

The Edinburgh Law School



PRESENTATION FOR UNIVERSITA' BOCCONI ON THE REFORM OF THE LAW OF DIRECTORS' DUTIES IN UK COMPANY LAW

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A. INTRODUCTION

The Companies Act 2006 (“the Act”) received Royal Assent in the UK on 8 November 2006. With 1,300 sections and 16 schedules, the Act is the largest act ever passed by the UK Parliament. In January 2007, the UK Government indicated that the lion’s share of the Act would be brought into force in three tranches, namely 1st October 2007, 6th April 2008 and 1st October 2008. However, in November 2007, the UK Government announced that the implementation of the majority of the provisions of the Act which they had envisaged bringing into force on 1st October 2008 would be postponed to 1st October 2009. Since the Act received Royal Assent, there have been seven commencement orders.

One of the main reforms introduced by the Act was the introduction of a statutory statement of the law of directors’ duties. The relevant sections of the Act are sections 171-187 and 190-196. Sections 171-174, 178-181 and 190-196 of the Act came into force on 1st October 2007, whereas sections 175-177 and 182-187 of the Act came into force on 1st October 2008. With the exception of sections 174, 182-187 and 190-196 of the Act, all of the duties are fiduciary in nature. Moreover, sections 178-187 and 190-196 are technically speaking not ‘directors’ duties’, but are covered here since they regulate self-dealing between directors and the company.

The purpose of this presentation is to provide a detailed treatment of the law of directors’ duties in the UK. Throughout the discussion, an attempt will be made to place the rules in their historical and comparative perspective. Moreover, consideration will be given to the principal means of enforcement of the directors’ duties in the UK, namely: -

- (a) the new statutory derivative proceedings contained in sections 260-269 of the Act; and
- (b) section 994 of the Act (the minority shareholders' 'unfair prejudice' remedy).

B. REFORM OF THE LAW OF DIRECTORS' DUTIES

Introduction

Traditionally, the law of directors' duties was regulated by the common law in the UK. That is to say the body of rules in the UK which were built up by the judiciary through incremental decision-making taken in like cases over a long period of time which were then forged into a formal source of law through the doctrine of judicial precedent (*stare decisis*). The law of directors' duties was carved by the judiciary over the course of the 1800s and 1900s by transplanting and adapting the existing law on the duties of trustees. To that extent, directors were equated with trustees by the common law and the duties of the directors were developed by analogy with the duties of trustees – which may have not been the perfect analogy since the overarching duty of the trustee in the law of equity is to preserve and conserve the assets of the trust, whereas in the case of the director of a company, it is the purpose of the director to engage in risk-taking with the assets of the company.¹

In terms of the common law, the general duties of directors were divided into the duty of loyalty and the duty of care, skill and diligence. The former was a fiduciary duty, whereas the latter was not since it was concerned about the competence or negligence of directors. Moreover, the fiduciary duty of loyalty could be divided into the following sub-duties each of which themselves had eminent lines of case authority to further 'flesh' out their content and scope: -

- The duty to act bona fide in what the director considered to be the interests of the company;²

¹ See Professor Sealy's criticisms in his seminal article, "The Director as Trustee" [1967] *Cambridge Law Journal* 83.

² *Re Smith & Fawcett Ltd.* [1942] Ch. 304, 306 per Lord Greene M.R.

- The duty not to act for any collateral purpose, i.e. that powers delegated to a director pursuant to the constitution must be used by the director for their proper purposes and not as a means of upsetting the constitutional balance of power settled in the constitution between the directors and the shareholders;³
- The duty not to fetter their discretion;⁴
- The duty to avoid placing themselves in a position where their duties and their personal interests conflict;⁵
- The duty to avoid making a profit from their position as a director;⁶ and
- The duty to avoid exploiting or misusing corporate information, contracts, property or opportunities.⁷

One of the advantages of the law of directors' duties being articulated through the common law system was that it could be adapted and modernised in light of changing commercial and economic conditions. In other words, the law would not stand still and was inherently flexible, permitting the judiciary to mould the law by a process of retrenchment and expansion of the categories of duties (and the circumstances in which the duties would be invoked and breached) as requirements demanded. The duties were expressed at a high level of generality, ensuring that the development of the common law was intrinsically dynamic.⁸ However, a particular difficulty with the law was that it was inaccessible to those to whom it was addressed, i.e. directors. Other than obtaining legal advice from practising lawyers in the UK, directors had no way of knowing what their duties were in law which they owed to the company. For this principal reason of a lack of transparency, the UK Government agreed with the

³ *Hogg v Cramphorn Ltd.* [1967] Ch. 254 and *Howard Smith Ltd. v Ampol Petroleum Ltd.* [1974] A.C. 821 (Privy Council).

⁴ *Fulham Football Club Ltd. v Cabra Estates plc* [1994] 1 BCLC 363.

⁵ *Aberdeen Railway Co. v Blaikie Bros* (1854) 1 Macq 461;

⁶ *Regal (Hastings) Ltd. v Gulliver* [1967] 2 AC 134n; [1942] 1 All ER 378, HL.

⁷ *Cook v Deeks* [1916] 1 AC 554, PC (misusing corporate property/assets by diverting a lucrative contract from the company to another company which the directors formed and controlled),

⁸ See the *obiter dicta* of Lady Justice Arden in *Item Software (UK) Ltd. v Fassihi* [2005] 2 BCLC 91, 103-104 at paras. [41]-[43].

Company law Review Steering Group,⁹ the Law Commission¹⁰ and the Scottish Law Commission¹¹ that the common law should be replaced by a written statutory statement of the legal duties of directors in a new Companies Act. In particular, the Company Law Review Steering Group had the following to say in its Final Report in 2001: -

“The case for and against providing a clear restatement of directors’ duties has been examined by the Law Commissions and has been set out by us in *Developing the Framework*¹² and *Completing the Structure*.¹³ We continue to recommend such a legislative statement. We do so for three main reasons:

⁹ A body which was specifically set up by the Government to review company law and report on its reform.

¹⁰ The Law Commission is a statutory body whose role it is to keep English law up to date and advise Government on its reform. See the Law Commission Report (Law Com 261; Scot Law Com 173; Cm4436), “Company Directors; Regulating Conflicts of Interests and formulating a Statement Duties” which is a joint report by the Law Commission and the Scottish Law Commission published in 1999 on their recommendations for the reform of the law of directors’ duties – available at [http://www.lawcom.gov.uk/docs/lc261\(1\).pdf](http://www.lawcom.gov.uk/docs/lc261(1).pdf).

¹¹ The Scottish Law Commission is a statutory body whose role it is to keep Scots law up to date and advise Government on its reform.

¹² This was a report of the Company Law Review Steering Group which preceded its Final Report - URN 00/656, available at <http://www.berr.gov.uk/whatwedo/businesslaw/co-act-2006/clr-review/page25086.html>.

¹³ This was a report of the Company Law Review Steering Group which preceded its Final Report - URN 00/1335, available at <http://www.berr.gov.uk/whatwedo/businesslaw/co-act-2006/clr-review/page25080.html>.

- it will provide greater clarity on what is expected of directors and make the law more accessible. We believe that this will in turn help to improve standards of governance...

- it will enable defects in the present law to be corrected in important areas where it no longer corresponds to accepted norms of modern business practice: this is particularly so in relation to the duties of conflicted directors and the powers of the company in respect of such conflicts... ; and

- it is a key element in addressing the question of “scope” – i.e. in whose interests should companies be run – in a way which reflects modern business needs and wider expectations of responsible business behaviour.

...

The need for clear, accessible and authoritative guidance for directors on which they may safely rely, on the basis that it will bind the courts and thus be consistently applied, combined with the need to clarify the law in the areas of uncertainty and to make good the defects, makes us all the more convinced that the case for a legislative restatement of directors’ duties, or codification, is well founded.”¹⁴

The purpose of the law on directors’ duties contained in sections 170 to 177 of the Act is twofold: -

- First, to codify the common law; and
- Second, to reform the common law.

The reform objective suggests that it is insufficient to rely on the old law. This is despite the terms of section 170(3) and (4) which provide as follows: -

“(3) 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.

¹⁴ “Modern Company law for a Competitive Economy: Final Report” at pages 40-41.

(4) 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.”

The Explanatory Notes to the Act state the following: -

“... subsection (3) of section 170 provides that the statutory duties are based on, and have effect in place of, certain common law rules and equitable principles... subsection (4) of section 170 provides that the general duties should be interpreted and applied in the same way as common law rules and equitable principles. The courts should interpret and develop the general duties in a way that reflects the nature of the rules and principles they replace...subsection (4) of section 170 also provides when interpreting and applying the statutory duties, regard should be had to the common law rules and equitable principles which the general duties replace; thus developments in the law of trusts and agency should be reflected in the interpretation and application of the duties.”¹⁵

Notwithstanding these statutory provisions and the proclamations in the Explanatory Notes, one’s suspicion is that there are two reasons for being wary of relying on the old law. First, it is clear that the list of duties does not offer a complete codification of the existing rules. This is partly due to simple gaps (such as the common law on (i) the misappropriation of assets and (ii) the duty of directors to consider the interests of creditors when insolvency is threatened, which are not separately addressed)¹⁶ and partly due to the nature of the duties in question. Second, the stated duties in the Act clearly go further than a simple restatement of the common law – section 172 of the Act is a prime example. Indeed, it is perhaps better to take a selective approach, whereby one treats the common law as being marginalised for the purposes of section 172, but that it may continue to command force as an interpretive tool in connection with sections 171, 173 and 174.

¹⁵ Para. 305.

¹⁶ In relation to these two issues – the ‘old’ common law will continue to apply.

Commentators have mused about the effect of the divergent objectives of the Act, namely codification and reform, remarking that a rush of litigation may ensue as a means of adding meaning and substance to the sections. In the end, the new law on directors' duties may mirror the old law. However, this is mere speculation at this stage. What is clear is that there is a tension between the twin aims of codification and reform, with the result perhaps being lesser clarity.

Another tension inherent within the statutory statement of directors' duties is that which exists between the Government's intention of securing (a) greater clarity and (b) flexibility. For example, the search for clarity has sometimes resulted in the duties being stricter than the common law, whether because of the content of the duties or the greater ease with which they are to be enforced (via the vehicle of the statutory derivative claim). Meanwhile, the demand for flexibility has resulted in certain provisions which are better suited to businesses, enabling them to authorise certain breaches, e.g. conflicts of interest.

Interpreting the Director's Duties

Since the directors' duties are contained in a new Act of Parliament, there will undoubtedly be difficulties and uncertainties as to how certain provisions ought to be construed. It is probably fair to say that the content, scope, nature and extent of the directors' duties are likely to be the provisions in the Act which generate the most disputes and litigation in practice. The main reason for this is that the duties are expressed at an extremely high level of generality.

The codification of the directors' duties in the Act is the culmination of 10 years' work by the Law Commission, The Company Review Steering Group, the Government and Parliament. Thus, in the case of a particular dispute concerning whether a director has breached his duties, the materials produced by each of these organisations will require to be closely dissected. Unfortunately, the degree and range of the interpretative documentation and the output of these bodies is truly staggering and the following documents will demand consultation: -

- Statement by Margaret Hodge, Minister of State for Industry and the Regions, giving guidance on directors' duties - the bulk of the ministerial statement

consists of selected (edited) extracts from Hansard which have been chosen to assist interpretation of the codified duties. See <http://www.dti.gov.uk/files/file40139.pdf>.

- The Explanatory Notes to the Act (available at <http://www.opsi.gov.uk/acts.htm>);
- Statements on the Bill as it progressed which are published in Hansard;
- The DTI Guidance Notes on the Bill – which are the ‘old’ Explanatory Notes to the Bill;
- The Reports of the Company Law Review Steering Group, namely *Developing the Framework*,¹⁷ *Completing the Structure*¹⁸ and its *Final Report*;¹⁹
- The Law Commission Report (Law Com 261; Scot Law Com 173; Cm4436), “Company Directors; Regulating Conflicts of Interests and formulating a Statement Duties”; and
- The UK Government White Papers 2002 and 2005.

What Philosophy Underpins the Duties?

This is really a discourse about a pivotal question which is endemic to the entirety of corporate law, namely ‘in whose interests should corporations be managed and run?’ The philosophy of ‘shareholder primacy’ was the traditional response of the common law, as espoused in classic cases such as *Percival v Wright*²⁰ and *Parke v Daily News*

¹⁷ This was a report of the Company Law Review Steering Group which preceded its Final Report - URN 00/656, available at <http://www.berr.gov.uk/whatwedo/businesslaw/co-act-2006/clr-review/page25086.html>.

¹⁸ This was a report of the Company Law Review Steering Group which preceded its Final Report - URN 00/1335, available at <http://www.berr.gov.uk/whatwedo/businesslaw/co-act-2006/clr-review/page25080.html>.

¹⁹ “Modern Company law for a Competitive Economy: Final Report” June 2001.

²⁰ [1902] 2 Ch. 421.

*Ltd.*²¹ In other words, companies are managed in the interests of the general fluctuating body of shareholders, past, present and future, directors owe duties to the company rather than any individual shareholder or outside constituency or class, that is to say duties are owed to the general fluctuating body of shareholders, past, present and future and the objective of the directors in managing the company is the maximisation of shareholder wealth. Needless to say, there are a number of criticisms which can be levelled at this shareholder primacy philosophy. The principal objection is allied to the increasingly important corporate social responsibility agenda and lobby, i.e. the agenda which seeks to rein in the considerable social and economic power of corporations by enjoining directors to take decisions for the benefit of other classes, such as employees. Here, the objection to this rabid wealth enhancement approach is that it fails to consider the interests of outside constituencies such as employees, creditors, suppliers, the general public and society at large, i.e. it is insufficiently pluralistic. In theory, where a director decides to allow toxic fumes to escape from the company's manufacturing factory, so long as that director is of the genuine belief that such a decision is in the best interests of the general body of shareholders, past, present and future, it is of no consequence that the decision resulted in the pollution of another factory adjacent to the company's premises for the purposes of ascertaining breach of duty in company law. Thus, the common law took the view that questions of the public good were not for company law to tackle. Another criticism of the shareholder primacy model is that it encourages short-term risk taking by directors at the expense of long-term corporate growth.

The alternative approach at the other extreme is the 'pluralistic' or 'stakeholder' approach. A good example of the pluralistic approach is evidenced by section 717(b) of the New York Business Corporations Law which is in the following terms: -

“In taking action, including, without limitation, action which may involve or relate to a change or potential change in the control of the corporation, a director shall be entitled to consider, without limitation, (1) both the long-term and the short-term interests of the corporation and its shareholders and (2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following:

²¹ [1962] Ch. 927.

- (i) the prospects for potential growth, development, productivity and profitability of the corporation;
- (ii) the corporation's current employees;
- (iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation;
- (iv) the corporation's customers and creditors; and
- (v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business.

In other words, the interests of outside constituencies who may be affected by corporate decision-making which has been taken by directors such as employees, customers, creditors, etc. are given the same priority as the company, i.e. the general body of shareholders, past, present and future. Thus neither takes priority over the other and so the directors must balance each of these considerations equally before making a decision. The concern is with the forging of a balance of interests, rather than any one particular interest taking precedence over the others.

Again, there are many objections to this pluralistic philosophy. But the main criticism is that any legal recognition of the importance of multiple interests in corporate decision-making serves to confuse directors and undermines the legitimacy of the law. As Easterbrook and Fischel argued: -

“A master told to serve two masters... has been freed of both and is answerable to neither. Faced with a demand from either group, the manager

can appeal to the interest of the other. Agency costs rise and social wealth falls.”²²

Thus, the effect of requiring a director to take into account the interests of multiple constituencies is self-defeating. It merely serves to undermine the whole purpose of imposing duties on directors in the first place, that is to say the eradication or minimisation of agency costs and self-dealing.

The UK Government decided to pursue a middle route. This was the ‘enlightened shareholder value’ approach. It is described by the Government in the following terms: -

“The Company Law Review considered and consulted on two main options. The first was “enlightened shareholder value”, under which a director must first act in the way that he or she considers, in good faith, would be most likely to promote the success of the company for its members...The Government agrees this is the right approach. It resolves any confusion in the mind of directors as to what that the interests of the company are, and prevents any inclination to identify those interests with their own. It also prevents confusion between the interests of those who depend on the company and those of the members.”²³

““enlightened shareholder value”... recognises that directors will be more likely to achieve long term sustainable success for the benefit of their shareholders if their companies pay attention to a wider range of matters...Directors will be required to promote the success of the company in the collective best interest of the shareholders, but in doing so they will have to have regard to a wider range of factors, including the interests of employees and the environment”²⁴

²² F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Massachusetts, Harvard University Press, 1991) 38.

²³ Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 255.

²⁴ Alistair Darling, Commons Second Reading, 6 June 2006, column 125.

The classic exposition of this ‘enlightened shareholder value’ approach is contained in section 172(1) of the Act which we consider below. The effect is that the primary duty of the directors is to consider that the decision they have taken is in the long-term interests of the company, but that the secondary duty owed by the directors is to certain outside constituencies. Thus, it is slightly different from the ‘shareholder primacy’ philosophy in that greater weight is placed on the importance of long-term strategic decision-making and some consideration, albeit secondary consideration, must be given to outside constituencies.

Who Owes the Duties?

This is fairly straightforward and is addressed in section 170(1) and (5): -

“(1) The general duties specified in sections 171 to 174 are owed by a director of a company to the company...

(5) The general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles so apply.”

Hence, de facto and shadow directors owe the duties.

To Whom are the Duties Owed?

See section 170(1) of the Act above. In other words, the duties are owed to the company as a whole, rather than the shareholders. Thus, only the company may enforce the duties – despite the outside constituencies identified in section 172(1) of the Act (director’s duty to promote the success of the company and have regard to the interests of others). However, section 172(3) of the Act provides that a director may owe duties to creditors in certain circumstances when it states: -

“(3) The duty imposed by this section [i.e. the duty of a director to act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole] has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.”

Thus, in the context of duties owed by directors to creditors, the common law will continue to apply.

Which Duties are Fiduciary in Nature?

Interestingly, unlike the common law, the statutory statement of directors' duties does not make a distinction between duties which are (i) fiduciary and (ii) non-fiduciary in nature. The reason for this is cited in the Company Law Review Steering Group's Report entitled *Completing the Structure* as follows: -

“The majority of responses took the view that there was no value in defining the duties as “fiduciary” so long as the intention of achieving substantial continuity with the present law is achieved. We accept this view... We believe that the relevant provisions can be drafted so that general principles of statutory interpretation will ensure that to the extent that they enact the common law the existing authorities will be capable of being invoked to explain the nature of the duties which they codify.”²⁵

Notwithstanding the lack of any distinction between fiduciary and non-fiduciary duties in the Act, it is extremely important to know within which of the fiduciary/non-fiduciary camps the duties fall. This is so, since if the duty is fiduciary, the remedies will be more extensive, since an aggrieved party will be able to seek an account of profits, i.e. gain-based damages. Not so in the case of a non-fiduciary duty. For this reason, the duties which are fiduciary in nature have been marked out in each of the headings below.

Duty No. 1: Section 171 Duty to Act within the Company's Powers – Fiduciary Duty

Section 171 of the Act provides that: -

“A director of a company must-

- (a) act in accordance with the company's constitution, and
- (b) only exercise powers for the purposes for which they are conferred.”

²⁵ Para. 3.12.

This duty is unlikely to be of wide application. The ‘company’s constitution’ is defined in section 17 of the Act²⁶ as (i) the company’s articles of association and (ii) any resolutions and agreements to which Chapter 3 of Part 3 of the Act applies. The effect of the reference in section 171 of the Act to the ‘company’s constitution’ is that there are potential risks for the unwary director who does not follow the progress of the decisions of the members by resolution. As for the duty to act for proper purposes, this is fact-specific. For example, the proper purpose of a rights issue is to raise capital, not to dilute the shareholding of a troublesome shareholder.

Duty No. 2: Section 172 Duty to Promote the Success of the Company – Fiduciary Duty

This is the overarching fiduciary duty owed by directors by virtue of the Companies Act 2006. It replaces the principal common law fiduciary duty to act in good faith in the interests of the company as a whole.²⁷ Section 172 of the Act provides as follows:

-

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

–

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company’s employees,
- (c) the need to foster the company’s business relationships with suppliers, customers and others,
- (d) the impact of the company’s operations on the community and the environment,

²⁶ Section 17 does not fully come into force until 1st October 2009, but came into force for the purposes of section 171 of the Act with effect from 1st October 2007.

²⁷ Having said this, the duty of a company to act in good faith in the interests of the company as a whole will continue to be relevant in the case of companies which are subject to the City Code on Takeovers and Mergers – see Principle 3 – “The board of an offeree company must act in the interests of the company as a whole”.

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.

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

The first point to make is that the subjective element to the director’s decision-making found in the common law (see *Re Smith & Fawcett Ltd.*)²⁸ has been retained by virtue of the words ‘in the way he considers, in good faith’ in section 172(1) of the Act. At common law, in relation to commercial decisions in general, the courts took the view that it would be wrong: -

“to substitute [their] opinion for that of the management, or indeed to question the correctness of the management’s decision ... if bona fide arrived at”.²⁹

This common law tradition has been preserved in section 172(1) of the Act. Therefore, on the face of these words, as long as the director acts in good faith, what matters is the director’s view, not that of the courts – and the courts will be unable to substitute their own judgment for that of the director. However, some commentators have argued that this is far too simplistic, posing the question as to how far the courts will interfere in the ‘good faith’ judgments of directors. There is an argument amongst practitioners that the objectivity introduced by section 174 of the Act (which concerns

²⁸ [1942] Ch. 304, 306 per Lord Greene M.R.

²⁹ *Howard Smith Ltd. v Ampol Petroleum Ltd.* [1974] AC 821, 832 (PC); *Re Tottenham Hotspur plc* [1994] BCLC 655, 660; *Runciman v Walter Runciman plc* [1992] BCLC 1084; and *Devlin v Slough Estates Ltd and others* [1983] BCLC 497, 504 per Dillon J: “The court does not interfere with the business judgment of directors in the absence of allegations of mala fides”. See also Cheffins, *The Theory, Structure and Operation of Company Law*, (Oxford, OUP, 1997) pp 312-314.

the director's duty to exercise reasonable skill, care and diligence)³⁰ may influence any examination of 'good faith' judgments by directors in connection with the duty to promote the success of the company under section 172. With regard to this argument, there is much to be sceptical. Duties of care, skill and diligence, which attract a mixture and objective and subjective assessments (and rightly so) should not be conflated with fiduciary duties (such as the duty to promote the success of the company) - and the introduction of objectivity into any assessment as to whether they have been breached, in my opinion, is unlikely to curry favour with the courts who one suspects will persist in their reluctance to disturb commercial decisions which have been taken honestly by directors. Traditionally, the courts have been reluctant to interfere in the business decisions of directors unless there is clear dishonesty or the decision is plainly an un-commercial decision. One can see no reason why this approach will not continue.

Second, what is meant by 'success'? When will a director be promoting the 'success' of the company? Here is what Lord Goldsmith had to say during the passage of the Act through Parliament: -

“What is success? The starting point is that it is essentially for the members of the company to define the objective they wish to achieve. Success means what the members collectively want the company to achieve. For a commercial company, success will usually mean long-term increase in value. For certain companies, such as charities and community interest companies, it will mean the attainment of the objectives for which the company has been established... For a commercial company, success will normally mean long-term increase in value, but the company's constitution and decisions made under it may also lay down the appropriate success model for the company... it is essential for the members of a company to define the objectives they wish to achieve, the normal way for that to be done – the traditional way – is that members do it at the time the company is established. In the old style, it would have been set down in the company's memorandum. That is changing... but the principle

³⁰ “... the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company...”

does not change that those who establish the company will start off by setting out what they hope to achieve. For most people who invest in companies, there is never any doubt about it – money. That is what they want. They want a long-term increase in the company. It is not a snap poll to be taken at any point in time... it is for the directors, by reference to those things we are talking about – the objective of the company – to judge and form a good faith judgment about what is to be regarded as success for the members as a whole... they will need to look at the company’s constitution, shareholder decisions and anything else that they consider relevant in helping them to reach that judgement... the duty is to promote the success for the benefit of the members as a whole – that is, for the members as a collective body – not only to benefit the majority shareholders, or any particular shareholder or section of shareholders, still less the interests of directors who might happen to be shareholders themselves. That is an important statement of the way in which directors need to look at this judgement they have to make.”³¹

The above is all well and good, but how a director is expected to ‘promote the success of the company’ in circumstances such as a takeover battle (where the current members will cease to have an interest going forward) or a winding up (where the company will cease to exist) remains clouded in mystery.

Third, the primary obligation of the director is to promote the success of the company. In other words, the interests of the company and its shareholders are paramount and the other six or more constituencies identified in subsection (1)(a) – (f) are subordinate. Hence, if a director takes a decision which is in the interests of the company, but contrary to the interests of one of the other constituencies, the director will not be in breach of duty. So long as a director can show that he did actually consider these statutory factors, even if he ultimately decided that they were less important than other factors, he will probably have discharged his duty.

³¹ Lord Goldsmith, Lords Grand Committee, 6 February 2006, columns 255 - 258, Hansard.

Fourth, there was some debate about what the import of the words ‘have regard to’ in section 171(1) were. Here is what Margaret Hodge, UK Government Minister, had to say: -

“The words “have regard to” mean “think about”; they are absolutely not just about ticking boxes. If “thinking about” leads to the conclusion, as we believe it will in many cases, that the proper course is to act positively to achieve the objectives in the clause, that will be what the director’s duty is. In other words “have regard to” means “give proper consideration to”... Consideration of the factors will be an integral part of the duty to promote the success of the company for the benefit of its members as a whole. The clause makes it clear that a director is to have regard to the factors in fulfilling that duty. The decisions taken by a director and the weight given to the factors will continue to be a matter for his good faith judgment.”

In certain circumstances, it is clear that there will be no need to ‘have regard to’ one or all of the six statutory factors. For example, in deciding whether to register the transfer of a share, it is unlikely that a director will have to worry about the effect this decision will have on the community, environment or employees! So, in some cases, some of the factors may be completely irrelevant. However, in having regard to the factors listed, the director’s duty in section 174 of the Act to exercise reasonable care, skill and diligence will apply. In other words, the director will have to meet the requisite standard of care (which is a mixture of objectivity and subjectivity) in considering the relevance of the listed factors. It is insufficient to pay lip service to these factors without giving the matter any great degree of thought.

If the directors fail to take into account a relevant factor in deciding to take a particular course of action, what are the practical consequences of this ‘omission’/‘breach’? In my opinion, the consequences will be minimal in the majority of cases. Why? There are three principal reasons: -

1. It will be extremely difficult for an aggrieved constituency to discover whether their interests were not considered by the director in coming to their decision. The current practice of board minutes with minimal coverage of the discussion leading up to decisions is likely to continue and to be treated as lawful – see

the approach of the GC100³² and what they consider to be best practice in light of the Companies Act 2006. As a result, barring successful discovery or commission and diligence proceedings in relation to briefing papers and other documents used by the board to form the decision, an aggrieved employee, member of the community, supplier or consumer is unlikely to have any way of actually knowing how the directors formed their decisions; and

2. There is no effective mechanism for a customer, supplier, employee, etc. to enforce their interest under section 172. Only the company can enforce the duty under section 172 (and all of the duties for that matter). Admittedly, they could buy shares in the company if it is listed and then raise statutory derivative proceedings under sections 265 to 269, but the court is likely to see right through such an attempt and refuse leave to continue with the proceedings. Alternatively, they could raise section 994 proceedings by petition procedure, but the court is unlikely (in most cases) to grant relief on the basis that (i) any 'unfair prejudice' occurred prior to the date of the acquisition of the shareholding and (ii) they have not been prejudiced by any breach of the director's duty under section 172 of the Companies Act 2006 qua member, but that they have only suffered unfair prejudice qua employee, supplier, customer, member of the community, etc.
3. Assuming that an aggrieved constituency can overcome the formidable obstacles at 1 and 2 above, they will require to demonstrate (i) that the decision which the directors took would have been different had their interests properly been taken into account and (ii) that the company has suffered loss as a result of the decision. Demonstrating (i) will be extremely difficult for evidential reasons and in the case of (ii) it will only be in an exceptional case that the company will have suffered loss where a director failed to consider the interests of the environment, suppliers, customers, employees, etc. in coming to a decision, but in taking that decision was convinced, in good faith, that the decision which he took was likely to promote the success of the company for the benefit of its members as a whole.

³² The GC100 are the 100 leading corporate counsel of the top 100 FTSE companies.

Thus, at most, it may well be that the importance of the failure of a director to consider the interests of such outside constituencies in taking a particular decision will be for internal purposes. In other words, a board may seek to take action against a director (to whom authority has been delegated for certain decisions) who fails to take into account the interests of customers, employees, suppliers, etc. in making a decision.

Fifth, if one looks at the statutory factors, one can see that they are extremely woolly concepts. For example, what is meant by the ‘need to foster the company’s business relationships with suppliers, customers and others’ and how can a director identify this? How is a director to know whether the company’s activities will have an impact on the community and the environment and what level of impact is relevant? A director is also under an obligation ‘to act fairly as between members of the company’. Does this duty require directors to take account of any interest a member may have and, if so, how are directors expected to establish what those interests are? Are they expected to take account of a member’s rights under the articles, or a shareholders’ agreement for that matter? There are real difficulties with these listed factors.

Sixth, what is meant by the words ‘(amongst other matters)’? This appears to mean that directors must have regard to all factors relevant to a decision in deciding whether a particular course of action will promote the success of the company: -

“... we have included the words “amongst other matters”. We want to be clear that the list of factors [for a director to have regard to] is not exhaustive”.³³

The upshot of this is that there is no hierarchy between the six matters set out above – and other factors which might have a bearing on the director’s decision – and indeed any or all of these statutory and non-statutory factors may conflict in a given case. However, it is for the board of directors to consider each of these matters, allocate sufficient weight to each of them as they deem appropriate and then decide which course of action is most likely to promote the success of the company.

³³ Lord Goldsmith, Lords Grand committee, 9 May 2006, column 846, Hansard.

Seventh, directors should be clear that one of the factors which they must have regard to is the long-term consequences of their decision. This is a departure from the common law to an extent which was predominantly concerned with the short-term consequences of decisions. The concern is that the Act does not provide any explanation to directors on how they are supposed to reconcile long-term and short-term interests where they are clearly incompatible with each other. A good example is provided by Attenborough in an article: -

“For example, a company in financial difficulties might accept a loan on disadvantageous terms, which solves its short-term problems, but this may create fresh problems in the long term. This is ostensibly going to be a difficult area for directors.”³⁴

Finally, the GC100 Group which represents the general counsel and company secretaries of the FTSE 100 companies, has issued guidance³⁵ which suggests that there is no reason for companies to document the decision-making process in any more detail than they currently do and, in particular no need to record negative statements in relation to factors considered to be irrelevant to any given decision. This appears to be consistent with the Government’s statement that the Act does not require a paper trail to demonstrate that the directors have considered the six listed factors.³⁶ However, it will important for directors to instil into their general approach to board decision-making and the formation of overall strategy a need to recognise and bear in mind those factors, and where briefing papers are produced prior to board decisions being taken, the contents of such board papers should reflect any one or more factors which may be relevant to the decision. Where the board of directors is

³⁴ Daniel Attenborough, “The Company Law Reform Bill: An analysis of directors’ duties and the objective of the company” (2006) 27(5) *The Company Lawyer* 162, 167.

³⁵ Please see the attached handout.

³⁶ See the statement of Lord Goldsmith that ‘[t]here is nothing in the Bill that says there is a need for a paper trail... I do not agree that the effect of passing the Bill will be that directors will be subject to a breach if they cannot demonstrate that they have considered every element. It will be for the person who is asserting breach of duty to make that case good...’ (Hansard, 9 May 2006, column 841).

taking a key decision to which any one or more of the listed factors is particularly relevant (for example, the effect of their decision on a takeover bid on the job prospects of a substantial portion of the company's workforce) or in potentially contentious situations or those where, because of the high-profile nature of the company or its business, there is likely to be wide scrutiny of the decision, the board may need to consider whether to minute the decision with extra care.

Duty No. 3: Section 173 Duty to Exercise Independent Judgment – Fiduciary Duty

The 'new' duty to exercise independent judgment codifies the current principle of law under which directors must exercise their powers independently, without subordinating their powers to the will of others, whether by delegation or otherwise (unless authorised by or under the constitution to do so). Section 173 is as follows: -

“(1) A director of a company must exercise independent judgement.

(2) This duty is not infringed by his acting-

(a) in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by its directors, or

(b) in a way authorised by the company's constitution.”

Section 172(2) replaces the common law duty that a director must not fetter his own discretion. However, the statutory duty to exercise independent judgment is not identical to the common law duty not to fetter one's discretion. It should be clarified that the duty to exercise independent judgment does not confer a power on the directors to delegate, nor does it prevent a director from exercising a power to delegate conferred by the company's constitution provided that its exercise is in accordance with the company's constitution. Under the draft model articles of association for private companies limited by shares,³⁷ the directors may delegate their functions in accordance with the articles.

³⁷ Which are available as the Companies (Model Articles) Regulations 2008 (available from <http://www.berr.gov.uk/files/file45533.doc>).

A failure to observe this duty can be authorised either by an agreement between the company and a third party or the company's constitution. Thus, the Act recognises that there may be circumstances in which the company has bound itself to a course of action which may fetter the discretion of the directors in the future and that this will not be unlawful (e.g. where a company and the directors enter into an agreement with a developer to support, and to refrain from opposing, planning applications by the developer for the development of land). It is likely that breaches of section 173 will run concurrently with section 172 (the duty to promote the success of the company) and section 175 (duty to avoid conflicts of interest) rather than establishing freestanding claims.

Consider nominee directors on the board of a company who vote in accordance with the instructions of their appointors. Will such directors be in breach of section 173 of the Act when they cast their vote at a board meeting or on a directors' resolution? Probably not, provided proper care is taken. For example, it is likely that appropriately crafted contracts (e.g. in the case of a director who is a bank nominee) or constitutions (e.g. (i) where a subsidiary company is being formed and a director acting as a nominee of the parent company is to sit on the board of the subsidiary and act and vote in accordance with the instructions of the parent company or (ii) where a joint venture company is being formed and a director acting as a nominee of one of the founding companies is to sit on the board of the joint venture company and act and vote in accordance with the founding company's instructions) will deal with the relevant issues as a means of avoiding litigation in the case of potential grey areas.

If a director simply follows external professional advice, will they be able to repel any argument that they have not discharged their duty to exercise independent judgment? Probably not. In the passage of the Act through Parliament, Lord Goldsmith had the following to say about the extent to which a director could rely on professional advice in discharging his duty to exercise independent judgment: -

“... the clause does not mean that a director has to form his judgement totally independently from anyone or anything. It does not actually mean that the director has to be independent himself. He can have an interest in the matter... It is the exercise of the judgement of a director that must be independent in the sense of it being his own judgement... The duty does not prevent a director

from relying on the advice or work of others but the final judgement must be his responsibility. He clearly cannot be expected to do everything himself. Indeed, in certain circumstances directors may be in breach of duty if they fail to take appropriate advice – for example, legal advice. As with all advice, slavish reliance is not acceptable, and the obtaining of outside advice does not absolve directors from exercising their judgement on the basis of such advice.”³⁸

Duty No. 4: Section 174 Duty to Exercise Reasonable Care, Skill and Diligence – Non-fiduciary Duty

There is no change from the common law in relation to this particular duty. In other words, the more rigorous approach to the director’s standard of care in *Re D’Jan of London Ltd.*³⁹ has been adopted, comprising a mixture of objective and subjective assessments of the director’s conduct. Section 174 provides as follows: -

“(1) A director of a company must exercise reasonable care, skill and diligence.

(2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with-

(a) the general knowledge, skill and experience that may reasonably be expected of person carrying out the functions carried out by the director in relation to the company, and

(b) the general knowledge, skill and experience that the director has.”

In the Explanatory Notes to the Act and during the passage of the Act through Parliament, it is/was expressly stated that the new law is modelled on the standard for

³⁸ Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 282, Hansard.

³⁹ [1993] BCC 646, 648 per Hoffmann LJ. This is in contrast to the orthodox position in *Re City Equitable Fire Insurance Co.* [1925] Ch. 407, 428 – 429 per Romer J, which was purely subjective and thus relatively straightforward for a director to discharge.

the purposes of wrongful trading in section 214 of the Insolvency Act 1986.⁴⁰ The hypothetical director thus sets the lowest acceptable standard but the actual director's skill, experience, expertise, knowledge and attributes can raise that particular threshold.

In applying their mind to decision-making, directors must bear in mind this duty. In other words, this duty will apply in connection with the duty to promote the success of the company under section 172 of the Act, i.e. to any good faith assessment as to which of the factors are relevant to a business decision and to what extent they need to be taken into account. If the good faith assessment turns out to be wrong, the decision could be open to challenge if the directors fail either the subjective or the objective test in section 174 of the Act, underlining the importance of taking the time to consider the list of statutory factors enumerated in section 172 of the Act.

In the heading to this duty above, it is stated that the duty to exercise reasonable care, skill and diligence is not a fiduciary duty. On what basis do is such an assertion made? Although it is of no legal effect, the following declaration from the Government is instructive (although, of course, the courts will be the final arbiters of the status of this duty): -

“... we take the view that the “duty to exercise reasonable care, skill and diligence” is not a fiduciary duty. It may be owed by someone who is a fiduciary. But that is not the same thing... it is important to keep to the

⁴⁰ In the Lords Grand Committee, Lord Goldsmith stated that “... the standard of care which a director owes is enormously important... it is now accepted that the duty of care... is accurately stated in Section 214(4) of the Insolvency Act 1986... Under the clause you take account both of the general knowledge, skills and experience that may be reasonably expected of a person carrying out those functions and the general knowledge, skills and experience that that director has. It is a cumulative requirement... I want to emphasise the point that it is not making a change from what is already the common law.” (Hansard, 6 February 2006, column 284).

principle that these are enforceable in the same way as any other fiduciary duty owed to the company by its directors.”⁴¹

Moreover, section 178(2), which relates to the mechanism for enforcement of a breach of the statutory duties provides as follows: -

“The duties in those sections (with the exception of section 174 (duty to exercise reasonable care, skill and diligence)) are, accordingly, enforceable in the same way as any other fiduciary duty owed to a company by its directors.”

Hence, it is expressly provided that section 174 is not enforceable in the same way as a fiduciary duty, which suggests that it is not a fiduciary duty.

The mixed subjective and objective standard applied to the director’s level of care and competence in the case of section 174 of the Act can be contrasted with the ‘business judgment’ rule which applies in the context of the duty of care and competence in the US State of Delaware which we will apply as a proxy for the entire United States of America. To recap, it is clear that section 174 of the Act functions in a manner whereby the objective test associated with the hypothetical director sets the lowest acceptable standard but the director’s actual skill, experience, expertise, knowledge and attributes assessed on a subjective basis can raise that particular threshold. Thus, the duty of care, skill, competence and diligence in UK law does not entail the application of a legal presumption. This can be contrasted with the business judgment rule applicable in the US. The business judgment rule can be conceptualised as a presumption that a business decision made by a director was reasonable and so

⁴¹ Lord Goldsmith, Lords Grand Committee, 9 February 2006, column 334, Hansard. While Lord Goldsmith’s statement that non-fiduciary duties are enforceable in the same way as fiduciary duties (i.e. by the company) is undoubtedly true, he underplays the importance of the fiduciary/non-fiduciary distinction, since the remedies available to the aggrieved party are greater in the case of fiduciary duties. In the case of a breach of a fiduciary duty, an aggrieved party also has the option to sue for disgorgement (i.e. an account) of profits and can thus obtain gain-based damages which are an exceptional remedy not available in the case of the enforcement of a non-fiduciary duty.

liability will not be established on the part of the director where the claimant suing the director cannot demonstrate that, in making the business decision, the director failed to act on an informed basis (in the sense that the director arrived at the decision after deliberating on the matter, exercising independent judgment and examining all of the reasonable facts reasonably available to him at the time of the decision), in good faith and in the genuine and honest belief that the action taken was in the best interests of the company. Hence, the business judgment rule consists of a series of presumptive or procedural steps which, if satisfied, relieve the director of liability.⁴² In the situation where the director is able to demonstrate that he is (i) disinterested, (ii) independent and (iii) informed (i.e. that he has taken the decision after deliberating on the matter, exercising independent judgment and examining all of the reasonable facts reasonably available to him at the time of the decision) that the director will benefit from the application of the presumption.⁴³ However, if the presumption is removed, it is incumbent on the court to enquire into the fairness of the director's decision. One of the dangers of the business judgment rule in the US – which does not arise in terms of the mixed subjective/objective formulation in section 174 of the Act – is that there is a tendency to treat a director as presumptively negligent in a cases where he is unable to establish that the presumptive standards (of (i) disinterest, (ii) independence and (iii) informed decision-making) have been satisfied.

Duty No. 5: Section 175 Duty to Avoid Conflicts of Interest – Fiduciary Duty

The UK Government decided to postpone the coming into force of section 175 (duty of directors to avoid conflicts of interest) of the Act to 1st October 2008. Section 175 of the Act must be distinguished from sections 176, 177 and 182-187 of the Act. Sections 175 of the Act governs all conflicts of interest which a director may have with the exception of: -

⁴² Hence, there is an argument that the focus of the business judgement rule is more on the rationality, rather than the reasonableness, of the director's decision in the sense that it tends to sway more towards an enquiry as to whether no rational director would have acted in the way that the director at hand did.

⁴³ See *Smith v Van Gorkom* (1985) 488 A. 2d 858.

- (a) a situation where the director is in receipt of a benefit from a third party in his/her capacity as a director – this is specifically governed by section 176 of the Act;
- (b) a situation where the conflict of interest amounts to a proposed transaction or arrangement between the director and the company – this is specifically governed by section 177 of the Act;⁴⁴
- (c) a situation where the conflict of interest amounts to an existing transaction or arrangement between the director and the company – this is specifically governed by sections 182-187 of the Act;⁴⁵ and
- (d) a situation where the conflict of interest amounts to the director selling or acquiring a ‘substantial property’ to or from the company – this is specifically dealt with by sections 190-196 of the Act.

Section 175(1) stipulates that a director 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 GC100 issued a publication providing guidance on directors’ conflicts of interest on 18th January 2008 (see document circulated)⁴⁶ which

⁴⁴ Indeed, section 175(3) provides that the duty to avoid a conflict of interest does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company.

⁴⁵ Indeed, section 175(3) provides that the duty to avoid a conflict of interest does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company.

⁴⁶ In August 2008, the GC100 also published a members’ pack on directors’ conflicts of interest containing (a) a checklist for company secretaries of member companies to ensure the directors will be in compliance with the law coming into force on 1st October 2008, (b) a short briefing note for directors setting out the new statutory duty to avoid conflicts of interest and other statutory duties that come into force on 1st October 2008 and (c) a questionnaire for directors to assist them with the identification of conflicts which will require subsequent authorisation by the company’s board of directors.

provides that ‘an example of an indirect interest would be where a director represents a major shareholder in the company whose interests conflict with those of the company.’ The Act does not define what is meant by ‘interest’ or ‘conflict of interest’. It is suggested that the following are some of the more common examples of conflicts:

-

- Circumstances in which the director has commercial interests competing with those of the company or which may be prejudiced by the company’s activities;
- The situation of cross or multiple directorships, i.e. circumstances in which a director is on the board of a major shareholder of the company (e.g. a holding company) or the actual or potential competitor, supplier or client of the company;
- Where a director has a role with one of the company’s advisers or competitors, this may amount to a conflict of interest;
- Circumstances where the director is a significant shareholder in, or is himself, a major shareholder or an actual or potential competitor, supplier or client of the company;
- The situation where a director wishes to take up an opportunity which has been offered to, but declined by, the company (see below);
- Where it is unclear in what capacity an opportunity has been offered to a director, (i.e. on a personal basis, as a director of the company or as a director or shareholder of another company) this may amount to a conflict of interest;
- Circumstances where the director also acts as a director of the company’s pension trustee company or a trustee of the pension fund;
- Where a director makes personal use of information, property or opportunities owned by the company, this may amount to a conflict of interest;
- Circumstances in which a potential purchaser of the company approaches a director and the director is offered a role with the purchaser’s group;
- The situation where a director makes a profit in the course of being a director without the approval or knowledge of the company; and
- Where, in any of the above situations, the director is a director of another company and that other company or a member of the director’s family has the relevant relationship with the company or is in the situation described.

Subsection (2) states that the duty ‘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).’ Thus, the common law corporate opportunity doctrine has been codified. The words in parentheses are very important. They codify the rule in *Regal Hastings (Ltd.) v Gulliver*⁴⁷ that any defence by a director that the company could not take up the opportunity is not allowed. This is perhaps unfortunate as it is arguably bad for the economy that directors are deprived from taking advantage of corporate opportunities which, for one reason or another, are not available to the companies which they serve. Indeed, it means that the economy is ultimately deprived of the benefits arising in terms of productivity from the exploitation of the opportunity. Moreover, there is no need for a link between the conflict of interest and the influence which the director has over the board, i.e. it is immaterial that the director has little influence over decision-making of the board as a pre-requisite for a conflict of interest to arise.

The general rule is subject to two exceptions which are listed in section 175(3) of the Act, the second of which is the most relevant in practical terms: -

1. if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest, the duty is not breached; and
2. if the matter has been authorised by the directors *in advance*, the duty is not breached.

In practice, for obvious reasons, directors will be keen to avoid having to rely on 1. above. However, before we move on to consider the practically more important 2., it is worth considering the effect of 1. on the words in parentheses in section 175(2). Here, there seems to be an internal contradiction in the law, since if the company cannot take advantage of the property, information or opportunity exploited by the director, then surely this ‘cannot reasonably be regarded as likely to give rise to a conflict of interest’ – yet section 175(2) states that the inability of the company to

⁴⁷ [1967] 2 AC 134n; [1942] 1 All ER 378. See also *Bhullar v Bhullar* [2003] 2 BCLC 241, 256 at para. [41] per Jonathan Parker LJ where the same point is made.

exploit that property, information or opportunity is not ‘immaterial’. There is an argument that this makes no sense at all, although one could argue that much depends on what is meant by ‘conflict of interest’ which, as we have seen, is not defined in section 175 of the Act.

Moving on to 2. above, for the purposes of private companies, the effect of the combination of section 175(5)(a) of the Act and paragraph 47(3) of Schedule 4 to the Companies Act 2006 (Commencement No. 5, Transitional Provisions and Savings) Order 2007 (SI 2007/3495) (“the Fifth Commencement Order”) is that a distinction must be made between companies incorporated before 1st October 2008 and those incorporated after 1st October 2008. In the case of private companies incorporated before 1st October 2008, they must pass an ordinary resolution of the shareholders to permit authorisation of the director’s conflict of interest by the board. Alternatively, a pre-1st October 2008 incorporated private company may alter its articles to empower such authorisation. As for private companies formed after 1st October 2008, they are entitled to exploit section 175 of the Act without taking any further action, unless the articles include a contrary provision. Private companies – whatever the date of formation of the company – must also be satisfied that their articles contain no provision which invalidates the authorisation of conflicts by directors and so they may wish to alter their articles to deal with conflicts of interest.

The case of the plc is governed by section 175(5)(b) of the Act which stipulates that authorisation may be given by the directors where the company is a plc and its articles include provisions enabling the directors to authorise the conflict. Therefore, plcs will require to change their articles to empower the directors to authorise conflicts where no such stipulation is contained in their articles.

It is important to stress that authorisation in respect of private companies or plcs cannot be given retrospectively. On another note, ICSA⁴⁸ recommends that: -

“... each director should consider if he or she has a conflict of interest through a connected person. Therefore it is important that the director informs those

⁴⁸ The Institute of Chartered Secretaries and Administrators in the UK.

individuals that would be regarded as connected persons. A list defining connected persons can be found in section 252 of the Act (essentially these are certain family members, certain companies with which the director is connected, trustees of a trust, certain partners and certain firms with legal personality).”⁴⁹

Section 175(6) of the Act states that the authorisation is effective only if 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 the matter was agreed to without their voting or would have been agreed to if their votes had not been counted.⁵⁰ For obvious reasons, this rule poses problems for companies with sole directors. In such circumstances, the sole director would not be able to authorise a potential conflict but the members could be asked to authorise it. The position is the same where there are no uninterested directors on the board of directors.

Where it is practicable for the interests that may amount to a conflict of interest to be authorised by the shareholders, this is likely to be preferable to authorisation by the board in the majority of cases. However, for obvious reasons, this will not be practicable in the case of a plc or a listed company where shareholder ownership is widely dispersed. Nevertheless, the company law sub-committee of the City of London solicitors prepared a pro forma circular for listed companies which amends the articles of association of listed companies.⁵¹ One of the benefits of obtaining shareholder consent to the directors’ conflict of interest is that shareholder approval avoids the necessity for the directors to be concerned about the application and exercise of their fiduciary duties. Moreover, if all of the directors have a similar conflicting interest, one wonders whether they can properly authorise each others’

⁴⁹ Paragraph 3.5.3 of ICSA ‘Guidance on Directors’ General Duties’, Reference Number 080102 – see <http://www.zoomerang.com/Survey/survey-intro.zgi?p=WEB227BLF2A2BG>.

⁵⁰ Where a conflict arises in respect of matters which are of importance to the company, the conflicted directors ought to consider obtaining independent advice.

⁵¹ Available from <http://www.citysolicitors.org.uk/FileServer.aspx?oID=411&IID=0>.

interests. Situations giving rise to conflicts can be authorised by the articles of association. A standard feature of articles in the past has been a list of permitted interests. In essence, the best way for a director to avoid a breach of this fiduciary duty is for the relevant conflict to be ratified by the shareholders by ordinary resolution in terms of section 239 of the Act.

Duty No. 6: Duty Not to Accept Benefits from Third Parties – Fiduciary Duty

Like section 175 of the Act, the Government decided to postpone the coming into force of section 176 (duty of directors not to accept benefits from third parties) of the Act to 1st October 2008. Section 176 of the Act sets out a duty on a director not to accept a benefit from a third party that is conferred by reason of his position as a director or his doing or not doing anything as a director. A third party is defined as a person other than the company, an associated body corporate or a person acting on behalf of the company or an associate body corporate. Acceptance of such a benefit is only permitted if it is authorised in advance by the members by ordinary resolution or if it cannot reasonably be regarded as likely to give rise to a conflict of interest. So, unlike section 175, benefits received from third parties cannot be authorised by the board, but, it will be appropriate to review policies concerning gifts or corporate hospitality. Section 176(3) stipulates that benefits received by a director from a person by which his services (as a director or otherwise) are provided by the company are not regarded as conferred by a third party.

This duty has raised certain alarm as to whether innocent corporate hospitality has been outlawed. Essentially, what is important is the nature and extent of the benefit received, including matters such as the circumstances in which it is received and whether it can be said to involve a conflict. The guidance of ICSA is particularly useful here, as follows: -

“This duty has opened up some interesting debates on how far these ‘benefits’ may extend. Some benefits are easily identified, such as financial rewards or money’s worth such as tickets to prestigious sporting or cultural events. Questions have been raised too as to how far this duty will cover the giving or receipt of corporate hospitality. Whether the giving or receipt of corporate

hospitality may be considered as creating a conflict of interest should be decided according to the context in which it is given or received. The following situations may be considered:

- If a director is currently involved in negotiating a new contract with another person or company and that party offers corporate hospitality it may be considered to infringe this duty, although it would depend on what was the ‘norm’ and whether it was excessive within the particular environment.
- Proportionate and defensible policies should be developed which outline how to deal with benefits offered by or received from third parties and which state what levels of corporate entertainment are significant for this policy or which need prior authorisation. The policies (including any updates) should be approved by the board, perhaps on a recommendation from the audit committee. All relevant employees and contractors should be informed of the policy and any updates and, for the company’s protection, required to sign a receipt and acknowledgement to study and comply with the terms of the policy and any updates to it. Those forms of receipt and acknowledgement should be filed carefully at a central point, such as on each employee’s personnel file.
- It is good practice to set up a register of benefits offered and received above whatever level is decided on by the board. It is suggested that the company secretary should report annually to the audit committee on compliance and issues arising.
- The Institute of Business Ethics provides practical guidance which directors and company secretaries can use to develop policies and codes of conduct for their organisations – www.ibe.org.uk/codesofconduct.html.⁵²

⁵² Paragraph 3.6.5 of ICSA ‘Guidance on Directors’ General Duties’, Reference Number 080102 – see <http://www.zoomerang.com/Survey/survey-intro.zgi?p=WEB227BLF2A2BG>.

Therefore, recommended guidance suggests that it would be most prudent for companies to set their own limits and parameters as to what constitute acceptable and unacceptable benefits in a formal policy document. This ought to be approved by the board. Whenever a director obtains a benefit, it is recommended that shareholder approval be obtained prior to the receipt of the benefit in terms of an ordinary resolution under section 239 of the Act. The alternative, which is perhaps more attractive, is to persuade the shareholders to pass a special resolution altering the articles of association which empowers the directors to receive benefits. What is an acceptable or unacceptable benefit would be defined in the articles of association.

Duty No. 7: Duty to Declare Interest in Proposed Transaction or Arrangement – Fiduciary Duty

Like sections 176-177 of the Act, the Government decided to postpone the coming into force of section 177 (duty to declare interest in proposed transaction or arrangement with the company) of the Act to 1st October 2008. Section 177(1) of the Act provides that if a director 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. Where section 177 of the Act applies, the directors do not require to comply with section 175. In terms of section 177(4) of the Act, such a declaration must be made before the company enters into the transaction or arrangement and section 177(2) states that the declaration may be made at a board meeting, by notice in writing to the directors in terms of section 184 of the Act or general notice in accordance with the stipulations in section 185 of the Act. Any failure of the director to make such a declaration amounts to a breach of fiduciary duty – it is not a criminal offence⁵³ - and so the director may be liable to the company for any profits generated in terms of section 178 of the Act. Section 177(3) of the Act contains a provision to the effect that if a declaration of interest made proves to be, or becomes, inaccurate, a further declaration is required. For a proposed arrangement, this is only necessary if the company has not yet entered into it. By virtue of section 177(5) of the Act, a director is under no obligation to disclose facts

⁵³ This can be contrasted with the duty to declare an interest in an existing transaction or arrangement under section 182. Here, any failure to make a declaration is a criminal offence in terms of section 183 of the Act.

of which the other directors should already know or ought reasonably to be presumed to know. If a director becomes aware that some of the information declared is not accurate or complete before the transaction or arrangement has taken place, he or she must ensure that he or she corrects the initial declaration so that it is accurate. Moreover, the duty to declare an interest stretches to interests of the director's connected persons, at least where the director ought reasonably to be aware of them. So the duty may still apply even if the director is not party to the transaction or arrangement, e.g. if the director's spouse would be entering into the transaction or arrangement, the director may need to declare an indirect interest in the transaction.

Section 177 can be contrasted with section 317 of the Companies Act 1985 to the effect that a director must declare not only the nature but also the extent of the interest. However, in practice, the articles of association of many companies already require those companies to make disclosure of the extent as well as the nature of permitted interests.

In terms of the transitional provisions in paragraph 48(2) of Schedule 4 to the Fifth Commencement Order, section 317 of the Companies Act 1985 continues to apply if the duty to declare the interest arose prior to 1st October 2008. Thus, interests in current or proposed transactions with the company which exist immediately before 1st October 2008 but have not already been declared should be declared in accordance with section 317. Any failure to make a declaration under section 317 of the Companies Act 1985 is a criminal offence.

In terms of section 177(6) of the Act, there are a number of exceptions where the duty to declare an interest in a proposed transaction does not apply as follows: -

1. As stated above, if the director is not aware of the interest or where the director is not aware of the transaction or arrangement in question (for these purposes directors are treated as being aware of matters of which they ought reasonably to be aware);
2. where the transaction or arrangement cannot reasonably be regarded as likely to give rise to a conflict of interest;

3. if, or to the extent that, the other directors are already aware of it (for these purposes they are treated as being aware of anything of which they ought reasonably to be aware); or
4. if, or to the extent that, it concerns terms of the director's 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 constitution.

The default position that shareholder approval is required for such declarations will be reversed, although in practice many companies already remove the need for members' approval by appropriate wording in their articles. Conversely, some companies may wish to retain shareholder approval for such a procedure.

Duty No. 8: Duty to Declare Interest in Existing Transaction or Arrangement – Non-fiduciary Duty, but Criminal Offence

Like sections 175-177 of the Act, the Government decided to postpone the coming into force of sections 182 to 187 (duty of directors to declare interest in existing transaction or arrangement with the company) of the Act to 1st October 2008. In terms of section 182 of the Act, it is provided that if a director is in any way, directly or indirectly, interested in an existing transaction or arrangement entered into by the company, he must⁵⁴ declare the nature and extent of that interest to the directors (i) at a board meeting, (ii) by notice in writing in terms of section 184 or (iii) by general notice in terms of section 185, as soon as is reasonably practicable. Any failure to make a declaration of such an existing transaction or arrangement is a criminal offence.

In terms of the transitional provisions in paragraph 50 of Schedule 4 to the Fifth Commencement Order, section 317 of the Companies Act 1985 continues to apply in relation to existing transactions or arrangements arising prior to 1st October 2008. For the purposes of section 182(1) of the Act, where an interest in an existing transaction

⁵⁴ Contrast this obligation with section 177(2) of the Act in the case of a proposed transaction or arrangement, to the effect that the manner of the declaration is permissive, i.e. the word 'may' is deployed.

was not previously declared under section 177 of the Act, paragraph 50(3) of Schedule 4 to the Fifth Commencement Order stipulates that a declaration of interest made before 1st October 2008 under section 317 of the Companies Act 1985 is treated on and after that date as if it was made under section 177 of the Act. Meanwhile, for the purposes of section 182(3) of the Act, where a previous declaration under section 182(3) of the Act proves to be, or becomes, inadequate, paragraph 50(4) of Schedule 4 to the Fifth Commencement Order provides that a declaration of interest made before 1st October 2008 under section 317 of the Companies Act 1985 is treated on and after that date as if it were made under section 182 of the Act. Any failure to make a declaration under section 317 of the Companies Act 1985 is a criminal offence.

Again, section 182(5) and (6) of the Act provides for situations where a director does not require to make disclosure as follows: -

1. If the director is not aware of the interest or where the director is not aware of the transaction or arrangement in question (for these purposes directors are treated as being aware of matters of which they ought reasonably to be aware);
2. where the transaction or arrangement cannot reasonably be regarded as likely to give rise to a conflict of interest;
3. if, or to the extent that, the other directors are already aware of it (for these purposes they are treated as being aware of anything of which they ought reasonably to be aware); or
4. if, or to the extent that, it concerns terms of the director's 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 constitution.

In the case of sole directors, disclosure is not generally required where the company only has one (and is permitted to have a sole) director. However, where there is a sole director of a company that is required to have more than one director, a declaration must be recorded in writing in accordance with section 186(1) of the Act. It is also worth noting that a director must also make a declaration under section 182 where a declaration has previously been made under section 177 of the Act. This stands to

reason since many proposed transactions or arrangements will become existing transactions.

As mentioned above, section 184 of the Act enables directors to declare an interest in an existing transaction or arrangement with the company by notice in writing. Section 184(2) states that the directors must send such notice to the other directors where they purport to make their declaration in terms of section 184. A section 184 notice may be sent in hard copy or electronic form by hand, by post or by agreed electronic means. Where a director declares an interest by notice in writing in accordance with section 184, the making of the declaration forms part of the proceedings at the next meeting of the directors after the notice is given and the provisions of section 248 of the Act (minutes of meeting of directors) apply as if the declaration had been made at that meeting.

The alternative provision, i.e. the provision of general notice, is detailed in section 185 of the Act. The main difference between the section 185 general notice and the section 184 notice in writing is that the former does not involve the production of written notice whereas the latter does. Section 185(2) of the Act states that general notice is notice given to the directors of a company to the effect that the director: -

- (a) has an interest (as member, officer, employee or otherwise) in a specified body corporate or firm and is to be regarded as interested in any transaction or arrangement that may, after the date of the notice, be made with that body corporate or firm, or
- (b) is connected with a specified person (other than a body corporate or firm) and is to be regarded as interested in any transaction or arrangement that may, after the date of the notice, be made with that person.

In terms of section 185(3) of the Act, the notice must state the nature and extent of the director's interest in the body corporate or firm or, as the case may be, the nature of his connection with the person. The general notice must be given at a meeting of the directors or the director must take reasonable steps to secure that the general notice is

brought up and read at the next meeting of the directors after it is given. Otherwise, the general notice is deemed to be ineffective.

Relationship Between the Directors' Duties

Is there a hierarchy of duties, with one or others demanding priority over any of the others in a particular case where more than one of the duties is relevant? Section 179 of the Act provides as follows:-

“Except as otherwise provided, more than one of the general duties may apply in any given case.”

On the face of it, one would assume that section 172 is the primary duty, commanding overlordship over the remaining six of the seven duties. Indeed, a number of practitioners commentating on the Act have adopted this line. The reason for this is that it is clear that the duty to promote the success of the company captures the imperative duty of loyalty which goes to the heart of the fiduciary relationship arising between the company and its directors. Notwithstanding the views of eminent commentators that section 172 is the first among equals, I am not convinced. The Explanatory Notes to the Act suggest that no one duty should be thought of as superior or inferior to any other in a case where the duties appear to conflict: -

“Many of the general duties will frequently overlap. Taking a bribe from a third party would, for example, clearly fall within the duty not to accept benefits from third parties (section 176) but could also, depending on the facts, be characterised as a failure to promote the success of the company for the benefit of its members (section 172) or as an aspect of failing to exercise independent judgment (section 173)... The effect of the duties is cumulative, so that it is necessary to comply with every duty that applies in any given case. This principle is stated in section 179... The cumulative effect of the duties means that where more than one duty applies, the director must comply with each applicable duty, and the duties must be read in this context. So, for example, the duty to promote the success of the company will not authorise the director to breach his duty to act within his powers, even if he considers that it would be most likely to promote the success of the company. As well as

complying with all the duties, the directors must continue to comply with all other applicable laws. The duties do not require or authorise a director to breach any other prohibition or requirement imposed on him by law.”⁵⁵

Thus, where a decision taken is likely to promote the success of the company but will breach another of the duties, the authority of section 172 will not operate to cure the breach of the other duty. This quite clearly means that section 172 cannot be viewed as a primary duty in such a case.

Nevertheless, there is an argument amongst commentators that the duty to promote the success of the company in section 172 will be elevated in particular situations to operate as a ‘tie-breaker’, e.g. where a course of action adopted by a director breaches one of the other duties (e.g. section 171) yet is nevertheless compliant with one of the other duties (e.g. section 173). In such a scenario, there may be a possibility that the courts will use section 172 as a yardstick by which to judge the director’s decision.⁵⁶ If this argument is correct, then in this particular scenario section 172 could be seen as a primary duty. However, I am sceptical of this argument, since if a duty has been breached, yet the decision resulting in such breach is nevertheless compliant with the director’s duty to promote success, I still cannot see a court relieving the director of liability. A duty has been breached, so surely the director is liable notwithstanding that the decision promotes the success of the company?

The upshot of all this is that directors will require to exercise great care in taking decisions where more than one of the duties is relevant.

Relationship Between the Directors’ Duties and the Company’s Constitution

Under section 171 of the Act, a director must act in accordance with the company’s constitution. However, companies may, through their articles of association, go further than the statutory duties by placing more onerous requirements on their directors (e.g. by requiring shareholder authorisation of the remuneration of the directors). The articles may not dilute the duties except to the extent that this is

⁵⁵ Paras. 311 – 314.

⁵⁶ This has been suggested by some commentators, but there is nothing in the Act, Hansard or the Explanatory Notes to substantiate it.

permitted by the following sections of the Act which came into force on 1st October 2007: -

- Section 173 provides that a director will not be in breach of the duty to exercise independent judgment if he has acted in a way that is authorised by the constitution;
- Subsection (4)(a) of section 180 preserves any rule of law enabling the company to give authority for anything that would otherwise be a breach of duty;
- Subsection (4)(b) of section 180 provides that a director will not be in breach of duty if he acts in accordance with any provisions in the company's articles for dealing with conflicts of interest;
- Section 232 places restrictions on the provisions that may be included in the company's articles. However, nothing in that section prevents companies from including in their articles any such provisions as are currently lawful for dealing with conflicts of interest.

Remedies for Breach of Directors' Duties

Section 178 of the Act provides as follows: -

“(1) The consequences of breach (or threatened breach) of sections 171 to 174 are the same as would apply if the corresponding common law rule or equitable principle applied.

(2) The duties in those sections (with the exception of section 174 (duty to exercise reasonable care, skill and diligence)) are, accordingly, enforceable in the same way as any other fiduciary duty owed to a company by its directors.”

In the case of fiduciary duties (i.e. all of the statutory duties with the exception of sections 174 and 182-187 of the Act), the consequences of breach may include: -

- Damages or compensation where the company has suffered loss;
- Restoration of the company's property;
- An account of profits made by the director, i.e. gain-based damages; and

- Rescission of a contract where the director failed to disclose an interest.

Thus, the common law continues to apply. In the case of a breach of section 174, only the remedy of damages will be available and the others are irrelevant.

Ratification

The company may wish to ratify a director's conduct where that amounts to a breach of duty. Section 239 of the Act permits this. Nevertheless, there are certain anti-avoidance provisions. Any votes held by a director in breach, or any member connected with him, are not to be taken into account. Bodies corporate in which the director and any persons connected with him together have broadly a 20% interest in the equity or the voting rights are connected with a director for this purpose. Ratification may not be possible where a holding company is asked to ratify the acts of a director of its subsidiary company and the director has a material interest in the holding company.

Moreover, in the recent decision of the High Court in England in *Franbar Holdings Ltd. v Patel*,⁵⁷ it was held that the wording of section 239(7) of the Act is ineffective to exclude the common law of ratification. Therefore, the following acts are not ratifiable by the company: -

- Acts which are *ultra vires* the company in the strict sense; and
- Any other acts which, pursuant to any common law rule of law, are incapable of being ratified for some other reason, e.g. acts of the directors of the company which are so bad that it is clear that they cannot be ratified by the shareholders. A good example is provided by the case of *Cook v Deeks*⁵⁸ where the directors of a company diverted in their own individual favour business which should properly have been given to, and belonged to, the company of which they were directors.

In other words, the old common law rules on the ratifiability of conduct taken by the directors continue to apply.

⁵⁷ [2008] EWHC 1534 (Ch); [2008] All ER (D) 14 (Jul).

⁵⁸ [1916] 1 AC 554.

The Regulation of Substantial Property Transactions

Sections 190 to 196 of the Act replace sections 320 to 322 of the Companies Act 1985. They require members' approval to substantial property transactions by ordinary resolution, i.e. transactions where the company sells or buys a substantial non-cash asset to or from:

- A director of the company;
- A director of a company's holding company;
- A person connected with a director of the company; or
- A person connected with a director of the company's holding company.

Where the director or connected person is a director of the company's holding company or a person connected with such a director, the arrangement must also have been approved by a resolution of the members of the holding company or be conditional on such approval being obtained. With regard to the identity of persons who are 'connected persons', the new rules in the Act cover a director's civil partner and adult children and step-children, the director's parents, a person living with the director 'as partner in an enduring family relationship' and any children or step-children under 18 of such a person who are not also the director's children or step-children.

The main difference between section 190 of the Act and the corresponding provisions in the Companies Act 1985 is that a company is permitted to enter into a contract which is conditional on member approval. This contrasts with the requirements of the Companies Act 1985 which provide that members' approval is required before the contract is signed. It implements a recommendation of the Law Commissions and the effect is that the company is not to be held liable under the contract if member approval is not forthcoming.

Section 1163 of the Act provides that a 'non-cash asset' means any property or interest in property, other than cash. Section 191 defines a 'substantial non-cash asset' as an asset whose value (i) exceeds 10% of the company's asset value and is more

than £5,000⁵⁹ or (ii) exceeds £100,000. 'Asset value', in turn, is defined as (i) the value of the company's net assets determined by reference to its most recent statutory accounts, or (ii) if no statutory accounts have been prepared, the amount of the company's called-up share capital.

The consequences of failing to comply with section 190 are purely civil in nature by virtue of the terms of section 195 of the Act – NB the absence of criminal penalties. Thus, the arrangement, and any transaction entered into in pursuance of the arrangement is voidable at the instance of the company, unless-

- Restitution of any money or other asset that was the subject matter of the arrangement or transaction is no longer possible,
- The company has been indemnified in pursuance of section 195 of the Act by any other persons for the loss or damage suffered by it, or
- Rights acquired in good faith, for value and without actual notice of the contravention by a person who is not a party to the arrangement or transaction would be affected by the avoidance.

Whether or not the arrangement or any such transaction has been avoided, each of the following persons is liable (i) to account to the company for any gain that he has made directly or indirectly by the arrangement or transaction, and (ii) (jointly and severally) to indemnify the company for any loss or damage resulting from the arrangement or transaction: -

- Any director of the company or its holding company with whom the company entered into the arrangement in contravention of section 190 of the Act,
- Any person with whom the company entered into the arrangement in contravention of section 190 of the Act who is connected with a director of the company or its holding company,
- The director of the company or of its holding company with whom any such person is connected, and
- Any other director of the company who authorised the arrangement or any transaction entered into in pursuance of such an arrangement.

⁵⁹ Note the change here from £2,000 contained in the Companies Act 1985.

It is important to note that a director will not be liable in terms of the third bullet point above if he can demonstrate that he took all reasonable steps to secure the company's compliance with section 190 of the Act. Moreover, where a transaction or arrangement is entered into by a company in contravention of section 190 of the Act but, within a reasonable period, it is affirmed by ordinary resolution of the members of the company and/or the members of the company's holding company (if applicable), then the transaction or arrangement may no longer be avoided under the rules outlined above.

Other differences between the Act and the Companies Act 1985 are as follows: -

- Provision is made for the aggregation of non-cash assets forming part of any arrangement or series of arrangements for the purpose of determining whether the financial thresholds have been exceeded so that member approval is required – see section 190(5) of the Act;
- Payments under directors' service contracts and payments for loss of office are excluded from the requirements of these sections (section 190(6) of the Act) – which was a recommendation of the Law Commissions;
- Exceptions for transactions with members have been expanded to include the acquisition of assets from a person in his capacity as a member of the company – section 192(a);
- As noted above, the scope of persons caught by the 'connected persons' test has been considerably expanded; and
- No approval is required on the part of the members of a company that is in administration or is being wound up (unless it is a members' voluntary winding-up) – see section 193.

Contracts with Sole members who are Directors

Section 231 of the Act applies to the situation where a limited company having only one member enters into a contract with the sole member - which is not in the ordinary course of business of the company. Here, the company must, unless the contract is in writing, ensure that the terms of the contract are either: -

- set out in a written memorandum; or

- recorded in the minutes of the first meeting of the directors of the company following the making of the contract.

Any failure to comply with section 231 of the Act is a criminal offence, but the contract is not deprived of validity.

C. STATUTORY DERIVATIVE PROCEEDINGS

The Act provides that the general duties of directors are owed to the company, rather than to individual members – see section 170(1) of the Act. It follows that, as now, only the company can enforce them provided that loss has been suffered by the company as a result of the breach. There are currently three main ways in which the company can take legal action against a director (or more commonly, a former director) for breach of duty: -

- If the board of directors decides to commence proceedings;
- If the liquidator or administrator following the commencement of a formal insolvency procedure such as liquidation or administration decides to commence proceedings; or
- A derivative claim or action brought by one or more of the members to enforce a right which is vested not in himself, but in the company.

In this part, we are concerned with the last of these avenues.

With regard to derivative proceedings in Scotland, the current position is that the member's right to raise such proceedings is conferred by the common law. Therefore, a member has title as a matter of substantive law to raise proceedings by petition procedure in respect of a director's breach of duty to obtain a remedy for the company. Such proceedings are raised in the name of the member but the remedy is obtained for the benefit of the company and the rights which the member can enforce against a director or third party are those of the company. The member's right arises where the proceedings complained of are fraudulent or *ultra vires* and so cannot be validated by a majority of the members of the company. This remedy is not available if the majority of members acting in good faith have validated or may validate the act complained of.

There are two current rules of substance which apply to actions brought by the member to protect the company's interests (as well as to actions brought to protect the shareholder's personal interests such as enforcement of rights in the articles of association). First, the directors of a company owe duties to the company and not to the members. Second, the court will not interfere in matters of internal management which may be sanctioned by a majority of the members. The effect of these rules is similar to the first two legs of the common law rule in *Foss v Harbottle*.⁶⁰

Sections 265 to 269 of the Act place the derivative action on a statutory footing in Scots law. The relevant rules applicable to the law of England and Wales are contained in sections 260-264 – the rules for England and Wales and Scotland are the same in substance. The main difference is the terminology. In Scotland, the proceedings are called 'derivative proceedings', whereas in England and Wales, they are known as 'derivative claims.' For the purposes of this presentation, we will concentrate on sections 265-269 of the Act which apply to Scotland, but it is worth bearing in the mind that the equivalent provisions applicable to England and Wales contained in sections 260-264 are in more or less identical terms.

Section 265 provides that a member⁶¹ of a company may raise an action in respect of certain acts or omissions in order to protect the interests of the company and obtain a remedy on its behalf. The specified actions or omissions may be actual or proposed⁶² and are as follows: -

- Negligence, default, breach of duty or breach of trust by a director⁶³ of the company.

Such 'derivative proceedings' may be raised against the director or some other person. Who will be 'some other person'? What this means is that derivative

⁶⁰ (1843) 2 Hare 461.

⁶¹ 'Member of a company' in this context includes a person who is not a member but to whom shares in the company have been transferred or transmitted by operation of law.

⁶² The actions or omissions are defined in the Act as the 'cause of action.'

⁶³ 'Director' includes former directors or shadow directors.

proceedings can be taken against persons involved in a breach of duty by a director. For example, in proceedings concerning the transfer of funds by a director in breach of trust, the proceedings may also be brought against the recipient who has knowledge of their source or nature.

Moreover, the statutory proceedings are additional to, rather than a replacement for, the rights of a member (i) under section 994 of the Act (i.e. the unfair prejudice remedy), (ii) section 122(1)(g) of the Insolvency Act 1986 (just and equitable winding up) or (iii) conferred personally upon them as a matter of contract under the articles of association, a shareholders agreement or on some other contractual basis.

A member may only raise derivative proceedings if they have obtained the leave of the court. In terms of the Companies Bill (as introduced), there was a separate requirement for the member to give notice of the claim to the company, but this has been deleted from the final version of the Companies Act 2006.

An application for the leave of the court must: -

- Specify the cause of action; and
- Summarise the facts on which the derivative proceedings are to be based;

The Court may: -

- Grant the application on such terms as it thinks fit;
- Refuse the application; or
- Adjourn the proceedings on the application and make such order as to further procedure as it thinks fit.

The Act provides that the court must refuse leave to raise derivative proceedings if it is satisfied that: -

- A person acting in accordance with the director's duty to promote the success of the company for the benefit of its members as a whole, would not seek to raise or continue the claim; or
- Where the cause of action is an act or omission that is yet to occur, that the act or omission has been authorised by the company; or

- Where the cause of action is an act or omission that has already occurred, that the act or omission (i) was authorised by the company before it occurred, or (ii) has been ratified by the company since it occurred.

In considering whether to grant leave to raise derivative proceedings, the court must take into account the following criteria: -

- Whether the member is acting in good faith in seeking to raise the proceedings;
- The importance that a person acting in good faith in accordance with the director's duty to promote the success of the company for the benefit of its members as a whole, would attach to raising or continuing it;⁶⁴
- Where the cause of action is an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would likely to be (i) authorised by the company before it occurs, or (ii) ratified by the company after it occurs;⁶⁵
- Where the cause of action is an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company;

⁶⁴ This was the subject of discussion in *Franbar Holdings Ltd. v Patel* [2008] EWHC 1534 (Ch); [2008] All ER (D) 14 (Jul). 'Good faith' is likely to be an issue in the case of a special interest group such as the environmental lobby who has bought shares in the company simply for the purpose of raising proceedings to challenge a director's actions or decisions. The same point applies in the case of a takeover situation, where the directors of the target company reject a bid without offering it to the shareholders and the offeror brings derivative proceedings to challenge this decision and thus ratchet up the pressure on the board.

⁶⁵ The fact that an act or omission is ratifiable no longer precludes derivative proceedings and instead it is simply something that the court must take into account in considering whether leave should be granted. However, if a breach of duty has been authorised or ratified, leave must be refused. Again, whether a breach of duty was capable of ratification was considered by the High court in *Franbar Holdings Ltd. v Patel* [2008] EWHC 1534 (Ch); [2008] All ER (D) 14 (Jul).

- Whether the company has decided not to raise proceedings in respect of the same cause of action or to persist in the proceedings (as the case may be); and
- Whether the cause of action is one in respect of which the member could raise an action in his own right rather than on behalf of the company.

Finally, in considering whether to grant leave to raise derivative proceedings, the court must have regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter (i.e. the passive members). The Secretary of State has the power to make regulations altering or adding to any of the above criteria.

The Act includes ‘continuation’ and ‘substitution’ procedures, whereby a member can apply to (i) have existing proceedings raised by a company continued in his own personal name where such proceedings are being conducted in a manner which amounts to an abuse of the process of the court, or has been pursued far from diligently or reluctantly, etc. and/or (ii) be substituted to derivative proceedings where another member of the company has commenced such proceedings in respect of a cause of action, but has pursued the proceedings far from diligently or reluctantly. The individual member must satisfy the court that: -

- The manner in which the company commenced or continued the proceedings amounts to an abuse of the court process; or
- The company has failed to prosecute the proceedings in a diligent fashion; or
- It is appropriate for the member to be substituted for the company.

Moreover, where a member has initiated the derivative proceedings or been substituted by the court (for the company) in terms of the above procedure, another member may seek authority from the court to be substituted for such member. The same criteria apply. In other words, the individual member must satisfy the court that:

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- The manner in which the member commenced or continued the proceedings amounts to an abuse of the court process; or
- The member has failed to prosecute the proceedings in a diligent fashion; or

- It is appropriate for the member to be substituted for the member.⁶⁶

Commentary

The statutory derivative proceedings are likely to form a good basis for enforcing a breach of a director's duty. However, an important factor which might prevent the use of statutory derivative proceedings in Scotland is the position with regard to the expenses of the member initiating the proceedings. There is nothing in the Companies Act 2006 which provides that a member will be entitled to reimbursement of their expenses from the company. There is such a procedure available in England and Wales – but not in Scotland.

My own feeling is that the impact of the statutory derivative proceedings will be marginal. There are three reasons for this. Firstly, in Scotland, the (currently) unclear position with regard to the recovery of a member's expenses will repel members from instigating proceedings. Secondly, I suspect that where a shareholder is aggrieved about the way they have been treated by the company or the directors, their preferred option is likely to be a s. 994 petition which enables them to effect an 'exit' by obtaining an order from the court sanctioning the majority to buy out their shares at 'fair value'. In most situations, a 'buy out' of their shares and an exit is likely to be more attractive than seeking to recover assets or funds on behalf of the company. Finally, the leave of court procedure will screen claims and is likely to 'weed out' vexatious proceedings and so, members may be deterred from initiating statutory derivative proceedings in the first place.

D. STATUTORY 'UNFAIR PREJUDICE' REMEDY

Section 994(1) of the Act enables a member to petition the court to declare that the company's affairs are being conducted in an unfairly prejudicial manner to the members generally or to particular members. The 'unfair prejudice' remedy enables a minority shareholder to take action against (a) the majority shareholders where the latter have abused their position or (b) the directors where they have breached their

⁶⁶ These 'Substitution' procedures were introduced into the Bill on 27th February 2006 by the Attorney-General (Lord Goldsmith) in committee of the House of Lords.

duties in terms of sections 171-177 of the Act. Section 994 of the Act differs from the statutory derivative proceedings in that (i) the remedies available are wider, (ii) the remedies may be awarded to the successful petitioner rather than the company and (iii) unlike, the statutory derivative proceedings, the wrongdoing may have been perpetrated by persons other than the directors, e.g. the majority shareholders. The precise terms of section 994 are as follows: -

“A member of a company may apply to the court by petition for an order... on the ground—

- (a) that the company’s affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members (including at least himself), or
- (b) that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.”

If the petition is successful, the court has the power to:

- Order the company to carry out certain acts or refrain from doing or continuing an act – including ordering the company to sue for a wrong done;
- Prevent the company from carrying out certain acts;
- Order members of the company to buy the shares of the prejudiced members, at a fair price; or
- Make any order which it sees fit.⁶⁷

In practice, the lion’s share of minority shareholders presenting a petition before the court will be seeking an exit from the company by obtaining an order from the court for their shares to be bought by the majority shareholders or the company at a fair price. In the case law, the courts have provided a number of examples of unfair prejudice, e.g. the non-payment of dividends,⁶⁸ the exclusion of a shareholder from the management of the company without offering a reasonable fair value for his/her

⁶⁷ S. 996 of the Act.

⁶⁸ *Re Sam Weller & Sons Ltd* [1990] Ch 682, p 693; *Grace v Biagoli* [2005] EWCA Civ 122, [2006] 2 BCLC 70.

shares,⁶⁹ excessive remuneration of directors,⁷⁰ sanctioning a rights issue which the minority are unable to afford,⁷¹ loading the board of directors which persons opposed to the good of the company,⁷² issuing new shares below their par/nominal value⁷³ and a delay in holding a general meeting.⁷⁴

The most important case on the scope of the court's jurisdiction is the House of Lords case of *O'Neill v Phillips*.⁷⁵ This case demonstrated that a complaining shareholder must be able to point to a breach of some settled or tacit understanding (which he/she had with the remaining shareholders or directors in the company) which has been breached. Such an understanding may be contained in writing in the company's constitution or may be discovered by oral evidence. In practice, most of the reported cases concern the latter situation which requires the shareholder to prove the 'understanding' in evidence in court (which the shareholder alleges has been breached), since in a case where the expectation and rights of the shareholder are written in black and white in the constitution, there is little purpose in the company disputing the claim. Furthermore, the requirement to demonstrate the existence of such a settled or tacit understanding renders the section 994 remedy almost practically useless in the case of a public limited company whose shares are listed on the London Stock Exchange: -

"In my judgment, as the authorities stand today, the [remedy] can have no place in the context of public listed companies. Moreover, its introduction in that context would, as it seems to me, in all probability prove to be a recipe for chaos. If the market in a company's shares is to have any

⁶⁹ *O'Neill v Phillips* [1999] 1 W.L.R. 1092.

⁷⁰ *Re Cumana Ltd* [1986] BCLC 430.

⁷¹ See *Grace v Biagoli* [2005] EWCA Civ 122, [2006] 2 B.C.L.C. 70 and *Re Cumana Ltd* [1986] B.C.L.C. 430.

⁷² *Re Whyte Petitioner* 1984 SLT 330.

⁷³ *Pettie v Thomson Pettie Tube Products Ltd* 2001 SC 431.

⁷⁴ *McGuinness v Bremner plc* 1988 SLT 891.

⁷⁵ [1999] 1 W.L.R. 1092.

credibility members of the public dealing in that market must it seems to me be entitled to proceed on the footing that the constitution of the company is as it appears in the company's public documents, unaffected by any extraneous equitable considerations and constraints.”⁷⁶

This stands to reason, since the courts generally take the view that a shareholder has the option of selling his/her shares in the event that he/she is unhappy about the way the company is being run. However, in the case of private companies, no such market for the shares will usually exist and hence the reason why the courts are more prepared to intervene in such contexts.

E. CONCLUSION

The UK Government has sought to trace a ‘middle path’ or ‘third way’ between the extremes of the ‘shareholder primacy’ and ‘pluralist/stakeholder’ approaches in framing the new law on directors’ duties in UK company law. This has been achieved by invoking or creating the ‘enlightened shareholder value’ approach. At the heart of this notion is an acceptance that the company should be run for the long-term rather than short-term benefit of the shareholders as a whole (past, present and future) duly allied with a recognition that some consideration must be given to the interests of outside constituencies or factors such as the good of the environment, the public, creditors, suppliers, employees, etc. The UK Government’s expectation and aspiration is that this will move directors away from taking decisions whose sole purpose is the achievement of short-term benefits for shareholders, (e.g. decisions purely motivated by a concern with the maintenance of, and/or increase in, dividend payments year on year) with greater consideration of decisions which will benefit the company in the long-term and not unduly trample on the interests of third parties. It is submitted that whether this (1) expectation is realisable and (2) aspiration is achievable, has been assisted by the events of the past month or so in the international banking sector. Indeed, one of the likely responses of governments internationally is to highlight existing laws such as the law of directors’ duties in the UK which focus strongly on long-term corporate growth at the expense of short-term performance. Moreover, it is

⁷⁶ *Re Astec (BSR) plc* [1998] 2 BCLC 556, 589 per Jonathan Parker J.

equally likely that a new international regulatory environment will be erected which builds on the law of directors' duties by striking this same message of long-term thinking.