealings and some potential abuses from shadow directors. Indeed, a sole director or several directors may engage in beneficial transactions for themselves without due disclosure because the board apparently knows about their interest in the transactions. However, these transactions might not be

⁹¹⁹ *Holder v Holder* (n 664).

⁹²⁰ *Lee Panavision v Lee Lighting* [1992] BCLC 22.

recorded anywhere at all, thus allowing directors to become involved in such operations without the due knowledge of the shareholders. For these reasons, denying the need for a formal declaration of interest in any transaction leads to increased uncertainty regarding directors' dealings, and it becomes much harder to bring a case against mischievous behaviour by company directors. Hence, some changes to the statutory law are proposed in Appendix A.

7.6.5.2 The CL 1965

While declaration of interest in related transactions by company directors is made mandatory in the CL 1965, the technique for the declaration is not clearly defined. Specifically, the following issues remain with regard to paragraphs 2-3 of Article 69, which deals with declaration of interest:

- The Article does not establish the procedure for board or shareholder voting on the issue;
- The Article does not require directors to declare an interest *before* the transaction;
- The Article does not require directors to explain the nature and the extent of their interest in the transaction in question.

Consequently, statutory changes to Article 69 of the CL 1965 have to be directed at resolving these issues. These changes are noted in Appendix B for Article 69, along with the changes suggested for the conflicts of interest matters.

7.7 Other Duties: Benefits from Third Parties and Disclosure of Secrets

So far, the analysis of the fiduciary duties of company directors toward company property in English and Saudi jurisdictions have covered the rules that were similarly worded and codified in both countries' statutes. However, each legal system also has a duty towards company property that is not found in the other's statutes. In English law, there is a duty to not accept benefits from third parties, while in Saudi Arabia, there is a duty not to disclose company secrets. For the completeness of the analysis, it is important to discuss these duties and see whether they can be respectively adopted by the countries in question to improve the regulation of directors' fiduciary duties towards property. Therefore, each of these duties is presented below.

7.7.1 Duty to Not Accept Benefits from Third Parties

The duty to not accept benefits from third parties can be considered an extension of the no-conflict approach in English company law. The duty prohibits directors from receiving benefits, which would possibly involve something in return as a result of acting in a director's capacity. As such, acting in the interests of third parties in return for material or other benefits involves a breach of the duty to avoid conflicts of personal interests with company interests. The rationale for including this duty in Section 176 of the CA 2006 is that it specifically covers profits received in the course of directorship⁹²¹.

Importantly, Section 176 does not explain the nature of the 'benefits' covered by its provisions. While there are some things that can be easily defined as a benefit from third parties such as financial rewards (money, stock, property holdings, for example) or money's worth items such as paid travel or tickets to sports events or entertainment⁹²², other cases, such as, for example, receipt of corporate hospitality, are reviewed in the context within which they are given⁹²³. In most cases, however, the common law has applied the term 'benefits' from third parties to bribes and secret commissions⁹²⁴. However, the recently decided case of *Towers v Premier Waste Management Ltd*⁹²⁵ established that virtually any benefit received by directors while serving as a director can be attributed to the breach of duty. The strict application of the rule holds that it does not matter whether the benefit was substantial or whether the company itself would find value in the benefit. The decision, however, has to be read together with the applicable duties of the conflicts of interest and declaration of interests.

Saudi company law does not include any statutory provisions regulating directors' duties to avoid accepting benefits from third parties. Nor does it have any regulations of such activities in the CL 1965 or other company statutes. It can be argued that the inclusion of such provision in the company law is not needed since the *Shariah* explicitly prohibits acts of

⁹²¹ Section 175 deals primarily with information and opportunities.

⁹²² These are mentioned in the *ICSA Guidance on Directors' General Duties* (2008) at para 3.6.5.

⁹²³ *Ibid.*

⁹²⁴ This is predicated by the equitable rule established in *Attorney General for Hong Kong v Reid* [1994] AC 324, which stated that bribes and secret commissions received by fiduciaries have to be held on constructive trust, and that all the profits acquired from this are also to be held on constructive trust.

⁹²⁵ [2011] EWCA Civ 923.

dishonesty, usurping of power, and breach of loyalty, which seem to be the main constituents of Section 176 of the CA 2006. However, the term ‘benefits’ can be extended beyond secret commissions and bribes (which was very possibly the intention of regulations under Section 176 of the CA 2006), and provisions of law regulating gift giving within the corporate context can become a strong addition to the existing company law in the Kingdom. Moreover, in the absence of the *Shariah* rules, it is sometimes difficult to link specific issues in corporate law to applicable *Shariah* tenets. From this perspective, adopting a duty to avoid acceptance of benefits from third parties is beneficial to both company law and the *Shariah*.

7.7.2 Duty to Not Disclose Company Secrets

Saudi company law has a distinctive provision in its statutory law that regulates the non-disclosure of company secrets coming to the directors’ knowledge within the capacity of their directorship. While the term ‘secrets’ is nowhere defined in Saudi company law, it can be logically linked to the confidential information of a company. As such, Article 72 of the CL 1965 deals directly with exploitation of company information by treating it as something that belongs to the company. The strict liability imposed by the provisions of the Article makes the breach of this duty a very serious matter in Saudi law⁹²⁶. This proves the fact that it accepts and treats intangibles as pieces of company property and rightfully protects them. But for this very reason, it is important that clarification is provided as to what ‘secrets’ (and ‘third parties’) mean in the context of the Article. The problem is that secret information can be of either a positive or negative character. For example, if a company engages in unethical (but not necessarily illegal) market behaviour, and the information comes to the surface during the board meeting, such information could be protected by Article 72 as ‘a company secret.’ Consequently, revealing this fact may legally cost a director his position in the company and impose additional liabilities. Therefore, a director may find himself in a difficult situation where fear of losing his position with the company may prevent him from revealing certain facts in respect of the company’s inappropriate actions, which could be harmful to the company stakeholders and society as a whole.

The idea of codifying protective measures for a company’s secret information could be considered within English company law. While Section 175 of the CA 2006 mentions

⁹²⁶ No other Article of the CL 1965 pertaining to directors’ duties includes removal from the office as part of the liability for the breach of duty. Article 72, however, mentions removal as a definite, not merely possible, measure of punishment.

information as something protected from exploitation, it has primarily been viewed as information about opportunities that directors may pursue for their own benefit disregarding company interests. Article 72 of the CL 1965, however, protects confidential information from being revealed to third parties. The scope of this rule is likely to apply to something that does not belong to the domain of public information, and that therefore can be considered as the property of a company. On these grounds, the introduction of a provision similar to Article 72 in English company law is justified. In any case, however, it is clear that adaptation of the rule in its present form is not acceptable: it has some undefined terms which may cause ambiguous interpretation of the Article. Suggestions to modify the statutory provisions of Article 72, therefore, are provided in Appendix B.

7.7.3 Suggested Statutory Changes

7.7.3.1 The CA 2006

The general issue that caused concern in relation to section 176 of the CA 2006 is the issue of ratification. Specifically, this chapter argued that section 176 covers largely illegal acts, which the company itself is not allowed to pursue. Perhaps for these reasons the section disallows a board authorisation procedure akin to the one noted in section 175. However, authorisation by shareholders is still possible under section 180(4), which deals with the consent and approval of the company members, and section 239 which covers the ratification of directors' acts. As such, there seems to be a significant problem where the possibility of approving of an illegitimate act remains. Unfortunately, the Act does not provide an answer anywhere as to whether there are non-ratifiable breaches. Therefore, although it is clear that there are breaches in common law that should not be given the power of ratification, it remains very unclear how wide the rule actually is. Therefore, there is a suggestion in Appendix A to introduce a limitation on the scope of the ratification rule.

7.7.3.2 The CL 1965

Article 72 was determined as a desirable provision in terms of regulating the fiduciary duties of company directors. However, in its present form, it is doubtful whether it is effective in creating clear boundaries for the effective protection of company information from exploitation. As discussed above, the primary reason for this is the presence of several concepts that are nowhere defined. In particular, the terms 'secrets' and 'third parties' are crucial to understanding the meaning of the Article and the true intention of the Saudi

legislator behind it. Without clarification of what these terms mean, it is impossible to determine what exactly the Article is intended to protect and what constitutes a breach of the duty. Therefore, the suggestions for amendments to the Article mainly relate to defining these terms, as demonstrated in Appendix B.

7.8 Property Exploitation through Loans

The final form of potential exploitation of company property considered in this study was exploitation through loans. As noted in the discussion related to company directors in Saudi Arabia, the CL 1965 does not provide adequate protection from property exploitation by means of company loans and loan guarantees for persons connected with company directors. In its present form, the CL 1965 does not explicitly distinguish between such persons and other third parties dealing with the company. Consequently, company loans and loan guarantees provided to these parties are the same. This, however, provides an opportunity for directors to use other parties to obtain loans and guarantees which are prohibited to them directly by means of Article 71. In order to avoid this, it is recommended that the amendments to Article 73 are made to 1) distinguish third parties from parties related to directors; 2) prohibit the issue of loans to related parties without shareholders' approval; and 3) establish appropriate procedures for the declaration of such transactions and their approval. Appendix B provides a suggested modified version of Article 73. These suggestions are drawn from the English Companies Act 2006, which covers similar transactions in a much more detailed manner.

7.9 Conclusions and Recommendations

As a country that is becoming actively integrated into the global economy, Saudi Arabia requires a strong, clear and transparent legal system that will ensure the application of the rules of law in a manner that is beneficial to the country's society and economy. Company law in this regard is a relatively new area in the legal fabric of Saudi Arabia. In many respects, it is also one of the hardest legal areas to govern. This stems from the fact that the traditional Islamic law can offer little advice in terms of effective governance of the modern business entities that have emerged in the Kingdom as a result of rapid economic expansion, the growth of foreign investments, and the strengthening of commercial ties with the rest of the world.

Saudi Arabia has come a long way since the adoption of its first statute regulating corporate governance issues. However, despite its apparent developments in the area of company law, many gaps and ambiguities still remain. This is especially true regarding the CL 1965 – the major statutory law regulating corporate affairs in the Kingdom. Despite numerous amendments, the statute has become obsolete in many respects, and requires significant changes in order to effectively meet the demands of the modern Saudi economy. This was the primary motivation for the research that has been conducted, which has focused on an area that has been given little attention by contemporary scholars in the Kingdom, namely, the fiduciary duties of company directors towards property.

The purpose of the study was to conduct a comparative analysis of the ways that fiduciary duties of company directors towards property are treated in England and Saudi Arabia. England was chosen because of its strong reputation in terms of its commercial legal system and company law in particular. The goal of the study was to determine the elements of statutory law in England that can be successfully adopted and adapted in Saudi Arabia to improve the existing way of treating the fiduciary duties of company directors toward property. At the same time, by critically evaluating the positive and negative aspects of the existing law in both countries, the study aimed to discover any inconsistencies and ambiguities in their legal systems and to provide useful suggestions for improvement.

As expected, the results of the study demonstrated that the English legal system is much better developed and suited for the treatment of the fiduciary duties of directors towards company property. Yet it is also not without some minor flaws that have been duly noted by the researcher with suggestions for improvement. At the same time, the research showed how poorly developed, incomplete and unbalanced the regulations of fiduciary duties of directors towards company property in Saudi Arabia are. There are issues that need clarification, amendments, and/or rewriting in nearly every related Article of the CL 1965. Using English company law as a peer to Saudi company law, the study provided many suggestions that the researcher believes will be able to contribute to the development of a new, more comprehensive and better company statute in the Kingdom. At the same time, it was found that some elements of the Saudi legal system could provide useful suggestions for improving English statutory law, thus making the work practical for both jurisdictions. The main contribution of the thesis, therefore, lies in the insights into the issues of managing the fiduciary duties of company directors towards property in England and Saudi Arabia, and

practical suggestions for reforming the statutory codes in both countries. The main contribution, however, is to Saudi company law, which is still struggling to introduce the new statutory provisions aimed at regulating business entities in the Kingdom.

Based on the outcomes of the research, a number of suggestions of both an academic and practical nature are provided. Academic research recommendations cover mostly the topics that could be beneficial for further development of the Saudi legal system. The current research compared Saudi company law with English company law. While there is no doubt that the English legal system is one of the most developed in the world, there is a need to compare such aspects as the treatment of fiduciary duties towards company property to the legal systems that are closer to the Saudi one in terms of the nature of law as well as the cultural and social environments. In this regard, it would be useful to compare Saudi jurisdiction with the legal systems of developed civil law countries, such as France or Germany. It would be also useful to conduct such an analysis with the Islamic countries that have more flexible systems and make the case law available to the public. This is necessary in order to understand how the various aspects of company law are working and being interpreted in practice in environments that closely resemble the one in Saudi Arabia. Finally, as the study emphasised many time throughout the thesis, research is needed with regard to the possible codification of *Shariah* rules, at least for the purposes of their inclusion in the statutory codes, so as to better align traditional Islamic law with modern corporate law.

Appendix A: Suggested Revisions to the Companies Act 2006

Section 175

Original section 175(2):

‘This applies in particular to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity).’

Modified section 175(2):

‘This applies in particular, but is not limited, to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity).’

The original section 175(4) (a):

This duty is not infringed—

(a) if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest.

The modified section 175(4) (a):

This duty is not infringed—

(a) if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest, such as in the case of pursuing an opportunity which is outside the scope of the company’s business or when a company cannot legally pursue an opportunity.

The original section 175(6)

The authorisation is effective only if—

(a) any requirement as to the quorum at the meeting at which the matter is considered is met without counting the director in question or any other interested director, and

(b) the matter was agreed to without their voting or would have been agreed to if their votes had not been counted.

The modified section 175(6)

The authorisation is effective only if—

- (a) any requirement as to the quorum at the meeting at which the matter is considered is met without counting the director in question or any other interested director,*
- (b) the director in question did not participate in the meeting at which voting on the matter was conducted;*
- (c) the matter was agreed to without their voting or would have been agreed to if their votes had not been counted;*
- (d) the act of authorisation is duly communicated to the shareholders.*

Sections 180 and 239

The original section 180(4)(a):

The general duties—

(a) have effect subject to any rule of law enabling the company to give authority, specifically or generally, for anything to be done (or omitted) by the directors, or any of them, that would otherwise be a breach of duty;

The original section 239(1):

This section applies to the ratification by a company of conduct by a director amounting to negligence, default, breach of duty or breach of trust in relation to the company.

The modified section 180(4)(a):

The general duties—

(a) have effect subject to any rule of law enabling the company to give authority, specifically or generally, for anything to be done (or omitted) by the directors, or any of them, that would otherwise be a breach of duty, but which is not otherwise illegal;

The modified section 239(1):

This section applies to the ratification by a company of conduct by a director amounting to negligence, default, breach of duty or breach of trust in relation to the company, but which is not otherwise illegal.

Section 177

The original section 177(4):

Any declaration required by this section must be made before the company enters into the transaction or arrangement.

The modified section 177(4):

Any declaration required by this section must be made before the company enters into the transaction or arrangement and duly recorded in the board meeting minutes.

Appendix B: Suggested Changes to The Companies Law 1965

Definition of Terms

Company Secret: *a piece of information possessed by the company, which is not publicly accessible, and which renders the company any potential economic advantage. A company secret may be any of the following (but not limited to): design of a product or production process, formula, instrument, pattern, or practice, for as long as they can be considered by the company as beneficial. Information about malpractices, unethical behaviour, or any illegal activity, even though profitable to the company, is not considered a company secret.*

Maladministration: *any action by a director or a board of directors that causes injustice in relation to the company and its shareholders or might cause such injustice. Injustice includes – but is not limited to – financial loss, unjustified financial expense, and the loss of right or amenity.*

Third parties: *persons or organisations not directly involved in the company management, but who, in view of their connection with the company, can be strongly affected by its actions. Third parties include (but are not limited to): employees, suppliers, customers, and business partners.*

Shadow Directors: *persons or organisations not directly involved in the company management, but in accordance with whose directions or instructions the directors of the company are accustomed to act. Shadow directors are subject to the duties mentioned in Articles 69-73 of the current Act in the same way that company directors are. Individuals acting in a professional capacity while advising the board of directors shall not be regarded as shadow directors.*

Article 69

‘A director has the duty to avoid situations where he has or may have a direct or indirect conflict of interest with the company. This applies in particular to the exploitation of real property, intellectual property, information or opportunities that a company pursues or intends to pursue.

The duty also includes transactions with third parties or between a company and a director for mutual benefit, unless otherwise provided in the company articles. The duty will not be infringed in cases where there is authorisation issued by the quorum of shareholders at the general meeting with the minimum percentage of votes as determined by the company articles (but not less than 50%). Such authorisation is to be renewed on an annual basis. Transactions made by way of public bidding shall be excluded from this restraint if the director submits a winning bid and the company does not participate in the bidding process.

The director must declare to the board of directors any personal interest that he may have in transactions or contracts made on behalf of the company. Such declaration should be made before the company enters into the transaction or arrangement. The declaration must be recorded in the minutes of the board meeting stating the nature and extent of the interest, and the interested director shall not participate in voting on the resolution to be adopted in this respect.

The chairman of the board of directors shall communicate to the regular general meeting, when it convenes, the transactions and contracts in which any director has a personal interest. Such communications shall be accompanied by a special report from the auditor.'

Any reference in this section to conflicts of interest also includes the conflict of duties. Former directors have to maintain the duty to avoid a conflict of interest for a reasonable amount of time to be regulated by the company articles. Prior to taking a seat on more than one board, a director must declare his position to all relevant company boards and obtain permission from all these companies to serve on a new board.'

Article 70

'A director may not, without authorisation from the regular general meeting, to be renewed annually, participate in any business which is in competition with that of the company, or engage in any of the commercial activities carried out by the company, or intentionally leave the company in order to engage in such activities; otherwise, the company shall have the right either to claim damages from him or to consider the operations he has conducted on his own account as having been conducted for the benefit of the company.'

The directors shall not accept board positions in companies that are directly competing with their current companies. In the case where a competitive situation arises between companies previously not engaged in competition, and where the director serves on the boards of these companies, he shall not participate or vote in the board meetings of either company on questions related to the competitive situation.'

Article 73: para 4-5

'Any transaction covered within this section has to be approved by the shareholder meeting if it is conducted with a party related to the company director(s). A related party, for the purposes of this Article, is any person or entity with whom or with which the director(s) in question has close ties by means of personal relationships (such as immediate relatives and spouses) and business relationships (such as business entities owned or operated by a director, or where the director has a controlling stake).'

The appropriate procedure for such transactions includes the issuing of a resolution to the company members with a reasonable amount of time allocated for a decision. The resolutions should include as a minimum: 1) the nature of the intended transaction; 2) the transaction's purpose and financial value of the transaction; 3) the degree of the company's possible liability in relation to the transaction.'

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