

# The Corporate Objective: Reinterpreting Directors' Duties

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# The Corporate Objective: Reinterpreting Directors' Duties

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# ABBREVIATIONS

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CLRG – Company Law Review Group (Ireland)

CLRSG - Company law Review Steering Group (UK)

DTI – Department of Trade and Industry (UK)

ESV – Enlightened Shareholder Value

ODCE – Office of the Director for Corporate Enforcement

OFR – Operating and Financial Review

UK – United Kingdom

# ABSTRACT

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John Quinn

## The Corporate Objective: Reinterpreting Directors' Duties

This thesis aims to find the model of the corporate objective which is most likely to provide maximum wealth for all participants in the company. The corporate objective deals with the question: in whose interests should a company be run? This question is answered by providing a legal and theoretical argument that it is best for all participants if directors focus on maximising the wealth of the company as a separate legal entity. The entity focused approach requires directors to prioritise the interests of the company as an entity ahead of the interests of any shareholder or stakeholder groups. The thesis also argues that it is possible to practically implement such a model in Ireland. Currently Ireland implements a shareholder value approach with the duty to act in the interests of the company being equated with a duty to act in the interests of the shareholders. However, with a reinterpretation from the Irish courts as to what it means to act in the best interests of the company, an entity focused approach can be implemented. It is submitted that there is a sufficient legal basis for the Irish courts to make this reinterpretation. It is also submitted that enforcement of the entity focused approach can be ensured through the directors' duty to act in good faith. Compliance with this good faith duty is a question of honesty and it is submitted that the test being applied for honesty is an objective one. This objective test means that it will be possible to hold directors to account when they fail to act in the best interests of the company. This thesis argues that in comparison to other models such as shareholder value, stakeholder theory and Enlightened Shareholder Value, the entity based approach provides the greatest potential for a company to maximise benefits for all its constituents.



## Chapter 1 Introduction

### 1.01 Introduction

Since the company has been given the status of a separate legal entity<sup>1</sup> there has been a remarkable change in the role of companies. Companies have gone from small organisations to enormous multinational enterprises. Companies, particularly large public companies, wield significant political, social and economic power in modern society.<sup>2</sup> The actions of such companies affect not only direct stakeholders of the company such as employees, creditors and customers but also governments, communities and the environment.<sup>3</sup> They employ millions of people and exercise significant control over public service sectors such as telecommunications<sup>4</sup> and food production.<sup>5</sup> Despite the significant impact companies have on society, there is no agreement between academics or law makers as to what their objective or purpose should be. This is despite the view that all purposeful behaviour requires the existence of a clear objective.<sup>6</sup> Is the function of companies simply to increase shareholder wealth or do companies have a wider responsibility to benefit stakeholders and society as a whole?

An answer to this question firstly requires a normative determination on the role of companies and secondly a determination as to which legal framework offers the greatest chance of achieving this normative goal. Hansmann et al provide the suitable solution to the normative question when stating that, '[t]he appropriate goal of corporate law is to advance the aggregate welfare of all who are affected by a firm's activities including the firm's shareholders, employees, suppliers and customers, as well as third parties such as local communities and beneficiaries of the natural environment'.<sup>7</sup> A similar goal was outlined by the Company Law Review Steering Group (CLRSG), who led the reform of UK company law leading to enactment of the Companies Act 2006. The Group stated its aim in the reforming the corporate objective was to achieve 'efficient creation of wealth and other benefits for all participants in the enterprise'.<sup>8</sup> It is submitted that a similar aim of maximising wealth for all constituents in a company should be the aim of the law when setting the corporate objective. The difficulty is finding a legal framework which attains this goal in practice. Any legal model which deals with the corporate objective will be required to deal with the duties of directors. Directors, as

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<sup>1</sup> Companies Act 1862; *Salomon v A Salomon & Co Ltd* [1897] AC 22.

<sup>2</sup> Kent Greenfield, 'There's a Forest in Those Tress: Teaching about the Role of Corporations in Society' (2000) 34 *Georgia Law Review* 1011, 1013.

<sup>3</sup> Daniel Attenborough, 'Giving Purpose to the Corporate Purpose Debate: An Equitable Maximisation and Viability Principle' (2012) 32(1) *Legal Studies* 4, 4.

<sup>4</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 5.

<sup>5</sup> John Parkinson, *Corporate Power and Responsibility* (Oxford University Press 1993), 15.

<sup>6</sup> Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' (2001) 7(3) *European Financial Management* 297, 302. Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 8.

<sup>7</sup> Henry Hansmann, Reinier Kraakman, Paul Davies, Gerard Hertig, Hideki Kanda, Edward Rock, Klaus Hopt Luca Enriques, John Armour, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009), 28.

<sup>8</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.8.

managers of the company, are charged with the day to day decision making in a company. The duties placed on directors, the enforcement methods used to enforce these duties and how directors respond to these legal requirements are the primary factors which will determine what a company's objective will be.

Traditionally there are two models which deal with the question of the corporate objective: stakeholder theory and shareholder value. Stakeholder theory holds the company should be run for the benefit of all stakeholders and no one interest group is to be prioritised over any other.<sup>9</sup> While normatively desirable, there are significant difficulties in practically implementing the theory.<sup>10</sup> Directors aiming to benefit all stakeholders will end up trying to maximise in several different directions, something which is likely to be detrimental to the company's attempts to be economically successful.<sup>11</sup> Because stakeholder theory provides no guidance on how to choose between stakeholders when their interests are in conflict,<sup>12</sup> it becomes impossible for directors to balance all divergent agendas, meaning that the company is likely to become inefficient.<sup>13</sup> Ultimately if the company is economically inefficient and unprofitable it will not serve to benefit any constituent.

A model which can be practically implemented and allows one particular stakeholder, employees, a significant role in the management of companies is the German model of codetermination. Through a two-tiered board model, certain German companies are required to give employees up to fifty per cent representation on the supervisory board. However, applying such models in a common law country would require major institutional reform and represent a significant change to corporate culture. The difficulties in implementing major reform have led the UK CLRS<sup>14</sup> and the Irish Company Law Review Group<sup>15</sup> both declining to adopt a two-tiered board model of governance or make any changes to board composition. At EU level the draft Fifth Directive<sup>16</sup> attempted to implement an EU wide two-tiered board model in line with that of Germany's. However due to strong opposition from Member

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<sup>9</sup> See Max Clarkson, 'A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance' (1995) 20 *Academy Management Review* 92; Edward Freeman, *Strategic Management: A Stakeholder Approach* (Pitman 1984); Thomas Donaldson and Lee Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence, Implications' (1995) 20 *Academy Management Review* 65; Thomas Donaldson, 'The Stakeholder Revolution and the Clarkson Principles' (2002) 12 *Business Ethics Quarterly* 107.

<sup>10</sup> See Elaine Sternberg, 'The Defects of Stakeholder Theory' (1997) 5(1) *Corporate Governance* 3; Anant Sandaram and Andrew Inkpen, 'The Corporate Objective Revisited' (2004) 15(3) *Organisation Science* 350; Amir Licht, 'The Maximalists of Corporate Governance: The Theory of Values and Cognitive Style' (2004) 29 *Delaware Journal of Corporate Law* 649.

<sup>11</sup> Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' (2001) 7(3) *European Financial Management* 297, 300.

<sup>12</sup> *Ibid*, 13.

<sup>13</sup> The Committee on Corporate Law, 'Other Constituency Statutes: Potential for Confusion' (1990) 45 *Business Lawyer* 2253, 2269.

<sup>14</sup> CLRS, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.32.

<sup>15</sup> Company Law Review Group, First Report, (Department of Jobs, Enterprise and Innovation, December 2011) available at <http://www.clrg.org/1streport/first.asp> p247 para 11.8.14.

<sup>16</sup> Concerning the structure of the Public Limited Companies and the Powers and Obligations of their Organs 15 OJ EUR. COMM. (No. C131) 49 (1972).

States, the Fifth Directive failed in its attempts to harmonise the law in this area. A Directive and a European Council Regulation introduced in 2001 now protects the rights of Member States to choose their own structure of company boards.<sup>17</sup> What these examples highlight is that any significant changes to legal frameworks in line with either stakeholder theory or the German two-tiered model are unlikely to be implemented in common law countries. The point is that when discussing legal models to practically implement in common law jurisdictions there are limits to the reform that can be proposed as countries are unwilling to make major changes to existing legal frameworks.

The other traditional framework that addresses the corporate objective is shareholder value<sup>18</sup> which requires the company to be run for the ultimate objective of maximising shareholder wealth.<sup>19</sup> While shareholder value is criticised on normative grounds,<sup>20</sup> it is possible to practically implement the model. Due to this ability to work in practice and the deficiencies of stakeholder theory, shareholder value is seen as the best way to achieve increased benefits for all constituents. After the enactment of the Companies Act 2006 the UK now implements a model called Enlightened Shareholder Value (ESV) but is a model which is much more shareholder orientated than the common law. ESV requires directors to promote the success of the company for the 'benefit of its members as a whole' and as a result ESV legislatively defines company success in terms of benefit to the shareholders. This removes any possibility for the courts to interpret the duty as anything other than a requirement to prioritise the shareholders' interests, even ahead of the interests of the company as a separate entity. After the enactment of ESV there is no room for a distinction between the interests of the shareholders and the interests of the company, a distinction which was possible under the common law.<sup>21</sup> ESV currently possesses what the common law never did: a clear corporate objective of running the company for the benefit of the shareholders which represents a strident affirmation of shareholder

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<sup>17</sup> Council Regulation 2157/2001 of October 8 2001 on the statute for a European Company (SE) [2001] OJ L294/1 and the SE employees' Directive [2001] OJ L294/22-23.

<sup>18</sup> See Stephen Bainbridge, 'In Defence of the Shareholder Wealth Maximisation Norm: A Reply to Professor Green' (1993) 50 *Washington and Lee Law Review* 1423; Anant Sunderam and Andrew Inkpen, 'The Corporate Objective Revisited' (2004) 15(3) *Organization Science* 350; Alistair Alcock, 'Corporate Governance: A Defence of Status Quo' (1995) 58(6) *Modern Law Review* 898; Jonathon Macey, 'An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Governance Fiduciary Duties' (1991) 21 *Stenson Law Review* 23; Bernard Black and Reiner Kraakman, 'A Self Enforcing Model of Corporate Law' (1996) 109 *Harvard Law Review* 1911; Henry Hansmann and Reiner Kraakman, 'The End of History for Corporate Law' (2001) 89 *Georgetown Law Review* 440.

<sup>19</sup> Stephen Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' (2003) 97 *Northwestern University Law Review* 547, 573.

<sup>20</sup> Henry Hansmann, Reiner Kraakman, Paul Davies, Gerard Hertig, Hideki Kanda, Edward Rock, Klaus Hopt, Luca Enriques, John Armour, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009), 28; David Millon, 'New Game Plan or Business as Usual? A Critique of the Team Production Model of the Corporate Board' (2000) 86 *Virginia Law Review* 1001, 1002-1004; Lynn Stout, 'Bad and Not-So-Bad Arguments for Shareholder Primacy' (2002) 75 *Southern California Law Review* 1189, 1191.

<sup>21</sup> See *Dawson International plc v Coats Platon plc* [1989] BCLC 233; *Re BSB Holdings Ltd* [1996] 1 BCLC 155; *Re Welfab Engineers* [1990] BCLC 833.

value.<sup>22</sup> ESV provides that directors are to have regard to a list of non-shareholder interests including employees, customers, suppliers, the local community. However due to the clear prioritisation of the shareholders, this requirement is extremely difficult to enforce and is largely ineffective in ensuring directors will actually consider the stakeholder interests. Despite its endorsement in the UK, shareholder value has its difficulties and is often not the best way to maximise wealth for all participants. Shareholder value primarily benefits shareholders, often at the expense of stakeholders and potentially the company itself, particularly in scenarios when the shareholders' interests and the company's interests do not align. In addition shareholder value is linked with short-termism<sup>23</sup> where directors sacrifice worthwhile investments with long term benefits in order to increase reported earnings in the short term.<sup>24</sup> This short term approach can be damaging for stakeholders and harmful to the company as an entity.<sup>25</sup>

Due to the impracticalities of stakeholder theory and the harms to stakeholders and the company likely to result from application of shareholder value, it is submitted that the best legal model to achieve the maximum benefit for all constituents is to maximise the wealth of the company as a distinct legal entity. Directors' focusing on the maximisation of the entity's wealth provides the greatest chance for the company to be successful and provide knock-on benefits to its constituents. The approach is dependent on applying real entity theory.<sup>26</sup> The proposition from entity theory is that the company is a separate legal entity which is distinct from its shareholders<sup>27</sup> meaning the company is a distinct autonomous being which has attributes not found among its human components.<sup>28</sup> This view of the company provides the basis for not following shareholder value and allows directors to act in favour of stakeholder interests when it benefits the company as a distinct entity to do so. This view of the company reflects two very well established legal doctrines: First that a company has a separate

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<sup>22</sup> Alistair Alcock, 'An Accidental Change to Directors' Duties' (2009) 30 *Company Lawyer* 362, 367.

<sup>23</sup> Andrew Keay, *Directors' Duties* (2nd edn, Jordan 2014), 148.

<sup>24</sup> John Grinyer, Alex Russell and David Collision, 'Evidence of Managerial Short-Termism in the UK' (1998) 9 *British Journal of Management* 13, 15.

<sup>25</sup> Larry Mitchell, *Corporate Irresponsibility: America's Newest Export* (Yale University Press 2001), 11.

<sup>26</sup> See Arthur Machen, 'Corporate Personality' (1911) 24 *Harvard Law Review* 253; Sanford Schane, 'The Corporation is a Person: the Language of Legal Fiction' (1986) *Tulane Law Review* 563; Waino Suojanen, 'Accounting Theory and the Large Corporation' (1954) 29 *The Accounting Review* 391; Morten Horwitz, 'Santa Clara Revisited: The Development of Corporate Theory' (1985) 88 *West Virginia Law Review* 173; Susan Watson, 'How the Company Became an Entity: A New Understanding of Corporate Law' (2015) *Journal of Business Law* 120; John Farrar, 'Frankenstein Incorporated or Fools Parliament? Revisiting the Concept of the Corporation in Corporate Governance' (1998) 10 *Bond Law Review* 142.

<sup>27</sup> Paddy Ireland, Ian Grigg-Spall and Dave Kelly, 'The Conceptual Foundations of Modern Company Law' (1987) 14(1) *Journal of Law & Society* 149, 150; Gregory Mark, 'The Personification of the Business Corporation in American Law' (1987) 54 *University of Chicago Law Review* 1441, 1468.

<sup>28</sup> Martin Petrin, 'Reconceptualizing the Theory of the Firm: From Nature to Function' (2013) 118 *Penn State Law Review* 1, 7.

legal personality<sup>29</sup> and second that directors owe their duties to the company as an entity and not directly to any interest group.<sup>30</sup>

Applying an entity focused approach to the corporate objective originates from Andrew Keay<sup>31</sup> and Daniel Attenborough.<sup>32</sup> These normative works call for a new model of the corporate objective, one which focuses on maximising the wealth and ensuring the sustainability of the company as an entity. Unlike shareholder value, the interest which has priority over all others is that of the company as an entity.<sup>33</sup> Rather than focusing on the individual interest groups as under stakeholder theory, the entity focused model prioritises the interests of the company and what will enhance its position.<sup>34</sup> Attenborough believes that entity maximisation will promote fairness between competing interests and will be more likely to increase the efficiency of the company than completing models.<sup>35</sup> Keay submits that following the model will benefit the public good as enhancement of the entity will result in benefits to all the company's constituents.<sup>36</sup> Jensen would seem to agree when he states that '200 years' worth of work in economics and finance indicate that social welfare is maximised when all firms in an economy maximise total firm value'.<sup>37</sup>

While the works of Keay and Attenborough are normative in nature, this thesis submits that there is legal basis and legal scope to implement this model in Ireland. The Companies Act 2014 requires a director to 'act in good faith in what the director considers to be in the interests of the company'.<sup>38</sup> It is submitted that this broad fiduciary duty allows for an entity focused approach. However the existing interpretation from the Irish courts implements a shareholder value approach. The Irish courts have equated the common law duty to act in the interests of the company with a duty to act in the

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<sup>29</sup> See for example, *Salomon v A Salomon & Co Ltd* [1897] AC 22; *A L Underwood Ltd v Bank of Liverpool* [1924] 1 KB 775; *Macura v Northern Insurance Co Ltd* [1925] AC 619; *Roberts v Coventry Corporation* [1947] 1 All ER 308; *Wallersteiner v Moir (No 2)* [1975] QB 373; *Lee v Lee's Farming Ltd* [1961] AC 12; *Re Frederick Inns* [1991] ILRM 582; *Johnson v Gore Wood & Co (A Firm)* [2002] 2 AC 1; *Attorney General v Jameson* [1904] 2 IR 644. *Allied Irish Coal Supplies Ltd. v Powell Duffryn International Fuels Ltd* [1998] 2 IR 519.

<sup>30</sup> See for example *Percivil v Wright* [1902] 2 Ch 421. *Dawson International plc v Coats Platon plc* [1989] BCLC 233; *Crindle Investments et al v Wymes et al* [1998] 2 ILRM 275; *Re A Company (No. 004415)* [1997] BCLC 479 Ch D; *Peskin v Anderson* [2001] 1 BCLC 372; *Smith v Cork and Bandon Railway Co* (1870) 5 IR EQ 63; *Bloxham (in Liquidation) v The Irish Stock Exchange Ltd* [2014] IEHC 93.

<sup>31</sup> Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71(5) *The Modern Law Review* 663; Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011).

<sup>32</sup> Daniel Attenborough, 'Giving Purpose to the Corporate Purpose Debate: An Equitable Maximisation and Viability Principle' (2012) 32(1) *Legal Studies* 4.

<sup>33</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 198.

<sup>34</sup> *Ibid*, 199.

<sup>35</sup> Daniel Attenborough, 'Giving Purpose to the Corporate Purpose Debate: An Equitable Maximisation and Viability Principle' (2012) 32(1) *Legal Studies* 4, 27.

<sup>36</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 175.

<sup>37</sup> Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' (2001) 7(3) *European Financial Management* 297, 302.

<sup>38</sup> Companies Act 2014 s 228(1)(a).

interests of the shareholders.<sup>39</sup> This thesis argues for a reinterpretation of what it means to act in the interests of the company in the Irish context. To legally implement an entity focused approach a directors' duty to 'act in the interests of the company' needs to be interpreted as exactly that, a duty to act for the company, as a separate legal entity. It is argued that this interpretation is more likely to meet the goal of maximising wealth for all company constituents. In addition this would reflect the legal reality that the company is a separate person distinct from its shareholders. There are also a number of cases which provide persuasive authority for not following a shareholder value based interpretation of the duty to act in the interests of the company. Prior to the enactment of the UK Companies Act 2006 several cases from England and Wales required directors to consider stakeholder interests when deciding what was in the interests of the company.<sup>40</sup> Other cases have recognised that the interests of the company and the shareholders may well diverge and that in such cases it is the entity's interests which should take priority.<sup>41</sup> There are also a number of cases from Canada, a jurisdiction which has very similar legislation to Ireland on this topic, which have advocated an entity focused approach to the duty to act in the interests of the company.<sup>42</sup>

It is also argued that, in Ireland, there is a changing context in the way in which directors' duties are viewed. Ahern argues that company law in Ireland is changing from serving the interests of shareholders to instead serving a public interest function.<sup>43</sup> This outlook is evidenced by the public enforcement of directors' duties and the inclusion of a new fiduciary duty to act honestly and responsibly<sup>44</sup> taken from the law on restriction.<sup>45</sup> The purpose of the restriction regime in Ireland is to protect the public<sup>46</sup> and several cases have found a director to not have acted honestly and responsibly when they have acted contrary to stakeholder interests.<sup>47</sup> Including a new fiduciary duty taken from this area of law does signal an implicit intention from the legislature to protect interests broader than just shareholders.

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<sup>39</sup> See *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC, 22; *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported), 77; *Re Frederick Inns Ltd.* [1994] 1 ILRM 387, 396.

<sup>40</sup> See *Evans v Brunner Mond & Co Ltd* [1921] 1 Ch. 359; *Lonhro v Shell Petroleum* [1980] 1 WLR 627; *Fulham Football Club v Cabra Estates* [1994] 1 BCLC 363.

<sup>41</sup> *Dawson International plc v Coats Platon plc* [1989] BCLC 233; *Re BSB Holdings Ltd* [1996] 1 BCLC 155; *Re Welfab Engineers* [1990] BCLC 833.

<sup>42</sup> *Peoples Department Stores Inc. (Trustee of) v Wise* [2004] 3 SCR 461; *BCE Inc v 1976 Debentureholders* [2008] SCR 560.

<sup>43</sup> Deirdre Ahern, 'Directors' Duties: Broadening the Focus Beyond Current Context to Examine the Accountability Spectrum' (2011) 33 *Dublin University Law Journal* 116, 140.

<sup>44</sup> Companies Act 2014 s 228(1)(b).

<sup>45</sup> Companies Act 2014 s 819.

<sup>46</sup> See *La Moselle Clothing Ltd and Rosegem Ltd* [1998] 2 ILRM 345; *Duignan v Carway* [2002] IEHC 1; *Re Colm O'Neil Engineering Services Ltd* [2004] IEHC 83.

<sup>47</sup> *Duignan v Carway* [2002] IEHC 1; *Re Outdoor Advertising Services Ltd* (28 January 1997, unreported) HC; *Re Usit World* [2005] IEHC 285.

Finally, it is submitted, that enforcement of the entity focused approach can be ensured through the duty of good faith which is assessed primarily on an objective basis. This objective test means that it is possible to hold director to account when they fail to act in the interests of the company. However the duty is often referred to as subjective<sup>48</sup> and is perceived to be a duty which is almost impossible to breach.<sup>49</sup> However an examination of the case law highlights that the duty is assessed primarily on objective grounds and that directors will be found in breach of the duty when they have not acted in line with reasonable standards.<sup>50</sup> This thesis argues for a clear pronouncement of an objective test for honesty under the duty of good faith in line with the judgment in *Royal Brunei Airlines v Tan*<sup>51</sup> which clarified a similar area of trusts law. Such a pronouncement of an objective test could have a declaratory effect on director behaviour by establishing a clear standard of conduct for directors. Such a clarification would also make it clearer as to when there has been a breach of duty from director making it more likely that a derivative action or an action by a liquidator will be taken. The aim is that any successful action on these grounds and the declaratory effect could function as a deterrent for directors' non-compliance and so ensure directors do to act in the interests of the company. For the duty of good faith to act in such a way it would require a reinterpretation and a clear pronouncement that the duty is to act in good faith is assessed by an objective standard. It is submitted that this objective standard of good faith coupled with the public enforcement regime currently in operation through the Office of the Director for Corporate Enforcement (ODCE) and the restriction regime offers the best method to enforce this duty to act in good faith in the interests of the company.

## 1.02 Research Question

The aim of the thesis is to determine the legal framework of directors' duties which is most likely to achieve maximum benefit for all company constituents. The research question is answered by requiring directors to focus on promoting the success of the company as a separate entity. In making this determination the thesis examines the models of shareholder value, stakeholder theory, German codetermination, Enlightened Shareholder Value, and the common law approach from the UK and Ireland.

## 1.03 Original Contribution to Existing Research

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<sup>48</sup> *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598; *Regentcrest plc v Cohen* [2001] 2 BCLC 80; Brenda Hannigan, *Company Law* (2<sup>nd</sup> edn, Oxford University Press 2009), 206; Richard Williams, 'Enlightened Shareholder Value in UK Company Law' (2012) 35(1) *University of New South Wales Law Journal* 360, 365; Davy Wu, 'Managerial Behaviour, Company Law and the Problem of the Enlightened Shareholder Value' (2010) 31(2) *Company Lawyer* 53, 54.

<sup>49</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law* (8<sup>th</sup> Edn, Sweet and Maxwell, 2008), 510.

<sup>50</sup> *Item Software Ltd (UK) Ltd v Fassihi* [2004] EWCA Civ 1244; *Re Coroin Ltd* [2012] EWHC 2343 (Ch); *Breitenfeld UK Ltd v Harrison* [2015] EWHC 399 (Ch); *Re Genosysis Technology* [2006] EWHC 989 Ch; *Howard Smith v Ampol Petroleum Limited* [1974] AC 821; *Bloxham (in Liquidation) v The Irish Stock Exchange Ltd* [2014] IEHC 93.

<sup>51</sup> *Royal Brunei Airlines Sdn Bhd v Tan Kok Ming* [1995] 2 AC 378.

The research provides an original contribution in two ways. Firstly the research proposes a practical way to legally implement an entity focused approach to the issue of the corporate objective. While normative models have been already proposed, this research submits that an entity focused approach can be legally implemented in Ireland. After the enactment of ESV it is not possible to adopt an entity focused approach in the UK, however, such a model remains possible to legally implement in Ireland with a reinterpretation from the Irish courts for what it means to act in the interests of the company.

Secondly the research makes an original argument that the duty to act in good faith can be used as an effective means to enforce the fiduciary duty to act in the interests of the company.

#### **1.04 Methodology**

The methodology involves traditional legal doctrinal analysis of statutory material, case law, academic commentary and company law reform documents. The thesis focuses primarily on the law of Ireland and England and Wales and there is a significant comparative analysis between the two jurisdictions. Brief references are also made to Canadian, Australian, US and Scottish law.

The German model of codetermination is also examined, primarily from secondary sources due to language and resource based restrictions. The aim of the German discussion is to outline the historical and cultural complexities involved in the development of Germany's two-tiered board model and to demonstrate that transplanting the model to a common law jurisdiction is very difficult.

#### **1.05 Language & Terms Used**

The term members and shareholders are used interchangeably throughout the thesis. The term member is used in the Irish Companies Act 2014 and the UK Companies Act 2006 as it applies to companies who are limited by guarantee as well as companies limited by shares. Companies limited by guarantee have no shareholders, only members, but for the purposes of this thesis there is no distinction between the two terms.

The discussion in this thesis regarding the corporate objective is most relevant to public companies where there is a separation of ownership and control. In small closely held companies there is less likely to be a divergence between the company's interests and the shareholders' interests.

This thesis deals primarily with the jurisdiction of Ireland. However given the reliance on English authority in Irish law and the general similarities between the UK Companies Act 2006 and the Companies Act 2014, the UK is the main comparator. As a result, the common law of England and Wales and the provisions of the UK Companies Act 2006 will be examined in detail.



The term stakeholder is used frequently in this thesis and the word has been subject to many different definitions.<sup>52</sup> The most well-known definition was provided by Freeman who defined a stakeholder as ‘any group or individual who is affected by or can affect the achievement of the organisations objectives’.<sup>53</sup> It is difficult to precisely define what is meant by the term stakeholder as there are potentially many groups that can be affected by a company or can affect the achievement of a company’s objectives. Generally speaking however, for the purposes of this thesis, the term refers to interest groups such as employees, creditors, customers, suppliers, the environment and society as a whole.

## **1.06 Thesis Outline & Structure**

Chapter two contains an analysis of the shareholder value model. It outlines the theoretical arguments in favour the model and the legal basis for its application. The chapter will compare and contrast shareholder value to an entity focused model and demonstrate that the latter is the more accurate legal approach. The chapter argues that the entity approach is more likely to achieve maximum benefits for all constituents.

Chapter three outlines stakeholder theory and discusses its difficulties with practical application. The chapter also describes German model of codetermination and the two-tiered board model of corporate governance. The aim of the examination is to highlight why the German model is unlikely to be applied in common law countries.

Chapter four has three sections. The first is a description and an analysis of the reform process leading to the enactment of ESV. The purpose of which is to establish underlying rationales as to why ESV was selected from the different options being considered. The second is a discussion on reporting requirements in corporate law and the role envisaged of corporate reporting under ESV. The third part is an analysis of the final result of ESV, the conclusion of which is that ESV represents an endorsement of shareholder value to a much greater degree than was ever required by the common law.

Chapter five describes the Irish law on the issue of the corporate objective. It outlines the common law approach to the topic and how the Companies Act 2014 has legislated on the issue. It argues for a reinterpretation of what it means to act in the interests of the company as a duty to act in the interests of the entity as a separate legal person.

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<sup>52</sup> See Ronald Mitchell, Bradley Agle and Donna Wood, ‘Towards a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts’ (1997) 22 *Academy Management Review* 853.

<sup>53</sup> Edward Freeman, *Strategic Management: A Stakeholder Approach* (Pitman Publishers 1984), 32.

Chapter six examines in detail the potential of enforcing directors' duties through the good faith duty. It is submitted that the good faith duty is primarily assessed on an objective basis and that it could be used as a means to ensure directors comply with the duty to act in the interests of the company.

Chapter seven is the conclusion and outlines the final reasons for advocating the entity approach as a solution to the corporate objective.

## Chapter 2 Shareholder Value

### 2.01 Introduction

Shareholder value theory requires the ultimate objective of the company to be the maximisation of shareholder wealth<sup>1</sup> and so requires directors to manage the company in the interests of the shareholders. Shareholder value has been regarded to be the cornerstone of UK corporate governance<sup>2</sup> and is generally perceived to be the dominant judicial approach taken in the UK.<sup>3</sup> Shareholder value has also significant support within Irish case law.<sup>4</sup> Since the work of Berle and Means,<sup>5</sup> academic support for the paradigm has remained strong,<sup>6</sup> culminating with Hansmann and Kraakman concluding that there is 'no longer any serious competitor to the view that corporate law should principally strive to increase long term shareholder value'.<sup>7</sup> The theory prioritises shareholder interests above all others while denying any responsibility to wider interests or any social responsibility, once compliant with the law. As Friedman states 'There is one and only one social responsibility of business...to increase profits so long as it stays within the rules of the game'.<sup>8</sup>

Despite the focus on increasing wealth for shareholders, shareholder value does not require directors to completely disregard all stakeholder interests. Instead, stakeholders are only to be considered to the extent to which they will assist the company in increasing wealth for the shareholders.<sup>9</sup> However, there is a difference in considering stakeholder interests as a means to promote shareholder wealth and considering stakeholders to promote company success. Often the interests of the company and the interests of the shareholders will align. However there are times when what is doing best for the shareholders will not equate with doing what is best for the company as an entity. It is submitted that

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<sup>1</sup> Stephen Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' (2003) 97 *Northwestern University Law Review* 547, 573.

<sup>2</sup> Steve Toms and Mark Wright, 'Divergence and Convergence within Anglo-American Corporate Governance Systems: Evidence from the US and UK, 1950-2000' (2005) 47(2) *Business History* 267.

<sup>3</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law* (8th edn, Sweet and Maxwell, 2008), 507; Jingchen Zhao, 'The Curious Case of Shareholder Primacy Norm: Calling for a More Realistic Theory' (2012) 15 *International Trade and Business Law Review* 1, 1; Jill Fisch, 'Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy' (2006) *Journal of Corporation Law* 637, 647.

<sup>4</sup> *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC, 22; *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported), 77; *Re Frederick Inns Ltd.* [1994] 1 ILRM 387, 396.

<sup>5</sup> Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (Transaction 1932).

<sup>6</sup> See Stephen Bainbridge, 'In Defence of the Shareholder Wealth Maximisation Norm: A Reply to Professor Green' (1993) 50 *Washington and Lee Law Review* 1423; Anant Sunderam and Andrew Inkpen, 'The Corporate Objective Revisited' (2004) 15(3) *Organization Science* 350; Alistair Alcock, 'Corporate Governance: A Defence of Status Quo' (1995) 58(6) *Modern Law Review* 898; Jonathon Macey, 'An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Governance Fiduciary Duties' (1991) 21 *Stenson Law Review* 23; Bernard Black and Reiner Kraakman, 'A Self Enforcing Model of Corporate Law' (1996) 109 *Harvard Law Review* 1911;

<sup>7</sup> Henry Hansmann and Reiner Kraakman, 'The End of History for Corporate Law' (2001) 89 *Georgetown Law Review* 440, 440.

<sup>8</sup> Milton Friedman, 'The Social Responsibility of Business is to Increase Profits', *New York Times*, 13 September 1970, [32].

<sup>9</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law* (8th edn, Sweet and Maxwell, 2008), 509.

in such circumstances shareholder value is flawed and is not the best model to promote company success and therefore not the best way to achieve the goal of increasing wealth for all participants in the company. It would be extremely difficult to maximise a company's success while consistently disregarding the interests of stakeholders<sup>10</sup> and so will eventually damage the company.<sup>11</sup> Yet in order to prioritise shareholders, it is inevitable stakeholder interests will be prejudiced.<sup>12</sup> Pursuing a shareholder value approach can not only be damaging to stakeholders but also to the company itself when the company's best interests do not align with the shareholders. Shareholder value has also been criticised on normative grounds with Handy stating that 'the idea that companies exist for profit is a myth',<sup>13</sup> and Hansmann et al state

It is sometimes said that the appropriate goal of corporate law....is simply to assure that the corporation serves the best interests of its shareholders, or more specifically, to maximise financial returns to shareholders....these claims neither describe corporate law as we observe it nor offer a normatively appealing aspiration for that body of law.<sup>14</sup>

Instead of applying shareholder value, when the interests of the company and the shareholders do not align, it is the entity's interests which should be prioritised. A significant number of cases from the England and Wales support this view that there is a difference between shareholder value and company success and that it is the latter which should take priority.

The legal basis for shareholder value stems from the common law fiduciary duty to act in the best interests of the company<sup>15</sup> being equated to mean a duty to act in the interests of the shareholders. There is strong support for this interpretation in Irish case law<sup>16</sup> and some English cases have also adopted this interpretation.<sup>17</sup> This has led many academics to believe that the English common law required a shareholder value approach.<sup>18</sup> However an examination of the English case law highlights

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<sup>10</sup> Alexander Schall, Lilian Mines & Simon Goulding, 'Promoting an Inclusive Approach on the part of the Directors: The UK and German Position' (2006) 6 *Journal of Corporate Law Studies* 299, 306.

<sup>11</sup> Bernard Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' (1992) 39 *University of California at Los Angeles Law Review* 811, 863.

<sup>12</sup> Constance Bagley and Karen Page, 'The Devil Made me do it: Replacing Corporate Directors' Veil of Secrecy with the Mantle of Stewardship' (1999) 36 *San Diego Law Review* 897, 898.

<sup>13</sup> Charles Handy, 'What is a Company For?' (1993) 1 *Corporate Governance* 14, 14.

<sup>14</sup> Henry Hansmann, Reinier Kraakman, Paul Davies, Gerard Hertig, Hideki Kanda, Edward Rock, Klaus Hopt Luca Enriques, John Armour, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009), 28.

<sup>15</sup> See *Re Smith v Fawcett Ltd* [1924] Ch 304; *Hutton v West Cork Railway* (1883) 23 Ch D 654; *Mutual Life Insurance Co v Rank Organisation Ltd* [1985] BCLC 11; *Bamford v Bamford* [1970] Ch 212; *Banfi Ltd v Moran* [2006] IEHC 257; *JJ Harrison (Properties) Ltd v Harrison* [2001] EWCA Civ 1467; *West Merica Safety Wear v Dodd* (1988) 4 BCC 30.

<sup>16</sup> See *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC, 22; *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported), 77; *Re Frederick Inns Ltd.* [1994] 1 ILRM 387, 396.

<sup>17</sup> *Parke v Daily News Ltd* [1962] Ch 927; *Brady v Brady* [1988] 3 BCC 535; *Heron International Ltd* [1983] BCLC 244; *Greenhalgh v Ardenne Cinemas Ltd* [1950] 2 All ER 1120.

<sup>18</sup> See for example, Jill Fisch, 'Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy' (2006) *Journal of Corporation Law* 637, 647; Jingchen Zhao, 'The Curious Case of Shareholder Primacy Norm:

that there is little support for shareholder value. As Deakin notes ‘it is surprisingly difficult to find support within company law for the notion of shareholder primacy’.<sup>19</sup> Some cases which appear to support shareholder value are in contexts other than directors’ duties<sup>20</sup> but are still cited in support of shareholder value in cases on directors’ duties.<sup>21</sup> While there are a small number of cases which support a shareholder value approach to directors’ duties<sup>22</sup> the common law often required stakeholder interests to be considered when deciding what was in the interests of the company.<sup>23</sup> The courts have been even willing to disregard the interests of the shareholders when there was a conflict between the interests of the shareholders and the company as an entity.<sup>24</sup>

The above cases demonstrate that the majority of case law does not offer support for the shareholder value doctrine. The duty to act in the interests of the company was held to include stakeholder interests and the company could be viewed as a separate entity when shareholder and company interest were in conflict. However, despite the commendable approach taken, the common law did have its difficulties, primarily that it was misunderstood, leading to a perception that the common law placed a duty on directors to promote short term shareholder value. A survey conducted by the Institute of Directors found that many directors believed that they were legally required to maximise short term shareholder benefits at the expense of the long term interests of the company itself.<sup>25</sup> As Stout explains ‘The widespread perception that corporate directors and executives have a legal duty to maximise shareholder wealth plays a large role in explaining how shareholder value thinking has become so endemic in the business world today’.<sup>26</sup> This mistaken perception of the common law led to the Company Law Review Group (CLRSG), who led the reform of UK company law, to conclude that the common law required directors to operate companies ‘for the benefit of shareholders’<sup>27</sup> and that companies are formed and managed in the interests of shareholders.<sup>28</sup> As will be discussed in

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Calling for a More Realistic Theory’ (2012) 15 *International Trade and Business Law Review* 1, 1; Paul Davies, *Gower and Davies Principles of Modern Company Law* (8th edn, Sweet and Maxwell, 2008), 507; Shuangge Wen, ‘Exploring the Rationale of Enlightened Shareholder Value (ESV) in the Realm of UK Company Law – The Path Dependence Perspective’ (2011) 14 *International Trade and Business Law Review* 153, 157.

<sup>19</sup> Simon Deakin, ‘The Coming Transformation of Shareholder Value’ (2005) 13 *Corporate Governance: An International Review* 11, 11.

<sup>20</sup> *Brady v Brady* [1988] 3 BCC 535; *Greenhalgh v Ardenne Cinemas Ltd* [1950] 2 All ER 1120.

<sup>21</sup> See *Parke v Daily News Ltd* [1962] Ch 927; *Heron International Ltd* [1983] BCLC 244; *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC.

<sup>22</sup> *Parke v Daily News Ltd* [1962] Ch 927; *Heron International Ltd* [1983] BCLC 244.

<sup>23</sup> See *Evans v Brunner Mond & Co Ltd* [1921] 1 Ch. 359; *Lonrho v Shell Petroleum* [1980] 1 WLR 627; *Fulham Football Club v Cabra Estates* [1994] 1 BCLC 363.

<sup>24</sup> See *Re BSB Holdings Ltd* [1996] 1 BCLC 155; *Dawson International Plc v Coats Platon plc* [1989] BCLC 233; *Re Welfab Engineers* [1990] BCLC 833.

<sup>25</sup> See Institute of Directors, *Good Boardroom Practice: Company Law Review, The Stakeholder Debate* (1999).

<sup>26</sup> Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (Berret-Koehler, 2012), 24.

<sup>27</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.7.

<sup>28</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.4.

chapter four, this misconception of the common law ultimately led to the implementation of Enlightened Shareholder Value (ESV) which, through the clear legislative prioritisation of shareholders, establishes a clear application of shareholder value which was not evident under the common law.

This chapter will first engage in a critical analysis of the arguments and justifications used in favour of shareholder value demonstrating that they are either legally incorrect or unpersuasive. Arguments based on property rights, agency theory and the nexus of contracts theory of the firm fail to reflect the legal reality that a company is a separate entity and that directors owe their duties to that entity while arguments based on company efficiency are unpersuasive when compared with prioritising the interests of the company as an entity. Secondly the chapter will outline the relevant case law. It will discuss the case law which offers support to the shareholder value principle and the case law which demonstrates that the company interests does not directly equate with the interests of the shareholders. The chapter argues that it is a misrepresentation of the majority of the English case law to describe it as requiring a shareholder value approach and that the entity approach is a superior model of the corporate objective.

## **2.02 Shareholders as Owners**

One of the arguments often used in favour of shareholder value is that shareholders are owners of the company<sup>29</sup> and operating the company in order to maximise the wealth of the shareholders respects the notion of private property.<sup>30</sup> The argument is that shareholders, as owners of the company, should have the right to ensure that the company is run for their benefit.<sup>31</sup> Any alternative view limits their freedom and impinges on the rights of private property.<sup>32</sup> It has been argued to do anything other than to run a company with the goal of providing shareholder wealth maximisation amounts to spending ‘other people’s money’.<sup>33</sup> Berle and Means argued for shareholder value based on property rights believing that shareholders were owners of the company contending that ‘owner-shareholders ought to receive the profits of the corporation because they acquired ownership of the corporate venture and are the rightful benefactors of all corporate economic surplus to the exclusion of non-owners’.<sup>34</sup>

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<sup>29</sup> See, Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (Transaction 1932), 6-7; Caspar Rose, ‘Stakeholder Orientation vs Shareholder Value: A Matter of Contractual Failures’ (2004) 18 *European Journal of Law and Economics* 77, 80.

<sup>30</sup> Ben Pettet, *Company Law* (2<sup>nd</sup> edn, Longman 2005), 161.

<sup>31</sup> Milton Friedman, The Social Responsibility of Business is to Increase Profits, *New York Times*, 13 September 1970, [32].

<sup>32</sup> Deryn Fisher, ‘The Enlightened shareholder – Leaving Stakeholders in the Dark: Will Section 172(1) of the Companies Acts 2006 Make Directors Consider the Impact of their Decisions on Third Parties’ (2009) 20(1) *International Company and Commercial Law Review* 10, 13.

<sup>33</sup> Douglas Baird and Todd Henderson, ‘Other People’s Money’ (2008) 60 *Stanford Law Review* 1309.

<sup>34</sup> Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (Transaction, 1932), 6-7.

However the claim that shareholders own the company is based on an incorrect perception of company law.<sup>35</sup> The company is a legal person incapable of being owned.<sup>36</sup> Owning shares does not allow the shareholders ownership of the company, instead they own a corporate security in the form of shares or stock.<sup>37</sup> In *Short v Treasury Commissioners* Evershed LJ stated ‘shareholders are not in the eyes of the law, part owners of the undertaking. The undertaking is something different from the totality of its shareholding’.<sup>38</sup> Classic representations of ownership of property do not apply to shareholders, for example shareholders have no control over the company’s assets<sup>39</sup> and have no automatic right to a dividend.<sup>40</sup> The argument that shareholders own the company is legally untenable<sup>41</sup> with Stout claiming it is the worst of all the arguments in favour of shareholder value.<sup>42</sup> Even advocates of the shareholder value model no longer maintain that shareholders own a company. Bainbridge states that no one group owns the totality of the company and that shareholders have none of the moral rights normally associated with ownership.<sup>43</sup> While Fama states that the ownership of capital in a company ‘should not be confused with ownership of the firm’ and that it is important to dispel ‘the tenacious notion that a firm is owned by its security holders’.<sup>44</sup> The idea of shareholders as owners of the company is no longer seen as a valid argument in favour of shareholder value having come under increasingly strong criticism.<sup>45</sup>

### 2.03 The Nexus of Contracts Theory

The nexus of contracts view of the company holds that companies should not be viewed as legal persons but rather as a set of complex set of explicit and implicit contracts based on a law and economics perspective.<sup>46</sup> Under this theory, companies are regarded as nothing more than a network

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<sup>35</sup> Ciaran O’ Kelly, ‘History Begins: Shareholder Value, Accountability and the Virtuous State’ (2009) 60(1) *Northern Ireland Law Quarterly* 35, 38.

<sup>36</sup> John Parkinson, ‘Model of the Company and the Employment Relationship’ (2003) 41 *British Journal of Industrial Relations* 481, 483.

<sup>37</sup> See *Short v Treasury Commissioners* [1948] 1 KB 116.

<sup>38</sup> *Ibid* 122.

<sup>39</sup> See *A L Underwood Ltd v Bank of Liverpool* [1924] 1 KB 775; *Lee & Co (Dublin) Ltd v Egan (Wholesale) Ltd* (18 October, 1979, unreported) HC; *Pearlberg v O’ Brien* [1982] Crim LR 405.

<sup>40</sup> See *Bond v Barrow Haematite Steel Co.* [1902] 1 Ch 353; *Re Drogheda Steampacket Co Ltd.* [1903] IR 512.

<sup>41</sup> Ciaran O’Kelly, ‘History Begins: Shareholder Value, Accountability and the Virtuous State’ (2009) 60(1) *Northern Ireland Law Quarterly* 35, 38.

<sup>42</sup> Lynn Stout, ‘Bad and Not-So-Bad Arguments for Shareholder Primacy’ (2002) 75 *Southern California Law Review* 1189, 1190.

<sup>43</sup> Stephen Bainbridge, ‘In Defence of the Shareholder Wealth Maximisation Norm: A Reply to Professor Green’ (1993) 50 *Washington and Lee Law Review* 1423, 1427.

<sup>44</sup> Eugene Fama, ‘Agency Problems and the Theory of the Firm’ (1980) 88(2) *Journal of Political Economy* 288, 290.

<sup>45</sup> See Paddy Ireland, ‘Company Law and the Myth of Shareholder Ownership’ (1999) 62 *Modern Law Review* 32; Razeen Sappiden, ‘Ownership of the Large Corporation: Why Clothe the Emperor?’ (1996) 7 *King’s College Law Journal* 27; Lynn Stout, ‘Bad and Not-So-Bad Arguments for Shareholder Primacy’ (2002) 75 *Southern California Law Review* 1189, 1190.

<sup>46</sup> Jonathon Macey, ‘Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective’ (1999) 84 *Cornell Law Review* 1266, 1266.

of contract based relationships<sup>47</sup> and are devoid of any social responsibilities.<sup>48</sup> Due to the company being made up a collection of contractual arrangements, the argument is that the company should be operated for the benefit of the residual claimants, the shareholders. Easterbrook and Fischel provide the classic contractarian argument in favour for shareholders as residual claimants.<sup>49</sup> They argue that all stakeholders have the protection of contracts; employees, suppliers etc. have all set remuneration in the form of salaries or payment for services. Shareholders have no such set income and so are entitled to claim whatever is left once the company has fulfilled its explicit obligations.<sup>50</sup> Because shareholders are residual claimants and are unprotected by explicit contract they receive the benefits and incur the costs of corporate decision making.<sup>51</sup> Therefore they are more likely to be affected by directorial decisions and so are the primary risk bearers in the company.<sup>52</sup> According to the theory, because the shareholders are the primary risk bearers and because their claims will be satisfied last in liquidation, shareholders have the greatest stake in the company and so the business should be run in their interests.<sup>53</sup> Shareholders bear the most risk as they are contractually speaking in a weaker position by comparison to other stakeholders and so are relatively indifferent to corporate decision making.<sup>54</sup>

There are a number of difficulties with the reasoning used in favour of the nexus of contracts view of the firm. The argument comes from an economic view of the company and is promoted primarily by economists and economically orientated corporate law scholars.<sup>55</sup> For example, Macey attempts to describe corporate law as not being mandatory but rather as simply as a convenient tool to reduce costs<sup>56</sup> basing his argument on the work of economist Oliver Hart.<sup>57</sup> Such views are incompatible with the reality of company law and there is a clear distinction between an economic view of a company

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<sup>47</sup> Michael Klausner, 'Corporations, Corporate Law and Networks of Contacts' (1995) 81 *Virginia Law Review* 757, 759.

<sup>48</sup> Sarah Kiarie, 'At Crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road should the United Kingdom Take?' (2006) 1 *International Company and Commercial Law Review* 329, 332.

<sup>49</sup> See Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991), 36-39.

<sup>50</sup> *Ibid*, 37.

<sup>51</sup> Frank Easterbrook and Daniel Fischel, 'Voting in Corporate Law' (1983) *Journal of Law and Economics* 395, 403.

<sup>52</sup> Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991), 36.

<sup>53</sup> Jonathon Macey, 'Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective' (1999) 84 *Cornell Law Review* 1266, 1267.

<sup>54</sup> Eugene Fama and Michael Jensen, 'Agency Problems and Residual Claims' (1983) 26 *Journal of Law and Economics* 367, 328.

<sup>55</sup> Robert Clarke, 'Contracts, Elites, and Traditions in the Making of Corporate Law' (1989) 89 *Columbia Law Review* 1703, 1704.

<sup>56</sup> Jonathon Macey, 'Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective' (1999) 84 *Cornell Law Review* 1266, 1269-1270.

<sup>57</sup> Oliver Hart, 'An Economists Perspective on the Theory of the Firm' (1989) 89 *Columbia Law Review* 1757, 1764.



and a legal one.<sup>58</sup> The company is a separate legal person<sup>59</sup> not simply a web of contracts. In the words of Courtney, a company ‘is more than an aggregation of individual units; it constitutes a juristic or legal person’.<sup>60</sup> A company has legal rights such as perpetual succession, a company can own property,<sup>61</sup> can sue<sup>62</sup> and be sued.<sup>63</sup> Viewing the company in purely economic terms as a collection of contracts fails to recognise the reality of a corporation and also has inherent inconsistencies. As Keay notes, the theorists advocating the nexus of contracts theory deny the separate personality of the company in some circumstances but at other times, particularly in relation to liability issues, invoke separate legal personality.<sup>64</sup> This point was summed up in *Wallersteiner v Moir (no.2)*<sup>65</sup> and the statement that ‘It is a fundamental principle of our law that a company is a legal person, with its own corporate identity, separate and distinct from the directors or shareholders, and with its own property rights and interests to which it alone is entitled’.<sup>66</sup>

There are other difficulties with the nexus of contracts argument in favour of shareholder value. The only time that shareholders are actually treated as residual claimants is during liquidation, as long as the company is maintained as a going concern shareholders are not legally entitled to any payment, until the directors declare a dividend.<sup>67</sup> Even on a winding up, the company’s creditors will have a prior claim, ahead of the shareholders, on any assets to the amount of the debt owed. While the company remains as a going concern, it is inaccurate to describe shareholders as the sole residual claimants.<sup>68</sup> Stakeholders also receive benefits from a successful company such as bonuses for employees and discounts for customers.<sup>69</sup> Shareholders are also not the sole risk bearers in a company. Shareholders are often not the interest group most affected by corporate decision making<sup>70</sup>

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<sup>58</sup> See Razeen Sappiden, ‘Ownership of the Large Corporation: Why Clothe the Emperor?’ (1996) 7 *King’s College Law Journal* 27.

<sup>59</sup> See for example, *Salomon v A Salomon & Co Ltd* [1897] AC 22; *A L Underwood Ltd v Bank of Liverpool* [1924] 1 KB 775; *Macura v Northern Insurance Co Ltd* [1925] AC 619; *Roberts v Coventry Corporation* [1947] 1 All ER 308; *Wallersteiner v Moir (No 2)* [1975] QB 373; *Re Frederick Inns* [1991] ILRM 582; *Johnson v Gore Wood & Co (A Firm)* [2002] 2 AC 1; *Attorney General v Jameson* [1904] 2 IR 644. *Allied Irish Coal Supplies Ltd. v Powell Duffryn International Fuels Ltd* [1998] 2 IR 519.

<sup>60</sup> Thomas Courtney, *The Law of Companies*, (3rd edn, Bloomsbury 2012), 168.

<sup>61</sup> See *Farrar v Farrars Ltd* (1888) 40 Ch D 395; *Re Strathblaine Estates Ltd.* [1948] Ch 228; *Redfern v O’ Mahony and McFeely, Carroll, Tafica Ltd and Aifca Ltd* [2010] IEHC 253

<sup>62</sup> *Rainham Chemical Works Ltd (In Liquidation) v Belvedere Fish Guano Co Ltd* [1921] AC 465; *British Thompson Houston Co v Sterling Accessories* [1924] 2 Ch 33; *Irish People’s Assurance Society v Dublin City Assurance Co* [1929] IR 25.

<sup>63</sup> *Williams v Natural Life Health Foods Ltd* [1998] BCC 428; *Pearson & Son Ltd v Dublin Corporation* [1907] 2 IR 27.

<sup>64</sup> Keay A, ‘Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model’ (2008) 71(5) *The Modern Law Review* 663, 684.

<sup>65</sup> *Wallersteiner v Moir (no.2)* [1975] QB 373.

<sup>66</sup> *Ibid*, 390.

<sup>67</sup> See *Re Drogheda Steampacket Co Ltd.* [1903] IR 512; *Bond v Barrow Haematite Steel Co.* [1902] 1 Ch 353.

<sup>68</sup> Lynn Stout, ‘Bad and Not-So-Bad Arguments for Shareholder Primacy’ (2002) 75 *Southern California Law Review* 1189, 1194.

<sup>69</sup> Jingchen Zhao, ‘The Curious Case of Shareholder Primacy Norm: Calling for a More Realistic Theory’ (2012) 15 *International Trade and Business Law Review* 1, 18.

<sup>70</sup> Luigi Zingales, ‘In Search of New Foundations’ (2000) 55 *Journal of Finance* 1623, 1632.

and other stakeholders do bear risk in the company. Even those in favour of the nexus of contracts theory accept that stakeholders can bear greater risk than shareholders. Macey uses the example of an employee who has gained a firm specific skill which is non-transferable and states that in such a case the employee bears much greater risk from directors deciding on employee redundancies or plant closures than the shareholders.<sup>71</sup> Similarly, liquidation will have negative effects on stakeholders as well as shareholders, employees will lose their jobs and if the liquidation is insolvent, creditors will be affected as they will not receive payment to the full amount of the debt owed. Further, shareholders do not go completely unprotected by contract. Shareholders can alter the articles and memorandum of association and also can negotiate terms of an issue when applying for an allotment or otherwise purchasing shares. These legal realities significantly weaken the argument that shareholders are the sole residual claimants and sole risk bearers, undermining the residual claimant argument in favour of shareholder value.

## 2.04 Agency Theory

Another argument which supports shareholder value is based on agency theory.<sup>72</sup> The agency argument has two main elements; first that directors are agents for the shareholders and owe them a fiduciary duty to act for their benefit. Second, that operating the company for the shareholders' benefit allows shareholders to supervise directors and therefore reduce agency costs. Agency costs are the costs associated with directors misusing their position<sup>73</sup> and engaging in opportunistic behaviour.<sup>74</sup> The first argument is based on the work of Berle and asserts that because directors are agents of the shareholders they have a responsibility to take decisions for the benefit of those shareholders.<sup>75</sup> Berle argued that all powers granted to the management of a corporation were 'at all times exercisable only for the ratable benefit of all the shareholders'.<sup>76</sup> His general belief was that because the power to run a company had been delegated from the shareholders to the directors and that the directors had the sole

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<sup>71</sup> Jonathon Macey, 'Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective' (1999) 84 *Cornell Law Review* 1266, 1274.

<sup>72</sup> See Eugene Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economy* 228; Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Economics* 305.

<sup>73</sup> See Margaret Blair, *Ownership and Control; Rethinking the Corporate Governance for the Twenty First Century* (Brookings Institute 1996).

<sup>74</sup> Andrew Keay, 'Ascertaining The Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71(5) *Modern Law Review* 663, 668.

<sup>75</sup> Adolf Berle, 'Corporate Powers as Powers in Trust' (1930) 44 *Harvard Law Review* 1049.

<sup>76</sup> *Ibid*, 1049.

responsibility to run the corporation in the interests of those shareholders.<sup>77</sup> Other scholars have also argued for directors owing their fiduciary duties directly to shareholders.<sup>78</sup>

However, similar to the last two arguments in favour of shareholder value, the argument that directors are agents to the shareholders and owe their fiduciary duties to the shareholders directly is legally incorrect. As Dodd stated in his rebuttal to Berle, the law treats the company ‘as an institution directed by persons who are primarily fiduciaries for the institution rather than for its members’.<sup>79</sup> The company is legally a separate entity distinct from its shareholders and directors are fiduciaries to the company and owe their duties exclusively to the company, not to the shareholders.<sup>80</sup> As was stated by Dillon LJ in *Multinational Gas*<sup>81</sup> ‘[t]he directors indeed stand in a fiduciary relationship to the company, as they are appointed to manage the affairs of the company, and they owe duties to the company though not to the creditors, present or future, or to individual shareholders’.<sup>82</sup> In *Re A Company* it was held that ‘it is long established and basic law that the directors of a company owe their fiduciary duties to the company and not to the shareholders’.<sup>83</sup> Irish law has also made it clear that directors owe their duties to the company and not the shareholders.<sup>84</sup> The UK Companies Act 2006<sup>85</sup> and the Irish Companies Act 2014<sup>86</sup> also state that directors’ fiduciary duties are owed to the company. Unless a special relationship exists between a director and a shareholder directors have no fiduciary duty to act for the shareholders’ benefit.<sup>87</sup> As a result they cannot be legally held to be agents for the shareholders. As Watson puts it, the fatal flaw of agency theory is that it does not take into account the fact that a modern company is a legal entity, distinct from the holders of its shares.<sup>88</sup>

The second agency based argument is that if directors are agents of the shareholders agency costs will be reduced. Berle saw the imposition of fiduciary duties to shareholders as a solution to agency costs,<sup>89</sup> arguing it would curb managers from serving their own self-interest and would provide the

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<sup>77</sup> John Macintosh, ‘The Issues, Effects and Consequences of the Berle-Dodd Debate’ (1999) 24 *Accounting, Organizations and Society* 139, 144.

<sup>78</sup> Frank Easterbrook and Daniel Fischel, ‘Voting in Corporate Law’ (1983) *Journal of Law and Economics* 395, 403; Jonathon Macey, ‘An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties’ (1991) 21 *Stenson Law Review* 23, 23.

<sup>79</sup> Merrick Dodd, ‘For Whom are Managers Trustees?’ (1932) 45 *Harvard Law Review* 1145, 1162-1163.

<sup>80</sup> *Percivil v Wright* [1902] 2 Ch 421. *Dawson International plc v Coats Platon plc* [1989] BCLC 233; *Crindle Investments et al v Wymes et al* [1998] 2 ILRM 275; *Re A Company (No. 004415)* [1997] BCLC 479 Ch D, 491; *Peskin v Anderson* [2001] 1 BCLC 372.

<sup>81</sup> *Multinational Gas and Petroleum Co v Multinational Gas and Petroleum Services* [1983] Ch. 258.

<sup>82</sup> *Ibid*, 288.

<sup>83</sup> *Re A Company (No. 004415)* [1997] BCLC 479 Ch D, 491.

<sup>84</sup> See *Smith v Cork and Bandon Railway Co* (1870) 5 IR EQ 63; *Bloxham (in Liquidation) v The Irish Stock Exchange Ltd* [2014] IEHC 93.

<sup>85</sup> UK Companies Act 2006 s 170.

<sup>86</sup> Companies Act 2014 s 227(1).

<sup>87</sup> See *Peskin v Anderson* [2001] 1 BCLC 372; 379; *Howard Smith V Ampol Petroleum* [1974] AC 821, 837-838; *Elliot v Wheeldon* [1993] BCLC 53.

<sup>88</sup> Susan Watson, ‘How the Company Became an Entity: A New Understanding of Corporate Law’ (2015) *Journal of Business Law* 120, 138.

<sup>89</sup> Adolf Berle, ‘Corporate Powers as Powers in Trust’ (1930) 44 *Harvard Law Review* 1049.

tools to hold them accountable when they acted irresponsibly.<sup>90</sup> The argument is that shareholder value provides shareholders with a clear means of assessing directors' performance through profit or increases in share price and they can reward them or fine them accordingly.<sup>91</sup> It is the shareholders' responsibility to assess whether they are doing their job correctly, taking on a supervisory role ensuring that directors use their powers in the proper manner. Therefore a principal argument in favour of shareholder value is that it allows for directors to be directly accountable to the shareholders<sup>92</sup> and therefore reduces agency costs. Stout has claimed the agency cost argument to be the most influential of all arguments in favour of shareholder value arguing that directors' being accountable to shareholders is likely to increase efficiency of the company by reducing agency costs.<sup>93</sup>

However, the degree to which shareholders can effectively monitor and control directors is questionable, particularly in public companies. Shareholders do have the power to remove a director but it is a somewhat illusory power in practice.<sup>94</sup> Shareholder voting can be a 'fraud or mere ceremony designed to give a veneer of legitimacy to managerial power'<sup>95</sup> rather than being an effective method of disciplining directors. While shareholders have the ability to bring a derivative action against a director, derivative actions are rarely an effective method for enforcing director's duties.<sup>96</sup> Many scholars acknowledge that shareholders have limited control over directors and that directors cannot be seen as being accountable to shareholders.<sup>97</sup> As Clarke states, the majority of large public corporations escape effective shareholder control.<sup>98</sup> As a result directors are not always going to be held to account for agency costs under shareholder value.<sup>99</sup> This is particularly the case in large public companies where rational apathy theory holds that shareholders are generally passive<sup>100</sup> and much

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<sup>90</sup> Fenner Stewart, 'Berle's Conception of Shareholder Primacy: A Forgotten Perspective for Reconsideration During the Rise of Finance' (2011) 34 *Seattle University Law Review* 1457, 1464.

<sup>91</sup> Sarah Kiarie, 'At Crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road should the United Kingdom Take?' (2006) 1 *International Company and Commercial Law Review* 329, 334.

<sup>92</sup> Gerald Vinten, 'Shareholder Versus Stakeholder – Is There a Governance Dilemma?' (2001) 9(1) *Corporate Governance* 36 at 41.

<sup>93</sup> Lynn Stout, 'Bad and Not So Bad Arguments for Shareholder Primacy' (2002) 75 *Southern California Law Review* 1189, 1200.

<sup>94</sup> Lucian Bebchuck, 'The Case for Increasing Shareholder Power' (2005) 118 *Harvard Law Review* 833.

<sup>95</sup> R Clark, *Corporate Law* (Little Brown 1986), 781.

<sup>96</sup> See Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press, 2007); Andrew Keay, 'An Assessment of Private Enforcement Actions for Directors' Breaches of Duty' (2014) 33(1) *Civil Justice Quarterly* 76; Hans Hirt, *The Enforcement of Directors' Duties in Britain and Germany* (Peter Lang, 2004).

<sup>97</sup> See, Andrew Keay, 'Company Directors Behaving Poorly: Disciplinary Options for Shareholders' (2007) *Journal of Business Law* 656; Antoine Riberioux, 'Does Shareholder Primacy Lead to a Decline in Managerial Accountability?' (2007) 31 *Cambridge Journal of Economics* 507.

<sup>98</sup> Blanaid Clarke, *Corporate Responsibility in Light of the Separation of Ownership and Control* (1997) 1 *Dublin University Law Journal* 57, 57.

<sup>99</sup> Daniel Attenborough 'Giving Effect to the Corporate Purpose Debate: An Equitable Maximisation and Viability Principle' (2012) 32(1) *Legal Studies* 4, 10.

<sup>100</sup> James McConvill, 'The Separation of Ownership and Control under a Happiness-Based Theory of the Corporation' (2005) 26(2) *Company Lawyer* 35, 36.

more likely to sell their shares rather than supervise directors<sup>101</sup> or become actively involved in management.<sup>102</sup> Sappideen argues that the large corporation is largely independent of shareholder influence<sup>103</sup> and Keay describes shareholders as ‘impotent’ stating that directors will not be held accountable to shareholders for increasing agency costs.<sup>104</sup> The result of this is that shareholder value is unlikely to provide the type of accountability necessary to significantly reduce agency costs. Therefore agency theory is not a reason to advocate shareholder value ahead of more normatively superior models of the corporate objective.

## 2.05 Efficiency

The most persuasive argument in favour of shareholder value is that it encourages economic efficiency within a company. Efficiency has been described as the core principle driving the shareholder value paradigm in corporate governance.<sup>105</sup> By providing directors a clear objective, shareholder value allows directors to act in a way which facilitates companies being financially successful and profitable. The claim is that increased economic efficiency, achieved by following a shareholder value approach, creates the best environment for the creation of wealth.<sup>106</sup> By generating wealth, companies not only benefit shareholders but also meet a number of other social objectives<sup>107</sup> such as providing employment, paying corporation tax and providing products and services for the public. As a result pursuing shareholder value can be viewed as the best way to promote wealth for all constituents in the company.<sup>108</sup> As O’ Sullivan argues the most compelling argument in favour of shareholder value is that the employment of the theory increases social wealth.<sup>109</sup> On this basis it can be argued that it is not just shareholders who benefit from a shareholder value approach but many other constituents<sup>110</sup> and that stakeholders of profitable companies often benefit from knock-on

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<sup>101</sup> See Dalia Mitchell, ‘Shareholders as Proxies: The Contours of Shareholder Democracy’ (2006) 63 *Washington and Lee Law Review* 1502, 1564.

<sup>102</sup> Blanaid Clarke, ‘Corporate Responsibility in Light of the Separation of Ownership and Control (1997) 1 *Dublin University Law Journal* 57, 57.

<sup>103</sup> Razeen Sappiden, ‘Ownership of the Large Corporation: Why Clothe the Emperor?’ (1996) 7 *King’s College Law Journal* 27, 41.

<sup>104</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 91.

<sup>105</sup> Ciaran O’ Kelly, ‘History Begins: Shareholder Value, Accountability and the Virtuous State’ (2009) 60(1) *Northern Ireland Law Quarterly* 35, 45.

<sup>106</sup> Sarah Kiarie, ‘At Crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road should the United Kingdom Take?’ (2006) 1 *International Company and Commercial Law Review* 329, 333.

<sup>107</sup> James Wallace, ‘Value Maximisation and Stakeholder Theory: Compatible or Not’ (2003) 15(3) *Journal of Applied Corporate Finance* 120, 121.

<sup>108</sup> Anant Sunderam and Andrew Inkpen, ‘The Corporate Objective Revisited’ (2004) 15(3) *Organization Science* 350, 353.

<sup>109</sup> Mary O’Sullivan, ‘The Innovative Enterprise and Corporate Governance’ (2000) 24 *Cambridge Journal of Economics* 393, 395.

<sup>110</sup> Jeffrey Macintosh, ‘Designing an Efficient Fiduciary Law’ (1993) 43 *University of Toronto Law Journal* 425, 452.

effects.<sup>111</sup> A study taken by Copeland, Koller and Murrin concluded that ‘empirical evidence indicates that increasing shareholder value does not conflict with the long-run interests of other stakeholders. Winning companies seem to create relatively greater value for all stakeholders’.<sup>112</sup> As a result it can be said that shareholder value and stakeholder welfare are not contradictory goals and according to some scholars there is no significant distinction between a shareholder value and a stakeholder approach to corporate governance.<sup>113</sup>

The persuasiveness of the efficiency argument is based primarily on the weaknesses of stakeholder theory. As will be discussed in chapter three, stakeholder theory requires the company to be run for the benefit of all stakeholders but practical application of theory proves to be very difficult.<sup>114</sup> Directors attempting to cater to the needs of all stakeholders will end up trying to maximise in several different directions, something which will be detrimental to the company’s attempts to successful.<sup>115</sup> The stakeholder model provides no guidance how to choose between stakeholders when their interests are in conflict.<sup>116</sup> As a result it is impossible for directors to balance all divergent agendas meaning that the company is likely to become inefficient.<sup>117</sup> Therefore implementation of stakeholder theory can be even more likely to damage the company than application of shareholder value. Shareholder value is the pragmatic solution to the issue of the corporate objective as stakeholder theory has been the only traditional alternative. As Berle argued, the only workable solution is to identify the company with its shareholders because it is ‘the only effective way of ordering business affairs’ and that extending directors’ duties to stakeholders would not work until there was ‘a clear and reasonably enforceable scheme of responsibilities’.<sup>118</sup> Berle’s point is that because stakeholder theory is unworkable, the only effective way to operate a company is by applying shareholder value. Therefore, due to the difficulties of practical application, the argument that shareholder value is the best way to benefit all constituents in a company is true when stakeholder theory is the proposed alternative.

However, it is submitted that shareholder value is not the best way to achieve maximum benefits for all constituents, rather the theory primarily benefits shareholders<sup>119</sup> and even then, only some of the

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<sup>111</sup> Keith Davis, ‘The Case For and Against Business Assumption of Social Responsibilities’ in Archie Carroll, *Managing Corporate Social Responsibility* (Little 1977), 40.

<sup>112</sup> Tom Copeland, Jack Koller and Tim Murrin, *Valuation: Measuring and Managing the Value of Companies* (2nd edn, Wiley 1995), 22.

<sup>113</sup> See Gerald Vinten, ‘Shareholder Versus Stakeholder – Is There a Governance Dilemma’ (2001) 9(1) *Corporate Governance* 45; Philip Goldberg, ‘Shareholders v Stakeholders: the Bogus Argument’ (1998) 19(2) *Company Lawyer* 34.

<sup>114</sup> See Elaine Sternberg, ‘The Defects of Stakeholder Theory’ (1997) 5(1) *Corporate Governance* 3.

<sup>115</sup> Michael Jensen, ‘Value Maximisation, Stakeholder Theory and the Corporate Objective Function’ 14 *Journal of Applied Corporate Finance* 8, 10.

<sup>116</sup> *Ibid*, 13.

<sup>117</sup> The Committee on Corporate Law, ‘Other Constituency Statutes: Potential for Confusion’ (1990) 45 *Business Lawyer* 2253, 2269.

<sup>118</sup> Adolf Berle, ‘For Whom Are Managers Trustees: A Note’ (1932) 45 *Harvard Law Review* 1365, 1367.

<sup>119</sup> Daniel Attenborough ‘Giving Effect to the Corporate Purpose Debate: An Equitable Maximisation and Viability Principle’ (2012) 32(1) *Legal Studies* 4, 11.

shareholders.<sup>120</sup> There are times when pursuing shareholder value can harm the company's ability to be successful. The interests of the company as an entity may not always coincide with those of the current shareholders.<sup>121</sup> Directors may determine that the only way to increase shareholder value is to harm stakeholder interests by closing factories or employee redundancies for example.<sup>122</sup> As highlighted by Stout<sup>123</sup>, the reality that shareholder value can be damaging to stakeholders and the company as an entity can be nicely illustrated by reference to a hypothetical. Take a company subject to two separate takeover bids. One bid offers a higher price to shareholders but plans to make all employees redundant, shut down production operations, and discontinue the company as a going concern. At a slightly lower price, the second bidder plans to continue production and retain all staff members. From a stakeholder and societal point of view the second bidder would be the preferred option. However, adhering to the shareholder value principle, the former bidder must be given priority by the directors, despite the consequences to the company itself, the employees and the local community. In examples such as this where shareholder value is not the best approach and does not represent the best model for company efficiency or economic success.

Shareholder value has also other negative consequences such as its link to short-termism<sup>124</sup> i.e. that under shareholder value directors are more likely to prioritise the short term wealth of the shareholders rather than the long term health of the company. Grinyer, Russell and Collision describe short termism as 'foregoing economically worthwhile investments with long term benefits in order to increase reported earnings for the current period'.<sup>125</sup> While shareholder value theory can cover both short term and long term, the emphasis in the past has been on short term increases in value<sup>126</sup> and shareholder value has long been linked with producing this short term focus which over shadows all else.<sup>127</sup> The problem with focusing on short term shareholder value is that it is likely to be damaging for stakeholders and harmful to the company as an entity.<sup>128</sup> For example, drastic cost cutting may increase profit in the short term but long term is likely to be harmful to the company's business.<sup>129</sup> Blair and Stout argue that a short term shareholder value approach discourages stakeholders from

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<sup>120</sup> Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71(5) *The Modern Law Review* 663, 671.

<sup>121</sup> Alistair Alcock, 'An Accidental Change to Directors' Duties' (2009) 30 *Company Lawyer* 362, 364.

<sup>122</sup> Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71(5) *The Modern Law Review* 663, 671.

<sup>123</sup> Lynn Stout, 'Bad and Not-So-Bad Arguments for Shareholder Primacy' (2002) 75 *Southern California Law Review* 1189, 1197.

<sup>124</sup> Andrew Keay, *Directors' Duties* (2nd edn, Jordan 2014), 148.

<sup>125</sup> John Grinyer, Alex Russell and David Collision, 'Evidence of Managerial Short-Termism in the UK' (1998) 9 *British Journal of Management* 13, 15.

<sup>126</sup> William Allen, Jack Jacobs and Leo Strine, 'The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide' (2002) 69 *University of Chicago Law Review* 1067, 1076.

<sup>127</sup> Steven Wallman, 'The Proper Interpretation of Corporate Constituency Statutes and Formulation of Directors' Duties' (1991) 21 *Stenson Law Review* 163, 176.

<sup>128</sup> Larry Mitchell, *Corporate Irresponsibility: America's Newest Export* (Yale University Press 2001), 11.

<sup>129</sup> Eric Orts, 'The Complexity and Legitimacy of Corporate Law' (1993) 50 *Washington and Lee Law Review* 1565, 1591.

investing in the company, investments that can be essential to a company's success.<sup>130</sup> Parkinson et al agree saying that stakeholders will be unlikely to invest in companies who pursue shareholder value as they will be aware at all times that their investments will be subordinate to shareholders.<sup>131</sup> Short term focused shareholder value is also closely linked to a corporate culture of excessive risk taking from directors<sup>132</sup> which can lead to corporate collapses.<sup>133</sup> Excessive risk taking in order to maximise shareholder wealth is one of the primary negatives associated with shareholder value and the collapse of several large companies has led to criticism of the shareholder value doctrine.<sup>134</sup> Corporate collapses and excessive risk taking in order to increase short term shareholder wealth can have an extremely negative impact on stakeholders and on wider society. As a result the short term approach to shareholder value has come in for increasing criticism in recent years.<sup>135</sup>

## 2.06 Entity Maximisation and Sustainability

The efficiency argument in favour of shareholder value breaks down when compared to viewing the company as an entity. Many of the negatives associated with both shareholder value and stakeholder theory can be avoided by viewing the company as a separate legal entity and directors focusing on the maximisation of the wealth for the company. For example, viewing the company as a separate legal entity is likely to facilitate a more long term approach to company decision making by comparison to a shareholder value approach 'where the goal of short term profits is likely to prevail'.<sup>136</sup> The view that the company is a real entity and should be treated as separate and distinct from all its constituents is not a new formulation of the company. Maitland in 1900 argued that the company 'is in no sense artificial or fictitious, but is every whit as real and natural as is the personality of a man'.<sup>137</sup> Shortly after Deiser argued that the company has an existence which was completely distinct from the members that compose it.<sup>138</sup> Machen in 1911 also argued for the company to be seen as a separate entity stating that in real entity theory 'There are two basic propositions, (1) that a corporation is an entity distinct from the sum of the members that compose it, and (2) that the entity is a person'.<sup>139</sup> The

<sup>130</sup> Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia Law Review* 247, 305.

<sup>131</sup> John Parkinson, Andrew Gamble and Gavin Kelly, *The Political Economy of the Company* (Hart 2000), 131.

<sup>132</sup> William Bratton, 'Enron and the Dark Side of Shareholder Value' (2002) 76 *Tulane Law Review* 1275, 1278; Jonathon Macey, *Corporate Governance* (Princeton University Press, 2008), 36.

<sup>133</sup> Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (Berret-Koehler 2012).

<sup>134</sup> Antoine Riberioux, 'Does shareholder Primacy Lead to a Decline in Managerial Accountability?' (2007) 31(4) *Cambridge Law Journal of Economics* 507, 508.

<sup>135</sup> See Eric Talley, 'On the Demise of Shareholder Primacy' (2002) 75 *South Carolina Law Review* 1211; Michael Jensen, 'Value maximisation, Stakeholder Theory and the Corporate Objective Function' (2001) 14 *Journal of Applied Corporate Finance* 8; Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (Berret-Koehler 2012).

<sup>136</sup> Deirdre Ahern, *Directors' Duties: Law and Practice* (Roundhall 2009), 153.

<sup>137</sup> Frederick Maitland, 'The Corporation Sole (1900) 16(4) *Law Quarterly Review* 335, 336.

<sup>138</sup> George Deiser, 'The Juristic Person' (1908) 57 *University of Pennsylvania Law Review* 131, 133.

<sup>139</sup> Arthur Machen, 'Corporate Personality' (1911) 24 *Harvard Law Review* 253, 258.



premise for real entity theory is that the company is 'an institution in its own right'<sup>140</sup> and is completely independent from all other parties who are connected with it.<sup>141</sup>

This view of the company is much better equipped to explain many principles of company law. Unlike viewing the company as a nexus of contracts, real entity theory is not at odds with the doctrine of separate legal personality. Real entity theory also explains why directors can owe their duties directly to the company and not to the shareholders. Real entity theory is also well equipped to justify the dominant position of directors and the relatively weak role of shareholders in large companies<sup>142</sup> and also explains why shareholders can be members of the company and still bring legal action against the company.<sup>143</sup> Entity theory can also provide an explanation for the legal distinction between corporate liability and the personal acts of shareholders and directors which leads to personal liability.<sup>144</sup> As a result this view of the company as a separate entity is more plausible than any other theory of what a company is.<sup>145</sup> Viewing the company as a distinct entity provides justification for directors to maximise the wealth of the company as a separate entity free from shareholder value. If the company is seen as a distinct entity from its shareholders, the company's actions do not need to reflect the shareholders' interests<sup>146</sup> and it allows for the fact that the interests of the company and the interests of the shareholders can diverge.<sup>147</sup> In such scenarios the real entity view of the firm would allow directors to act for the benefit of the entity even at the expense of the shareholders or act for the benefit of stakeholders where such action would benefit the company as an entity.

It is accepted that the company is obviously not an actual physical person and does rely on natural persons to act in order for the company to take action. Companies are also dependent on shareholders to begin their existence. However neither of these statements detracts from the point of view that the company is a separate legal person. Simply because the company requires the action of human persons to take decisions does not mean that the company cannot be seen as an entity distinct from the

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<sup>140</sup> Waino Suojanen, 'Accounting Theory and the Large Corporation' (1954) 29 *The Accounting Review* 391, 392.

<sup>141</sup> William Bratton Jr., 'The New Economic Theory of the Firm: Critical Perspectives from History' (1989) 41 *Stanford Law Review* 1471, 1475.

<sup>142</sup> Morten Horwitz, 'Santa Clara Revisited: The Development of Corporate Theory' (1985) 88 *West Virginia Law Review* 173, 220.

<sup>143</sup> Rutherford Campbell Jr, 'Corporate Fiduciary Principles for the Post-Contractarian Era' (1996) 23 *Florida State University Law Review* 561, 589.

<sup>144</sup> Sarah Worthington, 'Shares and Shareholders: Property, Power and Entitlement Part 2' (2001) 22 *The Company Lawyer* 307, 309.

<sup>145</sup> Sanford Schane, 'The Corporation is a Person: the Language of Legal Fiction' (1986) *Tulane Law Review* 563, 594.

<sup>146</sup> Gregory Mark, 'The Personification of the Business Corporation in American Law' (1987) 54 *University of Chicago Law Review* 1441, 1472.

<sup>147</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 180.

people who are running it. This point was explained by Lord Reid in *Tesco Supermarkets Ltd v Natrass*.<sup>148</sup>

A living person has a mind which can have knowledge or intention or be negligent and he has hands to carry out his intentions. A corporation has none of these: it must act through living persons, though not always one or the same person. Then the person who acts is not speaking or acting for the company. He is acting as the company and his mind which directs his acts is the mind of the company. There is no question of the company being vicariously liable. He is not acting as a servant, representative, agent or delegate. He is an embodiment of the company or, one could say, he hears and speaks through the *persona* of the company, within his appropriate sphere, and his mind is the mind of the company.<sup>149</sup>

Secondly just because a company is created by the shareholders it does not mean that in the future the interests of the company and the shareholders cannot diverge. As Blair and Stout state, once shareholders have formed a company they ‘have created a new and separate entity that takes on a life of its own and could, potentially, act against their interests’.<sup>150</sup> This idea that a company is capable of having interests in its own right was expressed in *Dawson International Plc v Coats*.<sup>151</sup>

At the outset I do not accept as a general proposition that a company can have no interests in the change of identity of its shareholders on a take-over. It appears to me that there will be cases in which its agents, the directors, will see the takeover of its shares by a particular bidder as beneficial to the company. For example, it may provide the opportunity for integrating operations or obtaining additional resources. In other cases the directors will not see a particular bid as not in the interests of the company.<sup>152</sup>

Entity maximisation involves directors endeavouring to increase the market value of the company as a whole over the long term and seek to maximise the total wealth creating potential of the company.<sup>153</sup> Focusing on the sustainability of the entity limits excessive risk taking in order to maximise entity wealth. Seeking maximisation without regard for the company’s survival may well lead to the company not surviving and if a company cannot sustain itself it will not benefit any constituent.<sup>154</sup> The reason for arguing in favour of an entity maximisation and sustainability approach to the corporate objective is that it is more likely to achieve the normative goal of increased benefits for all company constituents, including shareholders. This is despite the fact that entity maximisation is

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<sup>148</sup> *Tesco Supermarkets Ltd v Natrass* [1972] AC 153.

<sup>149</sup> *Ibid*, 170.

<sup>150</sup> Margaret Blair and Lynn Stout, ‘A Team Production Theory of Corporate Law’ (1999) 85 *Virginia Law Review* 247, 277.

<sup>151</sup> *Dawson International Plc v Coats Platon plc* [1989] BCLC 233.

<sup>152</sup> *Ibid*, 242-243.

<sup>153</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 198.

<sup>154</sup> *Ibid*, 220.

different to shareholder value as stakeholders' interests will not be sacrificed simply to benefit shareholders.<sup>155</sup> Yet shareholders are more likely to benefit from promoting the interests of the company as an entity rather than pursuing shareholder value as the company itself will be more likely to be successful, survive and develop.<sup>156</sup> The entity approach does not necessarily mean focusing on increased profitability for shareholders but may entail a focus on research and development that may reduce profitability in the short term but may have benefits in the long term. For example, the company might decline a project which would be profitable in the short term but would alienate its community and damage its reputation to such a degree which may cost the company in the future.<sup>157</sup> The company would be more likely to be successful in the long term gaining the benefits from research and development and from not harming the company's reputation. The more successful and profitable the company becomes over the long term the more likely shareholders will receive benefits. Therefore it is submitted that the best way to achieve shareholder value is through entity maximisation rather than constantly prioritising the shareholders at the expense of stakeholder interests. In the words of Goldberg 'it is only by giving appropriate weight to all stakeholders that directors can maximise the sustainable growth in value of their companies for the benefit of shareholders'.<sup>158</sup>

Entity maximisation is different from stakeholder theory but has the potential to benefit stakeholders to a greater degree than other competing models. Stakeholder theory requires directors to be guardians of all stakeholders<sup>159</sup> but under entity maximisation directors' duties will be owed to the company and the directors' objective will be on fostering the entity's wealth, not individual stakeholders. Yet as stakeholder theory is likely to lead to economic inefficiencies due to the difficulties involved in balancing competing interests the theory is, in practice, unlikely to actually provide much benefit to stakeholders. Stakeholders are more likely to receive benefits from an economically successful company but a company which does not automatically prioritise shareholders.

As with any model however, entity maximisation will not benefit all stakeholders and shareholders all of the time and there will be instances when these interests clash. However, unlike stakeholder theory, treating the company as a distinct entity provides a clear way for directors to act in such scenarios. Directors should act in the interests of which ever interest group is most likely to benefit the company as an entity. As a result entity maximisation does not have the issue of balancing competing interests and the problem of having to maximise in different directions, one interest prevails above the others - the company's.<sup>160</sup> Bainbridge gives the example of a company closing down an old factory and

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<sup>155</sup> Ibid, 22.

<sup>156</sup> Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71(5) *The Modern Law Review* 663, 689.

<sup>157</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 201

<sup>158</sup> Philip Goldberg, 'Shareholders v Stakeholders: the Bogus Argument' (1998) 19(2) *Company Lawyer* 34, 36.

<sup>159</sup> Xiuping Sun, Steve Letza and James Kirkbride, 'Shareholding and Stakeholding: A Critical Review of Corporate Governance' (2004) 12 *Corporate Governance* 242, 250.

<sup>160</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 205.

opening a new one, whereby the employees and local community will be harmed but creditors, shareholders and new employees will all benefit from opening the new plant.<sup>161</sup> Under shareholder value, as advocated by Bainbridge, directors must take the option which provides most benefit to the shareholders while stakeholder theory would seem to offer no guidance in such a scenario. In order to make any theory workable some guidance must be given to directors in scenarios where interests clash and under entity theory the determining factor would be what benefits the company in the long term.<sup>162</sup> Yet under entity theory the automatic prioritisation of shareholders does not exist so stakeholders are relevant to the decision and may well determine the decision if acting for their benefit would be the best for the company. There is not a balancing of different interests groups but rather a balancing of factors in order to determine what is best for the company.<sup>163</sup>

The entity maximisation approach can be criticised on accountability grounds. The argument would be that similar to stakeholder theory, directors are not accountable to any one interest group and so agency costs will increase and the company will suffer as a result. Yet all the current methods of holding directors to account will continue to be available under the entity maximisation. For example shareholders will still be able to take a derivative action when directors breach their duty to act in the interests of the company. Liquidators will also be able to actions against directors for such a breach and it is possible that directors will be restricted or disqualified if they act contrary to the company's interests. Enforcement is discussed in detail in chapter six where it submitted that it is possible to hold directors to account under an entity maximisation approach when they fail to act in the interests of the company. The accountability argument also assumes that under shareholder value directors are regularly held to account to shareholders. As argued above, it is very doubtful that shareholders can effectively enforce directors' duties,<sup>164</sup> particularly in public companies. There is plenty of opportunity to increase agency costs under shareholder value<sup>165</sup> and shareholders retain too little control over directors to be relied on to reduce agency costs.<sup>166</sup> As a result directors are not always going to be held accountable for agency costs under shareholder value.<sup>167</sup> By treating the company as an entity, the directors have one clear objective: promote the company's interests. Their performance will be objectively measurable and enforcement of the model is achievable as will be outlined in chapter six.

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<sup>161</sup> Stephen Bainbridge, *The New Corporate Governance in Theory and Practice* (Oxford University Press 2008), 66-67.

<sup>162</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 205.

<sup>163</sup> Ibid, 212.

<sup>164</sup> See Andrew Keay, 'Company Directors Behaving Poorly: Disciplinary Options for Shareholders' (2007) *Journal of Business Law* 656.

<sup>165</sup> Thomas Donaldson and Lee Preston, 'The Stakeholder theory of the Corporation: Concepts, Evidence, Implications' (1995) 20 *Academy Management Review* 65, 87.

<sup>166</sup> Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia Law Review* 247, 258.

<sup>167</sup> Daniel Attenborough 'Giving Effect to the Corporate Purpose Debate: An Equitable Maximisation and Viability Principle' (2012) 32(1) *Legal Studies* 4, 10.

## 2.07 Case law Advocating a Shareholder Value Approach

As well as weaknesses in shareholder value in theory, there is little judicial support for a shareholder value approach. While there may have been a perception that the English common law required a short term shareholder value approach, the majority of cases did not endorse shareholder value. An examination of the case law does not show an unequivocal acceptance of shareholder value.<sup>168</sup> The judgments show a much more diverse approach to the corporate objective and many cases quite clearly do not support the shareholder value principle.<sup>169</sup> Yet there are some English and Irish cases which do equate the duty to act in the interests of the company with a duty to act for the benefit of the shareholders.<sup>170</sup> One of the earliest and well known cases advocating the shareholder value approach is the American judgment of *Dodge v Ford*.<sup>171</sup> Henry Ford was pursuing a policy of reducing dividends in order to subsidise the sale price of Ford cars. The aim of the policy was to stimulate the market, increase company sales and thereby secure the jobs of the company's employees.<sup>172</sup> The Dodge brothers, as shareholders, argued this approach was at the expense of shareholders and an improper use of power. The court held that such a policy was not proper as it was not in the interests of the company's shareholders and the court stated that 'the business corporation is organised and carried on primarily for the profit of stockholders. The powers of directors are to be employed for that end'.<sup>173</sup> The case would seem to represent a clear endorsement of shareholder value although its relevance in modern US company law has been questioned.<sup>174</sup>

In the UK and Ireland the shareholder value approach originates from the duty to act in the interests of the company. This fiduciary duty is owed by the directors to the company and comes from the cases of *Hutton v West Cork Railway*<sup>175</sup> and *Re Smith and Fawcett*.<sup>176</sup> In *Hutton v West Cork Railway*, Bowen LJ, gave the oft cited statement 'the law does not say that there shall be no cakes and ale, but there are to be no cakes and ale except as such as are required for the benefit of the company'.<sup>177</sup> In *Re Smith and Fawcett* Lord Greene MR speaking in the Court of Appeal observed that 'directors must act, *bona fide*, in what they consider - not what the court considers - is in the best interests of the

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<sup>168</sup> Andrew Keay, *Directors' Duties* (2nd edn, Jordan, 2014), 41.

<sup>169</sup> See, *Evans v Brunner Mond & Co Ltd* [1921] 1 Ch. 359; *Lonhro v Shell Petroleum* [1980] 1 WLR 627; *Fulham Football Club v Cabra Estates* [1994] 1 BCLC 363; *Dawson International Plc v Coats Platon plc* [1989] BCLC 233; *Re Welfab Engineers* [1990] BCLC 833; *Re BSB Holdings Ltd* [1996] 1 BCLC 155.

<sup>170</sup> *Parke v Daily News Ltd* [1962] Ch 927; *Brady v Brady* [1988] 3 BCC 535; *Heron International Ltd* [1983] BCLC 244; *Greenhalgh v Ardene Cinemas Ltd* [1950] 2 All ER 1120. *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC, 22; *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported), 77; *Re Frederick Inns Ltd*. [1994] 1 ILRM 387, 396.

<sup>171</sup> *Dodge v Ford Motor Company* 170 NW 668 (Mich, 1919).

<sup>172</sup> *Ibid*, 684.

<sup>173</sup> *Ibid*.

<sup>174</sup> See Lynn Stout, 'Why We Need to Stop Teaching *Dodd v Ford*' (2008) 3 *Virginia Law and Business Review* 163.

<sup>175</sup> *Hutton v West Cork Railway* (1883) 23 Ch D 654.

<sup>176</sup> *Re Smith and Fawcett Ltd*. [1924] Ch 304.

<sup>177</sup> *Hutton v West Cork Railway* (1883) 23 Ch D 654, 673.

company.’<sup>178</sup> The duty to act in the best interests of the company has since become a well-established fiduciary duty in common law courts.<sup>179</sup> However despite *Hutton* and *Re Smith and Fawcett* often being cited a support for shareholder value,<sup>180</sup> the duty to act in the best interests of the company, by itself, does not support a shareholder value approach. It is the courts, by equating the duty to act in the interests of the company with a duty to act in the interests of the shareholders, which imposes a shareholder value model. As Ahern states, the application of shareholder primacy results in the interests of the company being equated with the collective interests of the shareholders.<sup>181</sup>

In the UK, the company’s interests have sometimes been viewed as being synonymous with shareholders’ interests and the duty to act in the best interests of the company has been equated with a duty to act in the interests of the shareholders.<sup>182</sup> This interpretation of the duty has also been evident in Ireland.<sup>183</sup> One case which is regularly cited in favour of this interpretation is *Greenhalgh v Ardene Cinemas* where Lord Evershed MR stated that, ‘[t]he phrase, the company as a whole does not mean the company as a commercial entity as distinct from the corporators. It means the corporators as a general body’.<sup>184</sup> Despite the case dealing with the shareholders’ power to alter the articles, the quote has been cited on many occasions in support of a shareholder value approach to directors’ duties.<sup>185</sup> However there seems to be little or no rationale for the courts to apply *Greenhalgh* to directors’ duties<sup>186</sup> because the case dealt with how shareholders are to act, not directors.<sup>187</sup> It is Attenborough’s view that it is doubtful if Evershed MR actually intended to lay down a principle of general application<sup>188</sup> as Lord Greene MR statements were obiter and his statements were limited to ‘such a case as the present’.<sup>189</sup> In addition, the interpretation given to the phrase ‘the interests of the company’ in *Greenhalgh* is not universally applied in relation to shareholder action. The judgment in

<sup>178</sup> *Re Smith and Fawcett Ltd.* [1924] Ch 304, 306.

<sup>179</sup> See *Mutual Life Insurance Co v Rank Organisation Ltd* [1985] BCLC 11; *Bamford v Bamford* [1970] Ch 212; *Banfi Ltd v Moran* [2006] IEHC 257; *JJ Harrison (Properties) Ltd v Harrison* [2001] EWCA Civ 1467.

<sup>180</sup> See Jeffrey Macintosh, ‘Designing an Efficient Fiduciary Law’ (1993) 43 *University of Toronto Law Journal* 425, 452; John Lowry, ‘The Duty Of Loyalty of Company Directors; Bridging the Accountability Gap Through Efficient Disclosure’ (2009) 68 *Cambridge Law Journal* 607, 617.

<sup>181</sup> Deirdre Ahern, *Directors’ Duties: Law and Practice* (Roundhall 2009), 152-153.

<sup>182</sup> *Parke v Daily News Ltd* [1962] Ch 927; *Brady v Brady* [1988] 3 BCC 535; *Heron International Ltd* [1983] BCLC 244; *Greenhalgh v Ardene Cinemas Ltd* [1950] 2 All ER 1120.

<sup>183</sup> *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC, 22; *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported), 77; *Re Frederick Inns Ltd.* [1994] 1 ILMR 387, 396.

<sup>184</sup> *Greenhalgh v Ardene Cinemas Ltd* [1951] 2 All ER 1120, 1126.

<sup>185</sup> *Parke v Daily News Ltd* [1962] Ch 927; *Gaiman v National Association for Mental Health* [1971] Ch 317; *Heron International Ltd* [1983] BCLC 244; *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC.

<sup>186</sup> See Daniel Attenborough, ‘How Directors Should Act When Owing Duties to the Companies’ Shareholders: Why We Need to Stop Applying *Greenhalgh*’ (2009) 20(10) *International Company and Commercial Law Review* 339.

<sup>187</sup> Andrew Keay, *Directors’ Duties* (2nd edn, Jordan, 2014), 42.

<sup>188</sup> Daniel Attenborough, ‘How Directors Should Act When Owing Duties to the Companies’ Shareholders: Why We Need to Stop Applying *Greenhalgh*’ (2009) 20(10) *International Company and Commercial Law Review* 339, 344.

<sup>189</sup> *Greenhalgh v Ardene Cinemas Ltd* [1951] 2 All ER 1120, 1127.

*Greenhalgh* is at direct odds with *Allen v Gold Reefs*<sup>190</sup> which held when altering the articles the interests of the company as an entity should take priority over shareholders' interests.<sup>191</sup> Despite both *Allen v Gold Reefs* and *Greenhalgh v Ardene Cinemas* reaching directly opposed conclusions on this topic, it is *Greenhalgh* which is often cited in directors' duties cases and not the judgment in *Allen v Gold Reefs*. Another case which is regularly used to support shareholder value is *Brady v Brady*<sup>192</sup> where Nourse LJ stated '[t]he interests of a company, an artificial person, cannot be distinguished from the interests of the person who are interested in it. Who are those persons? Where a company is both going and solvent, first and foremost come the shareholders present and no doubt future as well.'<sup>193</sup> The judgment is often cited in support of the view that the common law required a shareholder value approach but as highlighted by Keay,<sup>194</sup> the statement was made in the context of a potential breach of section 151 of the Companies Act 1985, which deals with financial assistance and not directors' duties.<sup>195</sup>

One of the few cases which does support a shareholder value approach in the context of directors' duties is *Parke v Daily News Ltd*.<sup>196</sup> The case involved payments to employees on the winding up of the company. The shareholders ratified the payment by a vote at a general meeting however Plowman J held that the payments were contrary to the duty to act in the interests of the company. Plowman J viewed the duty to act for the benefit of the company as meaning a duty to act for the benefit of the shareholders as a general body citing *Greenhalgh v Ardene Cinemas* as support for such an interpretation.<sup>197</sup> Plowman J stated that

the view that directors, in having regard to the question what is in the best interests of their company, are entitled to take into account the interests of the employees, irrespective of any consequential benefit to the company is one which may be widely held....but no authority to support that proposition of law was cited to me; I know of none and in my judgment such is not the law.<sup>198</sup>

There can be no other interpretation of the case than viewing it as one which supports shareholder value. The general principle of the case is that generosity to employees has no place in the boardroom unless it furthers the shareholders' interests.<sup>199</sup> Despite the statements of Ploughman J, generosity

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<sup>190</sup> *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656.

<sup>191</sup> *Ibid*, 671.

<sup>192</sup> *Brady v Brady* [1988] 3 BCC 535.

<sup>193</sup> *Ibid*, 552.

<sup>194</sup> Andrew Keay, *Directors' Duties* (2nd edn, Jordan, 2014), 43.

<sup>195</sup> Andrew Keay, 'Enlightened Shareholder Value, the Reform of the Duties of Company Directors and the Corporate Objective' (2006) *Lloyd's Maritime and Commercial Law Quarterly* 335, 343.

<sup>196</sup> *Parke v Daily News Ltd* [1962] Ch 927.

<sup>197</sup> *Ibid*, 963.

<sup>198</sup> *Parke v Daily News Ltd* [1962] Ch 927, 962-963.

<sup>199</sup> John Lowry, 'The Duty Of Loyalty of Company Directors; Bridging the Accountability Gap Through Efficient Disclosure' (2009) 68 *Cambridge Law Journal* 607, 617.

towards employees has long been seen as lawful. The early cases of *Hampson v Price*<sup>200</sup> and *Hutton v West Cork Railway*<sup>201</sup> did not advocate such strict adherence to shareholder value principles. Both cases held that gratuitous payments to employees were legal if they had the potential to indirectly benefit the company<sup>202</sup> and at no point, in either judgment, were the company's interests equated with the interests of the shareholders. In *Hampson v Price's Patent Candle Co*<sup>203</sup> the directors made payments to employees in recognition of their action to help the company be profitable. A shareholder brought an action alleging the directors had acted beyond their powers. The court rejected the claims of the shareholder stating that giving gratuitous payments to employees would likely to be beneficial to the company in the future.<sup>204</sup> The *Hutton v West Cork Railway* case also involved payments to employees who were dismissed and payments to directors for past services. Both were held to be legal once reasonable in the management of the affairs of the company.<sup>205</sup> It is difficult to see any real benefit to the shareholders for payments to redundant employees and to directors for past services yet both were seen as legal in the *Hutton* case. However *Parke v Daily News* seems to go against the principles laid down in *Hutton* and *Hampson* and Lowry criticises the decision stating it is a decision that belongs to a different age.<sup>206</sup> The decision in *Parke v Daily News* was reversed by section 74 of the UK Companies Act 1980. The section conferred a power on directors to make provision for the benefit of employees or former employees on the transfer or cessation of the company and is now in force under section 247 of the Companies Act 2006.

Another case which represents a shareholder value approach is *Heron International*<sup>207</sup> which dealt with a company subject to two rival takeover bids. Lawton LJ held that when the directors have established that it is in the interests of the company that the company should be taken over, and there are two bidders, the directors' duty is to obtain the best price for the shareholders.<sup>208</sup> Lawton LJ went on to state that when directors must decide between the rival bidders the 'interests of the company must be the interests of the shareholders'.<sup>209</sup> While this statement was expressly limited to the scenario of rival takeover bids, it still advocates a shareholder value approach. According to Lawton LJ no other consideration is to be given to stakeholder interests when considering the takeover bid, such as the effects on employees. In this regard the judgment can be contrasted to *Dawson International Plc v Coats*<sup>210</sup> discussed below, where employees interests played an important role in

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<sup>200</sup> *Hampson v Price's Patent Candle Co* (1876) 45 LJ Ch 436.

<sup>201</sup> *Hutton v West Cork Railway* [1883] L.R. 23 Ch.D 654.

<sup>202</sup> *Ibid*, 672- 673.

<sup>203</sup> *Hampson v Price's Patent Candle Co* (1876) 45 LJ Ch 436.

<sup>204</sup> *Ibid*, 439.

<sup>205</sup> *Hutton v West Cork Railway* [1883] L.R. 23 Ch.D 654, 672.

<sup>206</sup> John Lowry, 'The Duty Of Loyalty of Company Directors; Bridging the Accountability Gap Through Efficient Disclosure' (2009) 68 *Cambridge Law Journal* 607, 617.

<sup>207</sup> *Heron International Ltd* [1983] BCLC 244.

<sup>208</sup> *Ibid*, 265.

<sup>209</sup> *Ibid*.

<sup>210</sup> *Dawson International Plc v Coats Platon plc* [1989] BCLC 233.



determining the success of rival bidders. These are the main cases which support a shareholder value approach in the UK. By comparison, as will be highlighted below, there is much greater support for a less shareholder value focused interpretation of the duty to act in the best interests of the company.

However Ireland seems to endorse the shareholder value principle to a much greater degree. Support for shareholder value in the Irish context stems from *G&S Doherty v Doherty* where Henchy J stated that ‘directors are in a fiduciary position, and must exercise their power *bona fide* for the benefit of the company as a whole, that is to say, the shareholders as a whole: See *Greenhalgh v Ardenne Cinemas Ltd*’.<sup>211</sup> The shareholder value approach was echoed in *Irish Press v Ingersoll* where Barron J stated that ‘acting in the interests of the company is no more than acting in the interests of all its shareholders’<sup>212</sup> and was also endorsed in the case of *Re Frederick Inns Ltd*.<sup>213</sup> In *Re Frederick Inns* the Supreme Court of Ireland followed a shareholder value approach with Blaney J, citing with approval the case of *Kinsela v Russell Kinsela Pty. Ltd*<sup>214</sup> which stated ‘In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise’. Although *Re Frederick Inns* dealt with *ultra vires* payments and the duties of directors to creditors, endorsing the statement would seem to advocate a shareholder value approach.

## **2.08 Case Law which does not Represent a Shareholder Value Approach**

The majority of cases from the UK, prior to the enactment of the UK Companies Act 2006, allowed for stakeholder interests to be considered during the decision making process in so far as it benefitted the company, either directly or indirectly. This did not necessarily mean that there would have to be a benefit to the shareholders which highlights that the courts recognised that the interests of the company and the interests of the shareholders are not always aligned. Therein lies the difference between shareholder value and the common law approach taken in the UK. The common law allowed directors to act for stakeholder interests even when it cannot benefit the shareholders, if there is a possibility it will benefit the company as an entity. Dodd argued for a similar approach when he stated that a corporation becomes a distinct legal entity upon incorporation<sup>215</sup> and as such viewed the company as more than just a collection of shareholders.<sup>216</sup> Equating the duty to act in the interests of the company as being identical to a duty to act in the interests of the shareholders is also contrary to some well-established legal doctrines, the same legal doctrines which undermine many of the arguments in favour of a shareholder value approach. Firstly it is a fundamental principle of company

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<sup>211</sup> *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC, 22.

<sup>212</sup> *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported), 77.

<sup>213</sup> *Re Frederick Inns Ltd*. [1994] 1 ILRM 387, 396.

<sup>214</sup> *Kinsela v. Russell Kinsela Pty. Ltd. (in liquidation)* [1986] 4 NSWLR 722.

<sup>215</sup> Merrick Dodd, ‘For Whom are Managers Trustees?’ (1932) 45 *Harvard Law Review* 1145, 1146.

<sup>216</sup> *Ibid*, 1148.

law that the company is a legal entity which is separate from its shareholders.<sup>217</sup> The case which established the doctrine of separate legal personality was *Salomon v A Salomon & Co Ltd* where Lord Halsbury LC stated that:

Once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself, and that the motives of those who took part in the promotion of the company are absolutely irrelevant in discussing what those rights and liabilities are.<sup>218</sup>

In the same case Lord MacNaughton said that the corporation at law is a different person entirely from the subscribers to the memorandum of the company.<sup>219</sup> Since the judgment in *Salomon v A Salomon* there has been widespread judicial support of this separation between the company and its shareholders.<sup>220</sup> In *Credit Suisse v Allerdale Borough Council* Hobhouse LJ held that ‘it is elementary law that shareholders are not to be identified with the corporate entity even if there is only one shareholder’.<sup>221</sup> Similarly Lord Millet in *Johnson v Gore Wood* stated that the company is a legal entity ‘separate and distinct from its members.’<sup>222</sup> The Irish courts have also consistently applied the principle laid down in *Salomon*.<sup>223</sup> This well established doctrine of separate legal personality is contradictory to the approach of equating the company’s interests with the shareholders’ interests. The potential distinction between the interests of the company and its shareholder is illustrated by *Gaiman v National Association for Mental Health*.<sup>224</sup> Megarry J first stated that ‘it is not very easy to determine what is in the best for the company without paying due regard to the members’.<sup>225</sup> This would seem to endorse a shareholder value approach however he went on to state that paying due regard to the members does not mean prioritising the members’ interests above all others. Megarry J stated:

in the case of a company, whether limited by shares or guarantee, a new legal entity comes into existence, namely, the company; and many of the powers have to be exercised for the benefit of that entity. This distinguishes a company from an ordinary club, which is not a legal

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<sup>217</sup> Paddy Ireland, Ian Grigg-Spall and Dave Kelly, ‘The Conceptual Foundations of Modern Company Law’ (1987) 14(1) *Journal of Law & Society* 149, 150; Gregory Mark, ‘The Personification of the Business Corporation in American Law’ (1987) 54 *University of Chicago Law Review* 1441, 1468.

<sup>218</sup> *Salomon v A Salomon & Co Ltd* [1897] AC 22, 30.

<sup>219</sup> *Ibid*, 51.

<sup>220</sup> See for example, *Prest v Petrodel Resources Ltd & Ors* [2013] UKSC 34; *A L Underwood Ltd v Bank of Liverpool* [1924] 1 KB 775; *Macura v Northern Insurance Co Ltd* [1925] AC 619; *Roberts v Coventry Corporation* [1947] 1 All ER 308; *Wallersteiner v Moir (No 2)* [1975] QB 373; *Re Frederick Inns* [1991] ILRM 582, 587.

<sup>221</sup> *Credit Suisse v Allerdale Borough Council* [1997] QB 306, 359.

<sup>222</sup> *Johnson v Gore Wood & Co (A Firm)* [2002] 2 AC 1, 61.

<sup>223</sup> See for example, *Re Frederick Inns Ltd* [1991] ILRM 582; *Attorney General v Jameson* [1904] 2 IR 644. *Allied Irish Coal Supplies Ltd. v Powell Duffryn International Fuels Ltd* [1998] 2 IR 519.

<sup>224</sup> *Gaiman v National Association for Mental Health* [1971] Ch 317.

<sup>225</sup> *Ibid*, 330.

entity distinct from its members.....the conversion of a club into a limited company is no mere formality, but a change of substance. Where there is corporate personality, the directors or others exercising the powers in question are bound not merely by their duties towards other members, but also by their duties towards the corporation.<sup>226</sup>

This quote demonstrates that the shareholders' interests are not synonymous with the company's interests and that the company is an entity distinct from its shareholders. In further support of the separation between the company's interests and the shareholders' interests is the fact that the common law duty to act in the best interests of the company<sup>227</sup> is owed to the company as an entity and not to any individual shareholder or to any group of shareholders.<sup>228</sup> This rule was recognised in Ireland in the case of *Crindle Investments* which stated, '[t]here can be no doubt that, in general, although the directors of a company occupy a fiduciary position in relation to the company, they do not owe a fiduciary duty, merely by a virtue of their offices, to the individual members.'<sup>229</sup> In certain circumstances directors can owe special duties to shareholders as was noted in the case of *Peskin v Anderson*.<sup>230</sup> However Lord Justice Mummery noted that:

The fiduciary duties owed to the company arise from the legal relationship between the directors and the company directed and controlled by them. The fiduciary duties owed to the shareholders do not arise from that legal relationship. They are dependent on establishing a special factual relationship between the directors and the shareholders in the particular case.<sup>231</sup>

An example of such a special relationship can be seen in *Howard Smith v Ampol Petroleum* where a special duty was held to be owed by directors to shareholders when directors had used their power to allot shares for a different purpose for which it was granted.<sup>232</sup> However there is no general duty owed to shareholders from directors. Despite the doctrine of separate legal personality and the nature of directors' fiduciary duties there is evidence, particularly from *Parke v Daily News*<sup>233</sup> and *Heron International*<sup>234</sup>, as well as the Irish judgments,<sup>235</sup> that when it comes to directors' duties the best

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<sup>226</sup> Ibid.

<sup>227</sup> See *Re Smith v Fawcett Ltd* [1924] Ch 304; *Hutton v West Cork Railway* (1883) 23 Ch D 654; *Mutual Life Insurance Co v Rank Organisation Ltd* [1985] BCLC 11; *Bamford v Bamford* [1970] Ch 212; *Banfi Ltd v Moran* [2006] IEHC 257; *JJ Harrison (Properties) Ltd v Harrison* [2001] EWCA Civ 1467; *West Merica Safety Wear v Dodd* (1988) 4 BCC 30; *Percivil v Wright* [1902] 2 Ch. 421; *Re A Company (No. 004415)* [1997] BCLC 479 Ch D. *Multinational Gas and Petroleum Co v Multinational Gas and Petroleum Services* [1983] Ch. 258.

<sup>228</sup> *Smith v Cork and Bandon Railway Co* (1870) 5 IR EQ 63; *Percivil v Wright* [1902] 2 Ch 421. *Dawson International plc v Coats Platon plc* [1989] BCLC 233; *Re A Company (No. 004415)* [1997] BCLC 479 Ch D; *Multinational Gas and Petroleum Co v Multinational Gas and Petroleum Services* [1983] Ch. 258.

<sup>229</sup> *Crindle Investments et al v Wymes et al* [1998] 2 ILRM 275, 288.

<sup>230</sup> *Peskin v Anderson* [2001] 1 BCLC 372.

<sup>231</sup> Ibid, 379.

<sup>232</sup> *Howard Smith V Ampol Petroleum* [1974] AC 821, 837-838.

<sup>233</sup> *Parke v Daily News Ltd* [1962] Ch 927.

<sup>234</sup> *Heron International Ltd* [1983] BCLC 244.

<sup>235</sup> *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC; *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported); *Re Frederick Inns Ltd.* [1994] 1 ILRM 387.

interests of the company equates directly with the best interests of the shareholders. However this interpretation represents the minority of the judgments. As Keay states there does not seem to be a clear strain of authority running through the UK common law cases that supports the view that the best interests of the company means the best interests of the shareholders and certainly no patent support of shareholder value principle.<sup>236</sup>

There are two main stands of case law which interpret the duty to act in the interests of the company as not simply equating with a duty to act for the shareholders' interests. The first demonstrates that stakeholders can be taken into account when determining what is in the best interests of the company. Early cases such as *Hampson*<sup>237</sup> and *Hutton*<sup>238</sup> indicate that employee interests can be considered in determining what is best for the company even though there is no direct benefit to the shareholders. A similar conclusion was reached in *Evans v Brunner Mond & Co Ltd*.<sup>239</sup> In this case a large chemical company had resolved in a general meeting to make large donations to universities and other institutions for scientific research. Eve J rejected claims that the resolution was *ultra vires* on the basis that any benefit to the company would be too indirect, that it would benefit competitors, and that it amounted only to a benefit to the community. Despite the fact that there was going to be no direct benefit to the current shareholders Eve J held that such research was necessary for the company's continued progress as a chemical manufacturer.<sup>240</sup> These cases would support Wen's argument that the principle of non-shareholder consideration which leads to eventual benefit of the company has been acknowledged by English common law for over a century.<sup>241</sup>

Some more recent judgments have made very clear statements that the duty to act in the interests of the company can include considering stakeholder interests. In *Lonrho v Shell Petroleum*<sup>242</sup> it was stated that the best interests of the company were not exclusively those of the shareholders but may include the creditors.<sup>243</sup> Similarly in *Fulham Football Club v Cabra Estates*<sup>244</sup> Chadwick J held '[t]he duties owed by the directors are to the company and the company is more than just the sum total of its members' and includes creditors and employees.'<sup>245</sup> Cases such as *Gaiman, Fulham Football Club*

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<sup>236</sup> Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge, 2012), 57.

<sup>237</sup> *Hampson v Price's Patent Candle Co* (1876) 45 LJ Ch 436.

<sup>238</sup> *Hutton v West Cork Railway* [1883] L.R. 23 Ch.D 654.

<sup>239</sup> *Evans v Brunner Mond & Co Ltd* [1921] 1 Ch. 359.

<sup>240</sup> *Ibid*, 369.

<sup>240</sup> *Ibid*, 394.

<sup>241</sup> Shuangge Wen, 'Exploring the Rationale of Enlightened Shareholder Value (ESV) in the Realm of UK Company Law – The Path Dependence Perspective' (2011) 14 *International Trade and Business Law Review* 153, 157.

<sup>242</sup> *Lonrho v Shell Petroleum* [1980] 1 WLR 627.

<sup>243</sup> *Ibid*, 634.

<sup>244</sup> *Fulham Football Club v Cabra Estates* [1994] 1 BCLC 363.

<sup>245</sup> *Ibid*, 394.

and *Lonhro v Shell Petroleum* represent the reality that the company is not simply a collection of shareholders.

The second strand of case law demonstrates that not only should stakeholder interests be taken into account when acting in the interests of the company but also that if there is a conflict between the company as an entity and the shareholders, it is the company's interests which should be prioritised. These cases are clearly contrary to shareholder value and provide evidence that several of the common law cases from the UK did not endorse shareholder value. This approach can be seen in *Re BSB Holdings Ltd*<sup>246</sup> where it was stated that 'As respects the potential conflict between the interests of the members and the interests of the company, it seems to me..... the interests of the company prevail'.<sup>247</sup> Arden J went on to state that 'the law does not require the interests of the company to be sacrificed in the particular interests of a group of shareholders'.<sup>248</sup>

In the case of *Re Welfab Engineers*<sup>249</sup> the directors were subject to a suit from a liquidator under section 212 of the UK Insolvency Act 1986 in which it was alleged the directors had breached their duty to the company by accepting an undervalue bid for the company's principal asset. The directors chose not to sell to the highest bidder as the company would not have been able to continue as a going concern due to time constraints and its employees would have been made redundant. Accepting the lower bid allowed the company to continue in business and the bidder had agreed to preserve the jobs of the employees and the directors. The liquidator argued that the directors were in breach of their duties 'because they gave priority to the preservation of the business and the jobs of the employees'.<sup>250</sup> However Hoffman J held that the directors were not liable for a breach. What the case demonstrates is that directors, under the common law, were not in breach of their duties for prioritising the interests of the employees and the interests of the company as an entity ahead of maximising shareholder wealth.

In relation to how directors are to act when subject to takeover bid, the Scottish case of *Dawson International Plc v Coats Platon plc*<sup>251</sup> held that a director owe a duty to act in the best interests of the company and not the shareholders' best interests. He stated that there was 'no good reason why it should be supposed that directors are, in general, under a fiduciary duty to shareholders'.<sup>252</sup> Lord Cullen accepted that the interests of the company and its shareholders may well diverge and stated '[w]hat is in the interests of current shareholders who are sellers of their shares may not necessarily coincide with what is in the interests of the company. The creation of parallel duties could lead to

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<sup>246</sup> *Re BSB Holdings Ltd* [1996] 1 BCLC 155.

<sup>247</sup> *Ibid*, 249.

<sup>248</sup> *Ibid*, 251.

<sup>249</sup> *Re Welfab Engineers* [1990] BCLC 833.

<sup>250</sup> *Ibid*, 836.

<sup>251</sup> *Dawson International Plc v Coats Platon plc* [1989] BCLC 233.

<sup>252</sup> *Ibid*, 243.

conflict. Directors have but one master, the company'.<sup>253</sup> This case is a good example of why the company should be viewed as an entity and capable of having its own interests as accepting a takeover bid can be deleterious to the company in the long term.<sup>254</sup> As a result directors in deciding between takeover bidders should be able to act in the interests of the company instead of prioritising shareholder wealth at the expense of the company as an entity and its stakeholders.

Lord Cullen also explained why he was not following the decisions in *Greenhalgh v Ardene Cinemas* and *Parke v Daily News*.<sup>255</sup> In relation to *Greenhalgh* he stated that the case dealt with different issues as it was concerned with the actions of shareholders who were not fiduciaries of the company. In regards to *Parke v Daily News* Lord Cullen recognised that the case adopted the statement from *Greenhalgh* 'that the benefit of the company meant the benefit of the shareholders as a general body' and that the *Parke v Daily News* applied the doctrine to directors' duties but stated that 'I have some doubt as to whether that was an accurate way of putting the matter'.<sup>256</sup> He also recognised that the effect of the decision in *Parke v Daily News* reversed by a legislative amendment.<sup>257</sup>

The decisions in the above cases have led to claims that the common law may not have adopted a shareholder value approach at all<sup>258</sup> and certainly never advocated a strict interpretation of shareholder value.<sup>259</sup> It is submitted that the approach taken by these cases represent a far superior approach to shareholder value and the approach taken in the Irish case law. However, as will be highlighted in chapter four, the commendable approach taken by the courts is no longer possible due to the legislative intervention of the section 172(1) of the Companies Acts 2006 and ESV which represents a clear endorsement of shareholder value. Ireland has declined to follow the UK approach and still has the possibility of embracing a more entity focused view of the company as is the topic of chapter five.

## 2.09 Conclusion

This chapter has argued that the theoretical foundations of shareholder value are significantly flawed. Arguments such as property rights, nexus of contracts theory and agency theory attempt to provide the justification for the prioritisation of shareholders ahead of stakeholder interests such as consumers,

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<sup>253</sup> Ibid.

<sup>254</sup> Richard Mitchell, Anthony O' Donnell and Ian Ramsey, 'Shareholder Value and Employee Interests: Intersections Between Corporate Governance, Corporate Law and labour Law' (2005) 23 *Wisconsin Law Journal* 417, 438.

<sup>255</sup> *Dawson International Plc v Coats Platon plc* [1989] BCLC 233, 245.

<sup>256</sup> Ibid.

<sup>257</sup> Ibid. The decision in *Parke v Daily News* was reversed by s 74 of the UK Companies Act 1980. The section conferred a power on directors to make provision for the benefit of employees or former employees on the transfer or cessation of the company and is now in force under s 247 of the Companies Act 2006.

<sup>258</sup> Simon Deakin, 'The Coming Transformation of Shareholder Value' (2005) 13 *Corporate Governance: An International Review* 11, 12. John Armour, Simon Deakin and Suzanne Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41 *British Journal of Industrial Relations* 531, 531.

<sup>259</sup> Elaine Lynch, 'Section 172: A Ground Breaking Reform of Directors' Duties, or the Emperor's new Clothes?' (2010) 33(9) *Company Lawyer* 196, 198; Alistair Alcock, 'An Accidental Change to Directors' Duties' (2009) 30 *Company Lawyer* 362, 363.

employees and creditors.<sup>260</sup> The focus on shareholders and shareholder primacy are based on an outmoded conception of the company<sup>261</sup> and represent on a misunderstanding of the concepts of separate legal personality and the nature of directors' duties. The more legally accurate view is that a company is a separate legal entity distinct from all its participants. This view of the company is not only more legally accurate but also the theory of the firm which is most likely to benefit all constituents. Many of the cases would seem to agree with the proposal that shareholder value is not the optimal solution to the corporate objective. There are times when the interests of the company should be seen a separate from the shareholders and that stakeholder interests should have a significant role in determining what is in the interests of the company. However the problem with the common law was that it was misunderstood as requiring a short term shareholder value approach, a belief which was held by academics<sup>262</sup>, directors<sup>263</sup> and the Company Law Review Steering Group.<sup>264</sup> This misconception ultimately led to ESV being introduced through the UK Companies Act 2006.

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<sup>260</sup> Karel Williams, 'From Shareholder Value to Present Day Capitalism' (2000) 29(1) *Economy and Society* 1, 6.

<sup>261</sup> Susan Watson, 'How the Company Became an Entity: A New Understanding of Corporate Law' (2015) *Journal of Business Law* 120, 120.

<sup>262</sup> See for example, Jill Fisch, 'Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy' (2006) *Journal of Corporation Law* 637, 647; Jingchen Zhao, 'The Curious Case of Shareholder Primacy Norm: Calling for a More Realistic Theory' (2012) 15 *International Trade and Business Law Review* 1, 1; Paul Davies, *Gower and Davies Principles of Modern Company Law* (8th edn, Sweet and Maxwell, 2008), 507; Shuangge Wen, 'Exploring the Rationale of Enlightened Shareholder Value (ESV) in the Realm of UK Company Law – The Path Dependence Perspective' (2011) 14 *International Trade and Business Law Review* 153, 157.

<sup>263</sup> See Institute of Directors, *Good Boardroom Practice: Company Law Review, The Stakeholder Debate* (1999).

<sup>264</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.7.

## Chapter 3 Stakeholder Theory and German Codetermination

### 3.01 Introduction

Stakeholder theory has been the traditional alternative to shareholder value. In answering the question of in whose interests should a company be run, stakeholder theory requires that companies should be run for the benefit of all stakeholders. While the US scholarship has generally been supportive of shareholder value, the work of Edward Freeman<sup>1</sup> became the catalyst for economists and business strategists to analyse the validity of stakeholder theory<sup>2</sup> and the theory has since received significant support from within the academic community.<sup>3</sup> Freeman argued that managing companies for shareholder wealth was outdated and that stakeholders should no longer be seen as a means to attain shareholder value but instead increasing benefits for stakeholders should become an end in itself.<sup>4</sup> The primary aim of stakeholder theory is to get all parties involved in a company to ‘work together for a common goal and to obtain shared benefits’.<sup>5</sup> Instead of taking decisions for the sole benefit of the shareholders, stakeholder theory advocates that directors operate the company for the creation of wealth for all stakeholders. Despite having a strong normative basis, no way has been found to practically implement stakeholder theory.<sup>6</sup> The theory’s fundamental flaw is that it requires directors to balance the interests of all stakeholders but provides directors with little guidance as to how to do so when these interests clash and as a result the theory becomes unworkable in practice.<sup>7</sup>

Another alternative to shareholder value is the German model of codetermination where employees are given a significant role in the governance of companies. Through a two-tiered board structure, employees are given up to a fifty per cent representation on a supervisory board whose primary role is to monitor the performance of the management board and appoint directors on to the management board. Because of the strong representation of employees, the focus of German companies is not focused solely on increasing shareholder wealth. In addition directors’ duties do not require directors

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<sup>1</sup> Edward Freeman, *Strategic Management: A Stakeholder Approach* (Pitman 1984).

<sup>2</sup> Christopher Stoney and Diana Winstanley, ‘Stakeholding: Confusion or Utopia? Mapping the Conceptual Terrain’ (2001) 38(5) *Journal of Management Studies* 603, 604.

<sup>3</sup> See John Boatright, ‘Fiduciary Duties and the Shareholder Management-Relation: Or what’s so Special About Shareholders’ (1994) 4 *Business Ethics Quarterly* 393; Andrew Friedman and Samantha Miles, ‘Developing Stakeholder Theory’ (2002) 39(1) *Journal of Management Studies* 1; Thomas Donaldson and Lee Preston, ‘The Stakeholder Theory of for the Corporation: Concepts, Evidence, Implications’ (1995) 20 *Academy Management Review* 65; Scott Reynolds, Frank Schultz and David Hekman ‘Stakeholder Theory and Managerial Decision Making: Constraints and Implications of Balancing Stakeholder Interests’ (2006) 64 *Journal of Business Ethics* 285;

<sup>4</sup> Edward Freeman, *Strategic Management: A Stakeholder Approach* (Pitman 1984), 97.

<sup>5</sup> Janice Dean, *Directing Public Companies* (Cavendish, 2001), 94.

<sup>6</sup> See Elaine Sternberg, ‘The Defects of Stakeholder Theory’ (1997) 5(1) *Corporate Governance* 3; Anant Sandaram and Andrew Inkpen, ‘The Corporate Objective Revisited’ (2004) 15(3) *Organisation Science* 350; Amir Licht, ‘The Maximands of Corporate Governance: The Theory of Values and Cognitive Style’ (2004) 29 *Delaware Journal of Corporate Law* 649.

<sup>7</sup> Daniel Attenborough, ‘Giving Purpose to the Corporate Purpose Debate: An Equitable Maximisation and Viability Principle’ (2011) 32(1) *Legal Studies* 4, 15.



to pursue shareholder value and instead all directors must promote the success of the company.<sup>8</sup> Therefore the German model does not represent shareholder value but is not a practical application of stakeholder theory as only one stakeholder is being represented. As a result the German approach does not have the problem of balancing many different competing interests.

The positive aspects of the codetermination model prompted action at EU level through the Fifth Directive on company law,<sup>9</sup> the aim of the Directive being to implement a German style codetermination model throughout the European Union. The initial draft required that all public companies would have to establish a second supervisory board with significant employee representation. However despite repeated dilution the Directive has never been enacted into law and is now extremely unlikely to ever be enacted. A Directive and a European Council Regulation, introduced in 2001, now protects the rights of different Member States to choose their own style of management structures and employee participation models.<sup>10</sup> The primary reason for the failure of the Directive was that it was too major a reform for some corporate cultures.<sup>11</sup> There is unwillingness in some jurisdictions to radically alter their corporate culture, an argument referred to as path dependency. Path dependency theory suggests that transplanting a governance model with many historical and cultural influences is unlikely to work in a jurisdiction with a very different history and corporate culture.<sup>12</sup> There are many differences between European continental corporate governance systems and the approach taken in common law jurisdictions and Keay believes that path dependence is perhaps the reason for the resilience of shareholder value in common law countries.<sup>13</sup> The failure to reach an agreement on the draft Fifth Directive would seem to support Keay's view. Due to these difficulties with transplanting the model very few German commentators argue for codetermination as a model for other jurisdictions.<sup>14</sup> However it is submitted that it is possible to implement some positive elements of the German approach without altering the institutional structure of companies. Employee representation in Irish companies has been expanded in recent years through introduction of work councils<sup>15</sup> and increased employee consultation.<sup>16</sup> Furthermore, as argued for in this thesis, a

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<sup>8</sup> Aktiengesetz s 93(1)(2).

<sup>9</sup> Concerning the structure of the Public Limited Companies and the Powers and Obligations of their Organs 15 OJ EUR. COMM. (No. C131) 49 (1972).

<sup>10</sup> Council Regulation 2157/2001 of October 8 2001 on the statute for a European Company (SE) [2001] OJ L294/1 and the SE Employees' Directive [2001] OJ L294/22-23.

<sup>11</sup> Judith Marychursch, 'Harmonisation or Proliferation of Corporations law in the European Union?' (2002) *Australian International Law Journal* 80, 82; Jean Du Plessis and Otto Sandrock, 'The German Corporate Governance Model in the Wake of Company Law Harmonisation in the European Union' (2005) *Company Lawyer* 88, 91.

<sup>12</sup> Shuangge Wen, 'Exploring the Rationale of Enlightened Shareholder Value (ESV) in the Realm of UK Company Law – The Path Dependence Perspective' (2011) 14 *International Trade and Business Law Review* 153, 161.

<sup>13</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 42.

<sup>14</sup> Henry Hansmann and Reiner Kraakman 'The End of History for Corporate Law' (2001) 89 *The Georgetown Law Journal* 439, 441.

<sup>15</sup> Transnational Information and Consultation of Employees Act 1996.

<sup>16</sup> Employees (Provision of Information and Consultation) Act 2006.

reinterpretation of what it means to act in the interests of the company could ensure that, like Germany, the focus of directors is not solely on increasing shareholder value.

This chapter first provides a description and analysis of stakeholder theory and highlights why practical application of theory proves to be so problematic. Secondly the chapter outlines the legal rules of German codetermination and historical background leading to the development of the model. Thirdly it describes the legal requirements contained in the draft Fifth Directive and outline the reasons for its failure to be implemented and also the reasons why a two-tiered board model is so difficult to transplant to common law jurisdictions. Finally the chapter analyses the German model as a solution to the corporate objective and concludes that it is possible to follow elements of the model without implementing a two-tiered board structure.

### 3.02 Stakeholder Theory

Stakeholder theory rejects the idea that directors are agents of shareholders with the sole goal of increasing shareholder value but instead argues that directors should act as mediators between all interest groups and share the benefits of a company between them.<sup>17</sup> The main tenant of the theory is that no one interest group automatically ranks above any other.<sup>18</sup> Stakeholder theory holds that the economic and social purpose of the company is to create and distribute wealth and value to all stakeholder groups without favouring one interest group at the expense of others.<sup>19</sup> In achieving this goal directors are required to balance all stakeholders which involves ‘assessing, weighing and addressing the competing claims of those who have a stake in the company in the actions of the organisation’.<sup>20</sup> The facts of the situation faced by the directors are to guide how the different interests are to be balanced<sup>21</sup> and stakeholder management involves ‘a never ending task of balancing and integrating multiple objectives’.<sup>22</sup> The theory correctly asserts that there is nothing unique about the investment given by shareholders and it is often the case that many different stakeholders make large investments in their companies.<sup>23</sup> For example, an employee may train to develop highly specific

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<sup>17</sup> Margaret Blair and Lynn Stout, ‘Director Accountability and the Mediating Role of the Corporate Board’ (2001) 79 *Washington University Law Quarterly* 403, 405.

<sup>18</sup> Thomas Donaldson and Lee Preston, ‘The Stakeholder Theory of the Corporation: Concepts, Evidence, Implications’ (1995) 20 *Academy Management Review* 65, 66.

<sup>19</sup> Max Clarkson, ‘A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance’ (1995) 20 *Academy Management Review* 92, 112.

<sup>20</sup> Scott Reynolds, Frank Schultz and David Hekman ‘Stakeholder Theory and Managerial Decision Making: Constraints and Implications of Balancing Stakeholder Interests’ (2006) 64 *Journal of Business Ethics* 285, 286.

<sup>21</sup> Andrew Keay, ‘Stakeholder Theory in Corporate Law: Has it got what it Takes?’ (2010) 9 *Richmond Journal of Global Law and Business* 249, 257.

<sup>22</sup> Edward Freeman and John McVea, ‘A Stakeholder Approach to Strategic Management’ in Michael Hitt, Edward Freeman and Jeffrey Harrison (eds), *Handbook of Strategic Management* (Blackwell 2001), 194.

<sup>23</sup> Margaret Blair and Lynn Stout, ‘A Team Production Theory of Corporate Law’ (1999) 85(2) *Virginia Law Review* 247, 259.

skills with little relevance outside that company once he thinks his job is secure<sup>24</sup> or a supplier may invest in equipment for the use of a single customer.<sup>25</sup> Some employees may work in excess of what they are required to without extra remuneration and governments may invest in infrastructure to support major corporations.<sup>26</sup> As a result, each group of stakeholders merits consideration on its own right not simply to be seen as a vessel to further the interests of shareholders.<sup>27</sup>

From a normative point of view stakeholder theory is preferable to shareholder value as its primary aim is to benefit all participants in the company.<sup>28</sup> However stakeholder theory breaks down when it comes to practical application. A central aspect of stakeholder theory is the need to satisfy the legitimate expectations of all stakeholders and the need to fairly balance stakeholder interests.<sup>29</sup> However the theory provides no guidelines as to how directors are to achieve this goal.<sup>30</sup> The primary difficulty is that effectively balancing many different competing interests is very difficult when no set of interests are prioritised over the others. It is a fact of business that different interest groups involved in a company will come into conflict and it is not possible to consistently advance the interests of shareholders and at the same time advance the interests of many different stakeholders,<sup>31</sup> for example, the interests of employees will often be different to those of the creditors or the shareholders. In addition to balancing competing stakeholder groups directors must also find an effective and fair way to balance competing interests from within these groups.<sup>32</sup> For example creditors with different levels of security, different classes of employees, and different community groups can all have competing interests.<sup>33</sup> Balancing these different interests is an exceedingly difficult task particularly when stakeholder theory provides little guidance as to which interests should be prioritised in a given scenario.<sup>34</sup> Efforts have been made as to how different interests are to be ranked such as the importance of the stakeholder.<sup>35</sup> However as Sundaram and Inkpen highlight, without an overall

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<sup>24</sup> Deryn Fisher, 'The Enlightened Shareholder – Leaving Stakeholders in the Dark: Will Section 172(1) of the Companies Act 2006 make Directors Consider the Impact of their Decisions on Third Parties' 2009 20(1) *International Company and Commercial Law Review* 10, 14.

<sup>25</sup> CLRSg, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI 1999), para 5.1.10.

<sup>26</sup> Mia Rahim, 'The Stakeholder Approach to Corporate Governance and Regulation: An assessment' (2011) 8 *Macquarie Journal of Business Law* 304, 305.

<sup>27</sup> Thomas Donaldson and Lee Preston, 'The Stakeholder Theory of for the Corporation: Concepts, Evidence, Implications' (1995) 20 *Academy Management Review* 65, 67.

<sup>28</sup> Melvin Eisenberg, *Modernization of Corporate Law: An Essay for Bill Cary* (1982) 37 *University of Miami Law Review* 187, 209.

<sup>29</sup> Andrew Keay, 'Stakeholder Theory in Corporate law: Has it Got What it Takes?' (2010) 9 *Richmond Journal of Global Law and Business* 249, 281.

<sup>30</sup> Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' (2001) 7(3) *European Financial Management* 297, 305.

<sup>31</sup> Amir Licht, 'The Maximands of Corporate Governance: The Theory of Values and Cognitive Style' (2004) 29 *Delaware Journal of Corporate Law* 649, 686.

<sup>32</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the law* (Elgar 2011), 145.

<sup>33</sup> Anant Sandaram and Andrew Inkpen, 'The Corporate Objective Revisited' (2004) 15(3) *Organisation Science* 350, 354.

<sup>34</sup> Elaine Sternberg, 'The Defects of Stakeholder Theory' (1997) 5(1) *Corporate Governance* 3, 4.

<sup>35</sup> Edward Freeman, *Strategic Management: A Stakeholder Approach* (Pitman 1984), 112.

criterion to assess importance, directors are still left with no way to distinguish important stakeholders from unimportant ones.<sup>36</sup>

The problem with the lack of guidance given to directors is that it leads to confusion between objectives.<sup>37</sup> All purposeful behaviour requires the existence of a clear objective<sup>38</sup> and directors can generally work more efficiently if their focus is on one objective only.<sup>39</sup> However stakeholder theory provides directors with no such clear objective. Jensen sums up the issue by stating, 'it is logically impossible to maximise in more than one direction at the same time....In effect it leaves the manager with no objective. The result will be confusion and a lack of purpose that will fundamentally handicap the firm in its competition for survival'.<sup>40</sup> This confusion between objective can cause directors to become trapped in a 'no win situation' and the best thing to do is nothing at all.<sup>41</sup> As Goodpaster states, adopting stakeholder theory would push director 'decision making towards paralysis because of the dilemmas posed by divided loyalties'.<sup>42</sup> In addition, when directors are given no clear objective their performance cannot be evaluated in any principled way<sup>43</sup> and the potential for agency costs increase. In the words of Easterbrook and Fischel '[a] manager who is told to serve two masters...has been freed of both and is answerable to neither...agency costs rise and social wealth falls'.<sup>44</sup> Because there is no clear goal, stakeholder theory provides no way to measure director performance and directors become completely unaccountable for their actions.<sup>45</sup> As Mark Roe puts it 'a stakeholder measure of managerial accountability could leave managers so much discretion that managers could easily pursue their own agenda, one that might maximise neither shareholder, employee, consumer, nor national wealth but only their own'.<sup>46</sup> Therefore, in attempting to operate the company for the

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<sup>36</sup> Anant Sandaram and Andrew Inkpen, 'The Corporate Objective Revisited' (2004) 15(3) *Organisation Science* 350, 352.

<sup>37</sup> Andrew Gamble and Gavin Kelly, 'Shareholder Value and the Stakeholder Debate in the UK' (2001) 9(2) *Corporate Governance* 110, 113.

<sup>38</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 8; Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' (2001) 7(3) *European Financial Management* 297, 300.

<sup>39</sup> Mark Van Der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27, 56.

<sup>40</sup> Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' (2001) 7(3) *European Financial Management* 297, 301.

<sup>41</sup> Andrew Keay, 'Stakeholder Theory in Corporate Law: Has it got what it Takes?' (2010) 9 *Richmond Journal of Global Law and Business* 249, 282.

<sup>42</sup> Kenneth Goodpaster, 'Business Ethics and Stakeholder Analysis' in Max Clarkson (ed) *The Corporation and its Stakeholders: Classic and Contemporary Readings* (University Toronto Press, 1998), 115.

<sup>43</sup> Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' (2001) 7(3) *European Financial Management* 297, 302.

<sup>44</sup> Frank Easterbrook and Daniel Fischel, *The Economic Structure of Company Law* (Harvard University Press, 1991), 38.

<sup>45</sup> Thomas Donaldson, 'The Stakeholder Revolution and the Clarkson Principles' (2002) 12 *Business Ethics Quarterly* 107, 110.

<sup>46</sup> Mark Roe, 'The Shareholder Wealth Maximisation Norm and Industrial Organisation' (2001) 149 *University of Pennsylvania Law Review* 2063, 2065.

benefit of all participants, application of stakeholder theory will actually damage the company and reduce its ability to benefit any constituent.

The counter argument to the issue of balancing competing interests is to say it is a director's job to balance different objectives from different sectors.<sup>47</sup> However Sternberg argues that the reason that directors are capable of balancing competing interests, in practice, is because directors use the goal of company success as a criterion for selecting which interests to favour.<sup>48</sup> Under stakeholder theory all stakeholder interests are seen as equal and so there is no criterion for how directors are to resolve situations when interests do not align. By comparison, competing models do offer guidance as to how directors are to act in situations where interests clash. Entity maximisation provides directors with a clear objective of enhancing the value and sustainability of the company and provides a means to balance competing interests by requiring directors to take the decision which provides most benefit to the company as an entity. Similarly, the reason why shareholder value is seen as practical and workable<sup>49</sup> is that it gives directors a clear objective to maximise benefits conferred on shareholders and all other interests groups are subordinate to this one clear goal. Berle argued that shareholder value cannot be abandoned without a reasonably enforceable scheme to put in its place.<sup>50</sup> However, many years on, stakeholder theory has still failed to provide such a legally suitable and enforceable framework. One way to implement stakeholder theory would be to change the nature of directors' duties to confer a direct duty on directors to meet the legitimate expectations of all stakeholders. However, if a direct duty was placed on directors to act in the interests of a set group of stakeholders it would open directors up to a potentially never ending list of actions which would not be of benefit to the company. It would also be likely that directors would be able to escape liability because if they are required to act for the benefit of all stakeholders then every decision becomes justifiable and as described above, directors become completely unaccountable. The Hampel Committee<sup>51</sup> outlined the problems associated with extending directors' duties stating that if directors' duties were defined in terms of benefit to stakeholders it would mean

Identifying all the various stakeholder groups: and deciding the extent and nature of the directors' responsibility to each. The result would be that the directors were not effectively accountable to anyone since there would be no clear yardstick by which to judge their performance. This is a recipe neither for good governance nor for corporate success.<sup>52</sup>

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<sup>47</sup> Amir Licht, 'The Maximands of Corporate Governance: The Theory of Values and Cognitive Style' (2004) 29 *Delaware Journal of Corporate Law* 649, 731.

<sup>48</sup> Elaine Sternberg, 'The Defects of Stakeholder Theory' (1997) 5(1) *Corporate Governance* 3, 5.

<sup>49</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 173.

<sup>50</sup> Adolf Berle, 'For Whom are Corporate Managers Trustees: A Note' (1932) 45 *Harvard Law Review* 1365, 1367.

<sup>51</sup> The Hampel Committee, *Committee on Corporate Governance: Final Report* (1998).

<sup>52</sup> *Ibid*, para 1.18.

In addition the courts in deciding cases under such a broad set of duties would be required to assess the likely impact of business policies on a diverse range of stakeholder interests which would represent a near-impossible task.<sup>53</sup> It is difficult to disagree with Attenborough's assertion that it is not possible to hold directors, systematically accountable to multiple non-shareholder constituents.<sup>54</sup> While normatively desirable, there seems to be no way to establish a legal framework which actually implements stakeholder theory.

### 3.03 German Codetermination

As discussed above, application of stakeholder theory, where no one stakeholder group is prioritised over any other, appears to be impossible to implement in practice. What can be implemented however is a model which provides one specific stakeholder group, employees, with a direct say in the management of a company. Jurisdictions such as Germany divide the boards of certain companies into two separate structures: the management board (the Vorstand) and the supervisory board (Aufsichtsrat). Through a model known as codetermination, employees are represented on the supervisory board, varying from equal representation to one third representation depending on the type of company and the number of employees. The supervisory board has two primary functions: to appoint directors on to the management board and to supervise the management board.<sup>55</sup> They also have other functions such as the power to call shareholders meetings, to examine financial statements, and certain transactions may need supervisory board approval depending on the company's articles.<sup>56</sup> The supervisory board may also inspect the company books and records at any time<sup>57</sup> and the management board must inform the supervisory board of its policies for the future conduct of business as well as report to the supervisory board regularly regarding company affairs.<sup>58</sup>

Employee representation and the two-tiered model each developed quite independently of each other and a unique set of historical events led to the intermingling of the principles. Initially, the two-tiered board structure contained no employee representation and the early form of two-tiered management was focused on creation of wealth for shareholders. German companies are usually split into two types of company: companies who are on the stock market (AG) and the German equivalent of private companies (GmbH) and the separation of management and supervisory boards date back to 1861

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<sup>53</sup> John Parkinson, *Corporate Power and Responsibility: The Issues in the Theory of Company Law* (Clarendon Press, 1993), 86.

<sup>54</sup> Daniel Attenborough, 'Giving Purpose to the Corporate Purpose Debate: An Equitable Maximisation and Viability Principle' (2011) 32(1) *Legal Studies* 4, 14.

<sup>55</sup> Frank Wooldridge, 'The Composition and Functions of German Supervisory Boards' (2011) 32(6) *Company Lawyer* 190, 191.

<sup>56</sup> Klaus Hopt, *The German Two-Tiered Board(Aufsichtsrat): A German View on Corporate Governance in Comparative Corporate Governance* (De Gruyter 1997), 5.

<sup>57</sup> Carol Rasnic, 'Germany's Statutory Works Councils and Employee Codetermination: A Model for The United States?' (1992) 14 *Loyola of Los Angeles International & Comparative Law Journal* 275, 283.

<sup>58</sup> Klaus Hopt, *The German Two-Tiered Board(Aufsichtsrat): A German View on Corporate Governance in Comparative Corporate Governance* (De Gruyter 1997), 6.

when the German Commercial Code introduced a supervisory board for AG companies. The Code certainly did not have the effect of accommodating employee interests and at its inception the supervisory board role effectively supervised on behalf of the shareholders.<sup>59</sup> The fact that the original effect of the supervisory board was to serve the shareholders' interests caused the merits of the two-tiered system to be viewed for some time with considerable suspicion by stakeholders.<sup>60</sup> However the effect of supervising on the shareholders' behalf was not the intended purpose behind the supervisory board.<sup>61</sup> The supervisory board replaced a model whereby companies were subject to oversight and control by the then socialist Government<sup>62</sup> and this is the historical reason why the supervisory board serves interests other than the shareholders.<sup>63</sup> The supervisory board was intended to replace government supervision and reflect the interests of all stakeholders such as the state, employees and investors.<sup>64</sup> However the Commercial Code failed to achieve such ends. Instead companies took advantage of the removal of direct state oversight as an opportunity to focus solely on profits.<sup>65</sup> The response of the legislator was to continue with the two-tiered system but to adopt a series of specific reforms which would clarify the exact roles of each board.<sup>66</sup> These reforms led to the first implementation of codetermination in 1922, when employees were given the power to elect representatives on to the supervisory board.<sup>67</sup> The employee representation applied to a very small number of companies and was repealed in 1934 but was seen as a major breakthrough in terms of breaking the dominance of shareholders on the supervisory board.<sup>68</sup>

Equal representation on the supervisory board was secured for employees for the first time in 1951<sup>69</sup> making it meaning that 80 years separated the introduction of the supervisory board and parity between employees and shareholders. The system that the trade unions campaigned for was to make it compulsory for labour and management to work together, the aim being to ensure that a strict class

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<sup>59</sup> Rudolf Weitholter, 'Interessen und Organisation der Aktiengesellschaft im Amerikanischen und Deutschen Recht' (Verlag CF Muller, Karlsruhe, 1961), 280 as referenced in Jean du Plessis and Otto Sandrock, 'The Rise and Fall of Supervisory Codetermination in Germany?' (2005) *International Company and Commercial Law Review* 69, 71.

<sup>60</sup> Jean du Plessis and Otto Sandrock, 'The Rise and Fall of Supervisory Codetermination in Germany?' (2005) *International Company and Commercial Law Review* 69, 72.

<sup>61</sup> Carsten Jungman, 'The Effectiveness of Corporate Governance in One-Tier and Two-Tiered Board Systems' (2006) 4 *European Company and Financial Law Review* 426, 449.

<sup>62</sup> Mark Loewenstein, 'Stakeholder Protection in Germany and Japan: What Can We Learn From Foreign Systems?' (2002) 76 *Tulane Law Review* 1673, 1675.

<sup>63</sup> Klaus Hopt, *The German Two-Tiered Board (Aufsichtsrat): A German View on Corporate Governance in Comparative Corporate Governance* (De Gruyter, Berlin, 1997), 3-6.

<sup>64</sup> Mark Loewenstein, 'Stakeholder Protection in Germany and Japan: What Can We Learn From Foreign Systems?' (2002) 76 *Tulane Law Review* 1673, 1675.

<sup>65</sup> Ibid

<sup>66</sup> Klaus Hopt, *The German Two-Tiered Board (Aufsichtsrat): A German View on Corporate Governance in Comparative Corporate Governance* (De Gruyter 1997), 6.

<sup>67</sup> See Official Gazette of the Former Reich (Reichsgesetzblatt, 1922) Part 1 209-210.

<sup>68</sup> Thomas Raiser, 'The Theory of Enterprise Law in the Federal Republic of Germany' (1998) *American Journal of Comparative Law* 111, 117.

<sup>69</sup> Montanmitbestimmungsgesetz, 1951

distinction would not emerge again in Germany after the Second World War.<sup>70</sup> Other nations also implemented codetermination models after the Second World War but Germany was the nation which provided the most far reaching powers to employees.<sup>71</sup> The 1951 Act required that any company (AG or GmbH) in the iron, coal or steel industry which had over 1,000 employees was obliged to have a two-tier board.<sup>72</sup> The supervisory board was to consist of five shareholder representatives and five employee representatives with an eleventh neutral member from outside the company<sup>73</sup> thereby ensuring complete equality between employees and shareholders on the supervisory board.

What followed the 1951 Act was a series of expansions to codetermination. The adoption of Betriebsverfassungsgesetz in 1952 required every AG and GmbH with over 500 employees to establish a supervisory board.<sup>74</sup> The board was to be made of a number divisible by three with employee representation making up one third<sup>75</sup> and the other two thirds were to be made up of shareholder representatives elected at shareholder meetings. As a result there is no employee parity in companies which fall under this piece of legislation. The next expansion occurred with the implementation of the Codetermination Act 1976,<sup>76</sup> the effect of which was to ensure all companies who employed over 2,000 were to implement a form of codetermination. This was to include co-operatives and all companies limited by shares, thus extending the scope beyond just AG and GmbH companies. The supervisory boards of companies who fall under this legislation are to be made up of one half of shareholders, while employee delegates take up the other half. The chairman is to be appointed by the shareholders and does have the deciding vote on the board thus tipping the balance in favour of the shareholders.<sup>77</sup> This power of shareholders to have the deciding vote was upheld after a constitutional challenge in the Federal Constitutional Court.<sup>78</sup>

From the above description there are essentially three different types of codetermination. Each of the three pieces of legislation applies to different types of company and varies in the levels of employee participation. The 1951 Act provides parity for employees on the supervisory board but only applies to the iron, coal and steel industries. The supervisory boards of all other industries are still balanced in favour of shareholders by a two thirds majority or by a deciding vote of a chairman elected by the

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<sup>70</sup> Jean du Plessis, 'Reflections on Some Recent Corporate Governance Reforms in Germany: A Transformation of the German Aktienrecht?' (2003) *Deakin Law Review* 389, 391; Jean du Plessis and Otto Sandrock, 'The Rise and Fall of Supervisory Codetermination in Germany?' (2005) *International Company and Commercial Law Review* 69, 68.

<sup>71</sup> Henry Hansmann and Reiner Kraakman 'The End of History for Corporate Law' (2001) 89 *The Georgetown Law Journal* 439, 445.

<sup>72</sup> Montanmitbestimmungsgesetz 1951 para 1.

<sup>73</sup> Montanmitbestimmungsgesetz 1951 para 45.

<sup>74</sup> Betriebsverfassungsgesetz, Para 77.

<sup>75</sup> Jennifer Shearman, 'Corporate Governance – an Overview of the German Aufsichtsrat' (1995) *Journal of Business Law* 517, 519.

<sup>76</sup> Mitbestimmungsgesetz, 1976.

<sup>77</sup> Shawn Donnelly, *The Public Interest and the Company in Germany*, in John Parkinson, Andrew Gamble & Gavin Kelly (eds.), *The Political Economy of the Company* (Oxford 2000), 85.

<sup>78</sup> BVerfGE 50, 290, NJW (1989), 699.



shareholders. Therefore the power of supervisory boards in most companies is still held by the shareholders and in companies with a majority shareholder that shareholder will still dominate both supervisory and management boards.<sup>79</sup> However, even with the balance of most supervisory boards being in favour of the shareholders the German model could not be described as representing a shareholder value approach. In direct contrast to shareholder value and Enlightened Shareholder Value (ESV), where directors are elected by the shareholders and are legally required to prioritise the interests of the shareholders, codetermination ensures that shareholder value is not the exclusive priority of directors.<sup>80</sup> While codetermination prevents a sole focus on shareholder value, directors' duties in Germany also do not require a shareholder value approach. Section 93 of the Aktiengesetz is the main provision in German law dealing with directors' duties and requires directors to act in good faith and in the best interests of the corporation.<sup>81</sup> This rule is the same for all directors in Germany, even those elected by employees. There is no specific requirement to promote any interests other than the company's and as a result there is no legal obligation on German directors to maximise value for shareholders.<sup>82</sup> Therefore, due to the combination of the nature of directors' duties and employee representation on the supervisory board, the German model is a framework which does not implement shareholder value.

While the German model does not follow a shareholder value focused approach, it also does not represent a practical application of stakeholder theory. Under stakeholder theory operating a company in the interests of a single stakeholder group is expressly rejected<sup>83</sup> and balanced benefits for each set of stakeholders must be the definitive objective of the company.<sup>84</sup> Stakeholder theory is dedicated to benefit of all stakeholders equally however the German model clearly focuses on the interests of employees and shareholders, however it is this reason which allows the practical implementation of the codetermination model. Because only shareholders and employees are represented on the supervisory board there is requirement to balance many different competing interests and so there is not likely to be a confusion between objectives as would be the case under stakeholder theory. Therefore the German two-tiered board and codetermination model seems to be quite different to both shareholder value and stakeholder theory and does seem more likely to achieve the goal of increased

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<sup>79</sup> Theodor Baums & Kenneth E. Scott, Taking Shareholder Protection Seriously? Corporate Governance in the US and Germany (2003) *European Corporate Governance Institute, Working Paper* at 5 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=473185](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=473185).

<sup>80</sup> Jean Du Plessis et al, *German Corporate Governance in International and European Context* (Springer 2012), 14.

<sup>81</sup> Aktiengesetz s 93(1)(2).

<sup>82</sup> Florian Schwarz, 'The German Codetermination System: A Model for Introducing Corporate Social Responsibility Requirements into Australian Law? Part 2' (2008) *Journal of Banking Law and Regulation* 190, 194.

<sup>83</sup> Min Yan, 'Why Not Stakeholder Theory' (2013) 34(5) *Company Lawyer* 148, 156.

<sup>84</sup> Elaine Sternberg, 'The Stakeholder Concept' (1999) 4 *Foundation for Business Responsibilities* 6, 16.

benefits for all constituents.<sup>85</sup> It is possible that strong employee representation can benefit other stakeholder interests even without their representation on the supervisory board. For example if the employees live in the local community then they are very likely to oppose any action from the company which would harm that community.<sup>86</sup> Robilotti believes that strong employee representation may also force the supervisory board to give greater consideration to the social consequences of the company's actions.<sup>87</sup> The German model does possess some advantages over both shareholder value and stakeholder theory however legally implementing a two-tiered board model in a common law jurisdiction is fraught with difficulties.

### 3.04 Codetermination as a Solution for Common Law Jurisdictions

The German corporate governance system is a product of the country's unique culture and history<sup>88</sup> and its development has taken place over a long period of time. Attempting to emulate the German model in a common law country with its own corporate culture would require quite radical reforms and could not be established without extraordinary stresses.<sup>89</sup> The institutional make up of companies would have to be altered significantly and the powers of shareholders, such as the exclusive power to appoint directors, would need to be eroded. Such wide ranging reforms would be likely to be met with resistance from shareholders and directors and the theory of path dependence offers an explanation as to why. Path dependence was first applied to corporate governance in order to argue that different corporate governance models in different countries were unlikely to converge to a single system of best practice.<sup>90</sup> Path dependency theory holds that a corporate governance structure is deeply embedded in a country through both its historical evolution and its coherence with interrelated forces such as politics, legal influences and cultural backgrounds.<sup>91</sup> The internal workings of the corporate governance system such as shareholder powers and labour relations are shaped by surrounding legal, economic and social contexts which consequentially lead to persistence with the current corporate governance model.<sup>92</sup> These political, economic, legal, cultural and social contexts mean that there is

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<sup>85</sup> Bernd Singhof and Oliver Seiler 'Shareholder Participation in Corporate Decision Making Under German Law: A Comparative Analysis' (1998) 24 *Brooklyn Journal of International Law* 493, 551.

<sup>86</sup> Mark Lowenstein, 'Stakeholder Protection in Germany and Japan: What Can we Learn from Foreign Systems?' (2002) 76 *Tulane Law Review* 1673, 1678

<sup>87</sup> Mark Robilotti, 'Recent Developments, Codetermination, Stakeholder Rights and Hostile Takeovers: A re-Evaluation of the Evidence from Abroad' (1997) 38 *Harvard International Law Journal* 536, 547.

<sup>88</sup> Katharine Jackson, 'Towards a Stakeholder/Shareholder Theory of Corporate Governance' (2011) 7 *Hastings Business Law Journal* 327, 351.

<sup>89</sup> Detlev Vagts, 'Reforming the "Modern Corporation": Perspectives from the German' (1966) 80 *Harvard Law Review* 76, 78.

<sup>90</sup> See Lucian Bebchuck and Mark Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' (2000) 52 *Stanford Law Review* 127.

<sup>91</sup> Shuangge Wen, 'Exploring the Rationale of Enlightened Shareholder Value(ESV) in the Realm of UK Company Law – The Path Dependence Perspective' (2011) 14 *International Trade and Business Law Review* 153, 161.

<sup>92</sup> *Ibid.*

an unwillingness to move away from the current regime.<sup>93</sup> The basic argument of path dependency is that fundamental changes cannot occur in corporate governance in the absence of changes of the other complimentary factors.<sup>94</sup> Hence path dependency leads to a significant resistance from those involved in companies when major reforms are proposed.

This resistance to major change has been evident in both the UK and Irish Reforms of company law. The Company Law Review Steering Group (CLRSG) in the UK stated that altering board composition would require a 'radical change to British corporate culture and would be unlikely to receive wide support.'<sup>95</sup> In the Irish context the Company Law Review Group (CLRG) did not recommend any changes to board structures stating that there was 'little domestic pressure to change the board structure of companies'.<sup>96</sup> The most obvious evidence of the difficulties involved in applying major reforms to corporate governance can be seen from the failure of the draft Fifth Directive. The Fifth Directive<sup>97</sup> attempted to harmonise the approach in all EU Member States on the issue of employee participation in public companies. The original draft had a compulsory two-tiered board model but by the third draft of the Directive, several different options to include employee participation were made available to Member States. Despite the many concessions the Directive still did not receive the support necessary to be enacted into law.

The first draft of the Fifth Directive was issued in September 1972<sup>98</sup> and dealt with the structures of the public companies and employee participation. It has been argued that of all the EU harmonisation of company law, the issue of worker participation has proven to be the most challenging.<sup>99</sup> The primary difficulty involved was that the continental European model and the British approach to worker participation were in direct conflict.<sup>100</sup> Traditionally British and Irish company law has had no employee representation on the boards of companies and management's accountability has always

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<sup>93</sup> For information on the impacts of the different types of path dependency see Amir Licht, 'The Mother of all Path Dependencies: Towards a Cross-Cultural Theory of Corporate Governance Systems' (2001) 26 *Delaware Journal of Corporate Law* 147; John Coffee, 'The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications' (1999) 93 *Northwestern University Law Review* 642.

<sup>94</sup> Shuangge Wen, 'Exploring the Rationale of Enlightened Shareholder Value (ESV) in the Realm of UK Company Law – The Path Dependence Perspective' (2011) 14 *International Trade and Business Law Review* 153, 163.

<sup>95</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.32.

<sup>96</sup> Company Law Review Group, First Report, (Department of Jobs, Enterprise and Innovation, December 2011) available at <http://www.clrg.org/1streport/first.asp> p247 para 11.8.14.

<sup>97</sup> Amended Proposal for a Fifth Directive Founded on Article 54(3)(G) of the EEC Treaty Concerning the structure of the Public Limited Companies and the Powers and Obligations of their Organs 26 OJ (C 240) 2 (1983).

<sup>98</sup> Concerning the Structure of the Public Limited Companies and the Powers and Obligations of their Organs 15 OJ EUR. COMM. (No. C131) 49 (1972).

<sup>99</sup> Frank Wooldridge, *Company Law in the United Kingdom and the European Community: Its Harmonisation and Unification* (Athlone Press 1991), 80. Bernhard Grobfeld and Daniel Lehmann, 'Management Structure and Worker's Codetermination in Germany with European Perspectives' (1994) 1 *Corporate Law Development Series* 41, 55.

<sup>100</sup> Jean Du Plessis and Janet Dine, 'The Fate of the Draft Fifth Directive on Company Law: Accommodation instead of Harmonisation' (1997) *Journal of Business Law* 23, 25. .

been to the shareholders.<sup>101</sup> As a result any European legislation requiring employee representation on the boards of UK public companies would require major reform to British and Irish law. Attempting to harmonise the common law approach with a model which incorporates employee participation caused considerable tension.<sup>102</sup> The original draft of the Fifth Directive was aimed at implementing a German style codetermination throughout the European Economic Community<sup>103</sup> and was to apply to all public companies.<sup>104</sup> In order to achieve increased employee participation the Directive favoured the two-tiered board structure<sup>105</sup> with the explanatory notes to the Directive stating that the one-tiered board system ‘no longer answers the needs of modern management undertakings’<sup>106</sup> and that it ‘does not afford equivalent safeguards to shareholders and third parties’.<sup>107</sup> The Directive required all public companies with over 500 employees to allow the employees to elect up to one third of the supervisory board.

Unsurprisingly the First Draft Directive was met with substantial opposition from the UK.<sup>108</sup> And this opposition led to the redrafting of the Directive which diluted the degree of reform required from common law Member States.<sup>109</sup> The second draft required that employee participation would only be mandatory from public companies of over 1,000 employees.<sup>110</sup> Instead of having a mandatory two-tiered structure the second draft required Member States to choose between a one or two tiered-board structure. However if a single-tier board was chosen employees would still have to be given representation on the board.<sup>111</sup> Thus the only real change proposed by the second draft Directive was to remove the mandatory requirement of a two-tiered board structure and increase the threshold number of employees as opposed to any withdrawal of the mandatory requirement of employee participation.<sup>112</sup>

The second draft was also subject to opposition from the UK and most of the alterations which led to the third draft of the Directive came as a result of the objections from the UK.<sup>113</sup> However, in the third

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<sup>101</sup> Janet Dine, ‘Implications for the United Kingdom of the EC Fifth Directive’ (1988) *International and Comparative Law Quarterly* 547, 548.

<sup>102</sup> Frank Wooldridge, *Company Law in the United Kingdom and the European Community* (Athlone Press, 1991), 80.

<sup>103</sup> First Draft Fifth Directive, 15 OJ (No. C131) 49 (1972) article 4A.

<sup>104</sup> Ibid, Article 2.

<sup>105</sup> Ibid.

<sup>106</sup> Explanatory memorandum accompanying the First Draft Fifth Directive, 33.

<sup>107</sup> Ibid.

<sup>108</sup> Jean Du Plessis and Janet Dine, ‘The Fate of the Draft Fifth Directive on Company Law: Accommodation instead of Harmonisation’ (1997) *Journal of Business Law* 23, 35.

<sup>109</sup> Blanaid Clarke, Corporate Responsibility in Light of the Separation of Ownership and Control (1997) 1 *Dublin University Law Journal* 57,75.

<sup>110</sup> Second Draft Fifth Directive, Article 4(1).

<sup>111</sup> Second Draft Fifth Directive, Article 2.

<sup>112</sup> Jane Welch, ‘The Fifth Draft Directive – A False Dawn’ (1983) *European Law Review* 83, 92.

<sup>113</sup> Frank Wooldridge, *Company Law in the United Kingdom and the European Community* (Athlone Press 1991), 82.

draft directive other countries' demands were also accommodated.<sup>114</sup> The result was a complete dilution of the principles which were included in the original draft. The third draft<sup>115</sup> maintained the overall objective of establishing employee participation for companies with over 1,000 employees<sup>116</sup> but included a wide ranging set of options for how to introduce employee participation into public companies. Options such as the collectively agreed system based on the Italian model, where employee participation would be achieved by agreements between bodies such as trade unions and the companies.<sup>117</sup> Another change proposed by the Third draft of the Directive was the inclusion of an opt-out clause available to companies to completely avoid employee participation.<sup>118</sup> Member States would have the power to allow public companies to avoid employee participation if the employees of the company voted by a majority that they did not want any form of employee participation.

Despite the third draft of the Directive attempting to accommodate most Member States, the Fifth Directive could still not be agreed upon. Ultimately the conflict between the UK and continental systems proved too great an obstacle to overcome and was the reason why the Fifth Directive was never implemented in the EU.<sup>119</sup> The efforts at harmonising law on the area of codetermination have ceased with the introduction of a Directive and a European Council Regulation, introduced in 2001, protecting the rights of different Member States to choose their own style of management structures and employee participation models.<sup>120</sup> The primary aim of the Directive and the Regulation is to protect the different models within Member States and respect the wide diversity between the laws of the Member States in relation to employee participation in the management of companies.<sup>121</sup> It is now generally accepted that no harmonisation in the EU in the form of the Fifth Directive will ever be implemented.<sup>122</sup>

The experience of the draft Fifth Directive and the recent reforms in Ireland and the UK would suggest that path dependence theory does apply to this area of corporate governance and major reforms in relation to the institutional structure of companies and shareholders' power are unlikely to

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<sup>114</sup> Jean Du Plessis and Janet Dine, 'The Fate of the Draft Fifth Directive on Company Law: Accommodation instead of Harmonisation' (1997) *Journal of Business Law* 23, 36.

<sup>115</sup> Amended Proposal for a Fifth Directive Founded on Article 54(3)(G) of the EEC Treaty Concerning the structure of the Public Limited Companies and the Powers and Obligations of their Organs 26 OJ (C 240) 2 (1983).

<sup>116</sup> Third Draft Fifth Directive, 26 OJ (C 240) 2 (1983) Article 4(2).

<sup>117</sup> Third Draft Fifth Directive, 26 OJ (C 240) 2 (1983) Article 4E(2).

<sup>118</sup> Third Draft Fifth Directive, 26 OJ (C 240) 2 (1983) Articles 4(2)(A) and 21B(2)(A).

<sup>119</sup> Judith Marychursch, 'Harmonisation or Proliferation of Corporations law in the European Union?' (2002) *Australian International Law Journal* 80, 82; Jean Du Plessis and Otto Sandrock, 'The German Corporate Governance Model in the Wake of Company Law Harmonisation in the European Union' (2005) *Company Lawyer* 88, 91.

<sup>120</sup> Council Regulation 2157/2001 of October 8 2001 on the statute for a European Company (SE) [2001] OJ L294/1 and the SE employees' Directive [2001] OJ L294/22-23.

<sup>121</sup> Jean Du Plessis and Otto Sandrock, 'The German Corporate Governance Model in the Wake of Company Law Harmonisation in the European Union' (2005) *Company Lawyer* 88, 91.

<sup>122</sup> Henry Hansmann and Reiner Kraakman, 'The End of History for Corporate Law' (2001) 89 *The Georgetown Law Journal* 439, 441.

occur. It is the conclusion of many authors that replication of the German model should be done with caution<sup>123</sup> and even German commentators warn that their two-tiered system is not ideal for other countries.<sup>124</sup>

### 3.05 German Codetermination as a Solution to the Corporate Objective

It appears that a two-tiered system of corporate governance will not be applied in a common law jurisdiction for the foreseeable future. However the strength of the German model is not necessarily based simply on its two-tiered structure but rather that it does not apply either shareholder value or stakeholder theory. It is submitted that many of the positives of the German approach stem from employees being given a significant role in the governance of companies and from a framework of directors' duties which requires directors to focus on the best interests of the company rather than shareholders' interests. German companies are perceived to serve a broad social function rather than simply having an objective to increase shareholder wealth and there is significant freedom under German law for company directors to consider purposes other than profit maximisation for shareholders.<sup>125</sup> It is these factors which prevent a single focus on shareholder value rather than simply having a two-tiered board. As discussed above, the two-tiered board model itself does not guarantee an avoidance of shareholder value as early forms of supervisory boards operated on behalf of the shareholders. There can also be issues with the two-tiered model and certainly does not provide a perfect solution to all issues in corporate governance. For example the supervisory board is ineffective in monitoring against abuses by management<sup>126</sup> and is unlikely to prevent agency costs.<sup>127</sup> This is because there is a significant asymmetry of information between the two boards<sup>128</sup> due to the supervisory board being dependent on the management board for its information, the body that it is supposed to be supervising.<sup>129</sup> Further, if the management board is aware that there will be some resistance from the supervisory board they will normally try to inform the supervisory board as late as

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<sup>123</sup> See See Mark Roe, 'Some Differences in Corporate Structure in Germany, Japan and the US' (1993) *Yale Law Journal* 1927, 1979; Alfred Conard 'The Supervision of Corporate Management: A Comparison of Developments in European Community and US Law' (1984) *Michigan Law Review* 1459; Edward Rock, 'America's Fascination with German Corporate Governance' (1996) 74 *Washington University Law Quarterly* 367.

<sup>124</sup> Theodore Baums, 'Corporate Governance in Germany: the Role of the Banks' (1992) *American Journal of Comparative Law* 516, 523.

<sup>125</sup> Florian Schwarz, 'The German Codetermination System: A Model for Introducing Corporate Social Responsibility Requirements into Australian Law? Part 2' (2008) *Journal of Banking Law and Regulation* 190, 191.

<sup>126</sup> Viet Dinh, 'Codetermination and Corporate Governance in a Multinational Business Enterprise' (1999) 24 *Journal of Corporation Law* 975, 981.

<sup>127</sup> Katharine Jackson, 'Towards a Stakeholder/Shareholder Theory of Corporate Governance' (2011) 7 *Hastings Business Law Journal* 327, 360.

<sup>128</sup> Brian Cheffins, *Company Law Theory, Structure and Operation* (Clarendon Press 1997), 619.

<sup>129</sup> Jennifer Shearman, 'Corporate Governance – an Overview of the German Aufsichtsrat' (1995) *Journal of Business Law* 517, 530.

possible.<sup>130</sup> In addition, while employee representation on the supervisory boards helps ensure that shareholder value is not applied, ultimately the power of supervisory boards is limited.<sup>131</sup> The supervisory board does not make strategic management decisions of its own and is generally not involved in the decision making process.<sup>132</sup> Instead its role is limited to evaluating measures which have already been taken and so the supervisory board is always acting in a reactive way.<sup>133</sup>

The two-tiered board model does not provide a perfect solution. It is submitted Du Plessis is correct when he states ‘[t]he so-called fit all board structure does not exist and will probably never exist because there are simply too many local conditions, perceptions and practical realities applying to boards, their functions and their effectiveness’.<sup>134</sup> Davies would seem to agree when he argues that there is no one best system of board structure and corporate governance.<sup>135</sup> It is submitted that many of the benefits of the German model can be achieved without implementing a two-tiered board. When aiming to maximise benefits for all constituents the structures of boards themselves are less important than the objectives and perceptions of company directors and the legal requirements placed on them. It is possible for Ireland to follow elements of the German approach without changing the institutional structures of companies. For example the legislation on directors’ duties in Ireland are similar to Germany in that they require that directors act in the interests of the company and there is no express requirement to act for the benefit of shareholders.<sup>136</sup> It is the Irish courts who have determined that the duty to act in the interests of the company equates with a duty to act for the benefit of the shareholders.<sup>137</sup> As argued for in chapter five, with a reinterpretation of this duty from the Irish courts, the current shareholder value approach in Ireland could be altered to mean a duty to promote the success of the company as an entity. Should such a reinterpretation occur then Irish directors would be under a similar legal position to German directors where there is no specific requirement to promote any interests other than the company’s and as a consequence there is no legal obligation to maximise value for shareholders.<sup>138</sup> Such a reinterpretation would also help change any perception among

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<sup>130</sup> Jean du Plessis and Otto Sandrock, ‘The Rise and Fall of Supervisory Codetermination in Germany?’ (2005) *International Company and Commercial Law Review* 69, 74.

<sup>131</sup> Theodor Baums & Kenneth E. Scott, Taking Shareholder Protection Seriously? Corporate Governance in the US and Germany (2003) *European Corporate Governance Institute, Working Paper*, 14 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=473185](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=473185).

<sup>132</sup> Eberhard Scheffler, *Corporate Governance* (Gabler Verlag 1995), 18.

<sup>133</sup> Carsten Jungman, The Effectiveness of Corporate Governance in One-Tier and Two-Tiered Board Systems’ (2006) 4 *European Company and Financial Law Review* 426, 452.

<sup>134</sup> Jean Du Plessis et al, *German Corporate Governance in International and European Context* (Springer 2012), 12.

<sup>135</sup> See Paul Davies, ‘Employee Representation and Corporate Law Reform; A Comment from the UK’ (2000) 22 *Comparative Labour law and Policy Journal* 135, 137.

<sup>136</sup> Companies Act 2014 s 228(1)(a).

<sup>137</sup> See *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC, 22; *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported), 77; *Re Frederick Inns Ltd.* [1994] 1 ILRM 387, 396.

<sup>138</sup> Florian Schwarz, ‘The German Codetermination System: A Model for Introducing Corporate Social Responsibility Requirements into Australian Law? Part 2’ (2008) *Journal of Banking Law and Regulation* 190, 194.

directors that they must promote shareholder value. There has long been a spirit of broader corporate responsibilities in Germany and a philosophy that companies should be managed for the good of the enterprise, the employees and the country as a whole.<sup>139</sup> In this regard Ireland has seen a shift in the perceived role of companies and directors' duties from shareholder value to directors' duties serving a public interest function.<sup>140</sup> As will be discussed in chapter five, this change in perception is evidenced by the establishment of the Office of the Director for Corporate Enforcement, the introduction of restriction regime, the main aim of which is to protect the public from persons who are deemed unfit to be directors<sup>141</sup> and the introduction of a new fiduciary duty to act honestly and responsibly.<sup>142</sup> A reinterpretation of what it means to act in the interests of the company would continue this trend of moving away from shareholder value towards the law of directors' duties fulfilling a broader public function.

The most obvious difference between the Irish and German models is the significant representation afforded to employees of German companies. However it is not just through representation on supervisory boards which grants employees with a significant role in the management of companies. Work councils also play an important role in the Governance of German companies as all German companies, of five or more employees, must have work councils serving as labour representatives.<sup>143</sup> The work councils negotiate specific terms of union collective bargaining agreements and must be consulted with regards to any lay-offs, relocations or any fundamental change in business operations. The resolution of many specific employees issue such as collective bargaining or dispute resolution occurs through employee work councils rather than through supervisory boards.<sup>144</sup> The work councils generally assist to implement decisions taken by the board and provide employees with the opportunity to influence how those decisions are realised.<sup>145</sup> Similar work councils have been introduced in Ireland through Transnational Information and Consultation of Employees Act 1996 which implements the European Works Councils Directive.<sup>146</sup> Employee consultation has further been expanded by the Employees (Provision of Information and Consultation) Act 2006 which applies to

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<sup>139</sup> Jennifer Shearman, 'Corporate Governance – an Overview of the German Aufsichtsrat' (1995) *Journal of Business Law* 517, 531.

<sup>140</sup> Deirdre Ahern, 'Directors' Duties: Broadening the Focus Beyond Current Context to Examine the Accountability Spectrum' (2011) 33 *Dublin University Law Journal* 116, 140.

<sup>141</sup> See *La Moselle Clothing Ltd and Rosegem Ltd* [1998] 2 ILRM 345; *Duignan v Carway* [2002] IEHC 1; *Re Colm O'Neil Engineering Services Ltd* [2004] IEHC 83.

<sup>142</sup> Companies Act 2014 s 228(1)(B).

<sup>143</sup> Viet Dinh, 'Codetermination and Corporate Governance in a Multinational Business Enterprise' (1999) 24 *Journal of Corporation Law* 975, 981.

<sup>144</sup> Katharine Jackson, 'Towards a Stakeholder/Shareholder Theory of Corporate Governance' (2011) 7 *Hastings Business Law Journal* 327, 368.

<sup>145</sup> Florian Schwarz, 'The German Codetermination System: A Model for Introducing Corporate Social Responsibility Requirements into Australian Law? Part 1' (2008) 23(3) *Journal of Banking Law and Regulation* 125, 130.

<sup>146</sup> Council Directive 94/45/EC of 22 September 1994 on the establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of informing and consulting employees OJ L254/64.



companies of fifty employees or more. The purpose of the Act is to set a general framework of minimum requirements for the right to information and consultation of employees, and to provide a general right to information and consultation for employees from their employers on matters which directly affect them.<sup>147</sup> This expansion of employee consultation rights in Irish law is the reason why the CLRG recommended maintaining the status quo in relation to board structure and shareholders' exclusive right to elect directors.<sup>148</sup> As discussed previously, the CLRG declined to recommend a second-tiered board but subsequently went on to consider granting employees an entrenched right to elect a single representative on to single-tiered boards.<sup>149</sup> The stated reason for declining to grant such a right was because the group believed that employee involvement in large companies had been significantly improved by the European Works Councils<sup>150</sup> and that existing consultation legislation in Ireland had 'dealt with the requirement for employer/employee interface'.<sup>151</sup> The expansion of employee consultation practices in Ireland, while not representing a strong representation of employee interests as the German model, does go some way towards ensuring employee interests are represented in large Irish companies.

### 3.06 Conclusion

While stakeholder theory contains the normatively desirable goal of creating and distributing wealth to all stakeholder groups<sup>152</sup> when scrutinised, the theory becomes unworkable. The primary difficulty is that stakeholder theory provides no way for directors to balance competing interests. A superior alternative to both shareholder value and stakeholder theory is the German model of codetermination. However introducing a two-tiered board model, in line with that of Germany's, appears to be unlikely to occur in common law jurisdictions.<sup>153</sup> Both UK and Irish company law reform groups declined to make any recommendations for significant reforms to board structures and the failure of the draft fifth Directive indicates just how difficult major reforms are to introduce in corporate governance. Even by allowing Member States a wide range of options included in the third draft Directive an agreement could still not be reached. While major reforms are unlikely to occur it is submitted that an entity focused approach can achieve some of the positive aspects of German codetermination. Ultimately the strength of the German model is that the country's legal system allows companies to have an

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<sup>147</sup> Michael Doherty, 'It's Good to Talk...Isn't it? Legislating for Information and Consultation in the Irish Workplace' (2008) 1 *Dublin University Law Journal* 120, 126.

<sup>148</sup> Company Law Review Group, First Report, (Department of Jobs, Enterprise and Innovation, Dublin, December 2011) available at <http://www.clrg.org/1streport/first.asp> para 11.8.14.

<sup>149</sup> Ibid.

<sup>150</sup> Implemented by the Transnational Information and Consultation of Employees Act 1996.

<sup>151</sup> Company Law Review Group, First Report, (Department of Jobs, Enterprise and Innovation, Dublin, December 2011) available at <http://www.clrg.org/1streport/first.asp> para 11.8.14.

<sup>152</sup> Max Clarkson, 'A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance' (1995) 20 *Academy Management Review* 92, 112.

<sup>153</sup> Carsten Jungman, 'The Effectiveness of Corporate Governance in One-Tier and Two-Tiered Board Systems' (2006) 4 *European Company and Financial Law Review* 426, 430; Eilis Ferran, *Company Law and Corporate Finance* (OUP, 1999), 219.

objective beyond the goal of shareholder value<sup>154</sup> and views companies as serving the public interest.<sup>155</sup> The German model achieves this in a practical way without requiring directors to engage in a never ending balancing of competing interests at the expense of the economic success of the company. The entity focused model it is also different from the flawed models of shareholder value and stakeholder theory and in the Irish context implementing it would not require any major reform of company law and while employee representation is unlikely to meet the high levels of Germany, significant strides have been made with the representation of employee interests in Irish law.

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<sup>154</sup> Florian Schwarz, 'The German Codetermination System: A Model for Introducing Corporate Social Responsibility Requirements into Australian Law? Part 2' (2008) *Journal of Banking Law and Regulation* 190, 191.

<sup>155</sup> Jennifer Shearman, 'Corporate Governance – an Overview of the German Aufsichtsrat' (1995) *Journal of Business Law* 517, 531.

## Chapter 4 Enlightened Shareholder Value

### 4.01 Introduction

The reform of company law in the UK began in 1998 when the Department of Trade and Industry (DTI) established the Company Law Review Steering Group (CLRSG). Over the following three years, the CLRSG published several consultation papers outlining the reasons for reform, how it recommended the reforms to be applied and seeking feedback from the interested parties.<sup>1</sup> The primary reason given for the overall reform of company law was the sheer complexity of the existing common law framework.<sup>2</sup> In relation to directors' duties, a particular concern was expressed that the duties were detailed in case law as opposed to statute and as a consequence were more difficult to locate and understand making them less well known to the people to whom they applied.<sup>3</sup> The CLRSG published its final report in July 2001, which was followed by the publication of the British Government's white paper which responded to many of the claims and statements set out by the CLRSG.<sup>4</sup> The Company Law Reform Bill was submitted to Parliament in November 2005 and received the Royal Assent as the Companies Act 2006.

During the reform process, the CLRSG spent a significant amount of time addressing what it referred to as the proper 'scope' of company law.<sup>5</sup> It defined the scope issue as identifying in whose interests should company law serve and in whose interests should a company be run.<sup>6</sup> The group, after significant analysis of the different potential options, decided that Enlightened Shareholder Value (ESV) should become its proposed solution to the issue of the corporate objective believing it to be the best way of securing overall prosperity and welfare for all participants in the company.<sup>7</sup> To implement ESV the CLRSG recommended that a new codified set of directors' duties be enacted, recommendations with which the British Government agreed, ultimately leading to the enactment of section 172(1) of the UK Companies Act 2006:

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—

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<sup>1</sup> See CLRSG, *Modern Company Law for a Competitive Economy* (Department of Trade and Industry (DTI), 1998), CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999), CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999), CLRSG, *Modern Company Law for a Competitive Economy: Completing the Structure* (DTI, 2000), CLRSG, *Modern Company Law for a Competitive Economy: Final Report* (DTI, 2001).

<sup>2</sup> CLRSG, *Modern Company Law for a Competitive Economy* (DTI, 1998) para 3.2.

<sup>3</sup> *Ibid* para 3.7.

<sup>4</sup> DTI, *Company Law Reform* (White Paper, Cm5553-1, 2005).

<sup>5</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.1.

<sup>6</sup> *Ibid*.

<sup>7</sup> *Ibid* 5.1.8.

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

The most noteworthy element of section 172(1) is that the success of the company is now framed in the overall context of providing benefit to the members as a whole. The CLRSG claimed that the common law required directors to operate companies for the benefit of shareholders and that its aim was simply to clarify the principles of the common law.<sup>8</sup> As highlighted in chapter two, this interpretation simply does not accurately represent the common law judgments on this issue.<sup>9</sup> The consequence of this misunderstanding of the common law position is that ESV represents a clear endorsement of shareholder value. Shareholders' interests are given clear priority and stakeholders are only to be considered to the extent that they promote success of the company for the benefit of the members.<sup>10</sup> This shareholder focused model was clearly intended to be offset by the express requirement to have regard to the stakeholder interests. However, difficulties in enforcing this requirement renders the stakeholder element of section 172(1) ineffective. As will be outlined in chapter six, enforcing the duty to have regard stakeholder interests is extremely difficult, particularly when company success is framed in such a way as to prioritise the interests of shareholders.

However in its original plans for ESV, the CLRSG intended that increased disclosure and transparency would ensure that stakeholder interests were considered by directors. ESV was originally to be made up of two elements; the updated set of directors' duties in section 172(1) and an increased reporting requirement called the Operating and Financial Review (OFR).<sup>11</sup> The CLRSG's hope was that the increased transparency and reporting requirement would help ensure directors would pursue a more stakeholder orientated approach to business. The OFR required mandatory disclosure of company policy on a range of stakeholder issues and details about the successful implementation of

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<sup>8</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.7. CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.4

<sup>9</sup> See *Re BSB Holdings Ltd* [1996] 1 BCLC 155; *Dawson International Plc v Coats Platon plc* [1989] BCLC 233; *Re Welfab Engineers* [1990] BCLC 833; *Lonhro v Shell Petroleum* [1980] 1 WLR 627; *Fulham Football Club v Cabra Estates* [1994] 1 BCLC 363.

<sup>10</sup> Shuangge Wen, 'The Magnitude of Shareholder Value as the Overriding Objective in the UK: The Post Crisis Perspective' (2011) *Journal of International Banking Law and Regulation* 325, 331.

<sup>11</sup> UK Companies Act 1985 (Operating and Financial Review and Directors Report etc.) Regulations 2005 Statutory Instrument No. 1011.

those polices.<sup>12</sup> It was legally required<sup>13</sup> to be prepared in accordance with a detailed reporting standard<sup>14</sup> and was to be reviewed by the company's auditors.<sup>15</sup> The CLRSg believed that the OFR and the updated set of directors' duties working in combination offered the best solution to the scope issue. This outlook was agreed with by the British Government<sup>16</sup> and the OFR was enacted in 2005.<sup>17</sup> However the OFR was withdrawn<sup>18</sup> only a few months after its enactment and was replaced by the much less prescriptive Business Review.<sup>19</sup> The withdrawal of the OFR seemed to undermine the overall framework planned by the CLRSg as the importance of the OFR was emphasised at numerous points throughout the reform documents.<sup>20</sup> Certainly the less demanding Business Review stood very little chance of ensuring a more stakeholder approach.<sup>21</sup> However it is questionable as to what extent the OFR would have effectively ensured compliance with the stakeholder element of ESV as there are limitations in relation to the effect that corporate reporting can have on director behaviour. This is particularly the case under a system where directors are under a legislative duty to prioritise the shareholders' interests and even if the more detailed OFR was still in operation, as Villier argues, it is debateable whether corporate reporting would assist in achieving the aims associated with ESV.<sup>22</sup>

The aim of this chapter is to analyse ESV and the reform process which led to its implementation. The chapter will examine the CLRSg's consideration of stakeholder theory and the reasons why it was rejected. The chapter will then argue that ESV represents a significant departure from the common law despite the CLRSg's view that ESV represented only minor changes of substance.<sup>23</sup> The chapter will also address the corporate disclosure aspect of ESV. It will outline the requirements of the OFR and the Business Review and evaluate the likelihood of detailed corporate reporting ensuring

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<sup>12</sup> Ibid Part 3 Schedule 7ZA (4)

<sup>13</sup> Ibid Part 3 Schedule 7ZA (8).

<sup>14</sup> Accounting Standards Board, Reporting Statement: Operating and Financial Review, January 2006 available at <http://www.frc.org.uk/Our-Work/Publications/ASB/UITF-Abstract-24-Accounting-for-start-up-costs/Reporting-Statement-Operating-and-Financial-Review.aspx>.

<sup>15</sup> UK Companies Act 1985 (Operating and Financial Review and Directors Report etc.) Regulations 2005 Statutory Instrument No. 1011 Part 3 Schedule 7ZA (10).

<sup>16</sup> DTI, *Company Law Reform* (White Paper, Cm5553-1, 2005) para 3.3.

<sup>17</sup> UK Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005 Statutory Instrument No. 1011.

<sup>18</sup> Explanatory Memorandum to The UK Companies Act 1985 (Operating and Financial Review)(Repeal) Regulations 2005 Statutory Instrument No. 3442 para 7.11.

<sup>19</sup> UK Companies Act 2006 s 417(5). The Business Review has since been replaced by the Strategic Report which is identical to the Business Review on the disclosure of information on stakeholder issues.

<sup>20</sup> CLRSg, *Modern Company Law for a Competitive Economy: Completing the Structure* (DTI, 2000) para 3.9; CLRSg, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.22.

<sup>21</sup> Andrew Johnston, 'After the OFR: Can UK Shareholder Value still be Enlightened?' (2006) 7 *European Business Organization Law Review* 817, 842.

<sup>22</sup> See Charlotte Villiers, 'Narrative Reporting and Enlightened Shareholder Value under the Companies Act 2006' in Joan Loughrey (ed), *Directors' Duties and Shareholder Litigation in the Wake of the Financial Crisis* (Elgar 2013).

<sup>23</sup> CLRSg, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 3.40.

stakeholder consideration under the ESV approach. Finally the chapter will analyse ESV and its likely impacts on some of the stakeholders listed in section 172(1).

#### 4.02 The Pluralist Approach

In order to achieve its goal of ‘efficient creation of wealth and other benefits for all participants in the enterprise’<sup>24</sup> the CLRSG considered two models: ESV and Pluralism. Pluralism seemed to be identical to stakeholder theory and represented the option for major reform. Under the CLRSG’s model of pluralism directors would serve a wide range of stakeholder interests not subordinate to or as a means of achieving shareholder value.<sup>25</sup> The CLRSG stated that the implementation of pluralism would require a reform of directors’ duties to allow directors to further the interests of non-shareholder participants even at the detriment of shareholders.<sup>26</sup> The CLRSG sought responses on whether it should be obligatory for directors to operate the company for purposes other than shareholder value, in cases where the needs of ‘employees, or suppliers or the local community or the wider public interest demanded it’.<sup>27</sup>

The principal argument proffered in favour of pluralism was that shareholder value failed to recognise that companies’ best generate wealth when all participants operate harmoniously and so directors should recognise stakeholder interests in their activities.<sup>28</sup> The shareholder value model, in making shareholder interests ultimately overriding, reinforces an environment which relationships of trust are difficult to sustain which decreases efficiency between directors and its stakeholders.<sup>29</sup> As a result of this environment, stakeholders will be less likely to make firm specific investments in a company, such as an employee requiring a specialised skill or a supplier investing in equipment for a particular customer. The CLRSG viewed such investments as being extremely beneficial to a company but that such investments are risky as they are very difficult to transfer and are generally long term in nature.<sup>30</sup> The counter argument was that pluralism was not the only model which would allow a company to build relationships with non-shareholders, the CLRSG believed that ESV also had the capabilities of meeting such goals.<sup>31</sup> The only other argument, offered by the CLRSG in favour of Pluralism was that shareholders should no longer be regarded as the sole bearers of residual risk and hence the economic case for giving shareholders ultimate control of the company is no longer valid.<sup>32</sup> These were the only

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<sup>24</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.8.

<sup>25</sup> Ibid para 5.1.13.

<sup>26</sup> Ibid para 5.1.30.

<sup>27</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.7.

<sup>28</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.9.

<sup>29</sup> Ibid para 5.1.24.

<sup>30</sup> Ibid.

<sup>31</sup> Ibid para 5.1.25.

<sup>32</sup> Ibid.

two arguments examined in favour of pluralism which suggests the CLRSG were sceptical of its potential to be a workable model.

The CLRSG recognised that implementing pluralism would represent a dramatic change in British corporate culture as well as requiring significant institutional changes such as adopting a two-tiered board system and removing shareholders exclusive rights to elect directors.<sup>33</sup> It stated,

if the legal basis were to be changed, to allow possible priority for interests other than shareholders', this would require underpinning with changes in institutional rules. For example it might require change in rules on board composition and relationships between directors, shareholders and others – particularly, perhaps in the rules which give the shareholders' ultimate exclusive power to appoint, dismiss and control directors. An obvious example of such a structure would be a two-tiered board system.<sup>34</sup>

While acknowledging the need for institutional changes, the CLRSG believed that altering board composition would require a 'radical change to British corporate culture and would be unlikely to receive wide support.'<sup>35</sup> The Group stated that attempting to graft a continental model of directors duties into a different culture and political-economic environment would not produce the benefits desired and instead create an environment of decreased accountability.<sup>36</sup> The CLRSG went on to state that the continental approaches of the two-tiered boards have developed in a juridical and politico-economic environment which is very different from the UK.<sup>37</sup> This outlook of the CLRSG would lend support to the view that path dependency is a block on any radical reforms taking place in corporate law as was discussed in chapter three. The CLRSG stated there was 'no support for, and we would not favour, any institutional modification of the relationship between directors and shareholders which changes the ultimate power of shareholders to intervene in management to the extent that the constitution permits'.<sup>38</sup>

One peculiar element of the CLRSG's analysis is when, considering institutional changes, it stated 'there is clearly an inconsistency between leaving these powers of shareholders intact and enabling or requiring directors to have regard to wider interests'.<sup>39</sup> Ultimately ESV did exactly this, no institutional changes were implemented, the power of shareholders to elect and remove directors remained in place, yet directors were required to 'have regard to' a wide range of stakeholder

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<sup>33</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.8.

<sup>34</sup> Ibid.

<sup>35</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.32.

<sup>36</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 3.35.

<sup>37</sup> Ibid para 3.34.

<sup>38</sup> Ibid para 3.29.

<sup>39</sup> Ibid.

interests. As recognised in the above quote from the CLRSG's report, conferring a legal duty on directors to consider stakeholder interests in the overall context of a shareholder value model is inconsistent and fraught with difficulties. In the absence of institutional changes to the structure of companies enforcing stakeholder consideration proves to be very difficult. In this context of implementing significant reforms in order to apply pluralism, the CLRSG did consider changing the definition of the company. The CLRSG believed that to implement pluralism the definition of the company would have to be changed and instead of equating the interests of the company with the interests of the shareholders, the company would have to be defined as an entity, not wholly reducible to its shareholders.<sup>40</sup> The CLRSG recognised that directors aiming to promote the success of the company as an entity will often be beneficial to shareholders and other participants.<sup>41</sup> It believed the difficulty with such an approach was that, inevitably, there will be a choice between competing interests. The Group provided the example of making employees redundant or sacrificing a long term supply relationship when continuation, in either case, is expected to have a negative effect on shareholder returns.<sup>42</sup> The CLRSG argue, quite correctly, that the law must give some guidance to directors in such a case<sup>43</sup> and support the argument with referencing to the difficulties of balancing competing interests under stakeholder theory. The CLRSG argued that

an appeal to the 'interests of the company' will not resolve the issue, unless it is first decided whether 'the company' is to be equated with its shareholders alone (enlightened shareholder value), or the shareholders plus other participants (pluralism).

The issue with the CLRSG's reasoning is that it viewed the entity argument as a means of implementing stakeholder theory. The issue of balancing competing interests makes the implementation of stakeholder theory or pluralism impossible in practice.<sup>44</sup> However there is a difference between viewing the company as an entity in order to apply stakeholder theory and viewing the company as a separate legal entity in its own right. The CLRSG viewed the phrase 'the interests of the company' as having two possible interpretations: it meant either the interests of the shareholders or the shareholders plus other participants. The Group did not consider the possibility of the company existing as a *qua* legal person independent of third parties. The above problem between choosing between employee redundancies and increased shareholder returns could be answered determining which action benefits the company as an entity.

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<sup>40</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.145.

<sup>41</sup> *Ibid.*

<sup>42</sup> *Ibid.*

<sup>43</sup> *Ibid.*

<sup>44</sup> Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' 14 *Journal of Applied Corporate Finance* 8, 13; Elaine Sternberg, 'The Defects of Stakeholder Theory' (1997) 5(1) *Corporate Governance* 3, 5.



The CLRSG's main reasons for not recommending pluralism were the requirement for significant institutional changes and the difficulty for directors in attempting to balance competing interests. It feared that changing directors' responsibilities from one single clear objective to a trade-off between members and a wide variety of interest groups would 'dangerously distract management into a political balancing style at the expense of economic growth'<sup>45</sup> and would create a dangerously broad and unaccountable discretion for directors.<sup>46</sup> The CLRSG concluded that the practical difficulties involved in implementing pluralism made it as neither 'workable nor desirable', the issues with balancing competing interests being a 'key objection'.<sup>47</sup> The CLRSG proposed the way forward on the scope issue to be ESV but maintained that the reforms involved in ESV should be seen as pluralist, in the sense that the aim was that companies should be run in a way which maximises overall competitiveness and wealth for all.<sup>48</sup>

#### **4.03 Enlightened Shareholder Value**

ESV, as envisaged by the CLRSG, aimed to continue but clarify, the common law. The CLRSG viewed the common law as primarily shareholder orientated. It stated that the common law required directors to operate companies 'for the benefit of shareholders'<sup>49</sup> and that companies are formed and managed in the interests of shareholders.<sup>50</sup> While the CLRSG wished to implement a shareholder orientated model, it had issues with the existing structure. The CLRSG believed that the duties as expressed and interpreted by directors under the common law, resulted in an undue focus on the short term interests of the members at the expense of the longer term interests of the enterprise.<sup>51</sup> The group believed directors were misinterpreting the common law and had the erroneous belief that increased short term profits equated with shareholder value.<sup>52</sup> The CLRSG blamed this misunderstanding that the common law required short term shareholder value on the fact that directors' duties were derived from 250 years of case law.<sup>53</sup> The issue the CLRSG had with the common law was in relation to the focus on the short term rather than having an issue with shareholder value itself and stated that the belief that the common law required a short term increase in shareholder value was based on a misunderstanding.

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<sup>45</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.28.

<sup>46</sup> Ibid para 5.1.30.

<sup>47</sup> CLRSG, *Modern Company Law for a Competitive Economy: Completing the Structure* (DTI, 2000) para 3.5.

<sup>48</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.21.

<sup>49</sup> Ibid para 2.7.

<sup>50</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.4.

<sup>51</sup> Ibid para 5.1.17.

<sup>52</sup> Ibid para 5.1.12.

<sup>53</sup> Ibid para 5.1.20.

However the CLRSG went to state that ESV has the ultimate objective as currently enshrined by law i.e. to generate maximum value for shareholders.<sup>54</sup> The CLRSG noted that directors' fiduciary duties required them to act for the benefit of the company but that this usually meant 'the benefit of the shareholders as a whole'.<sup>55</sup> At no point did the CLRSG discuss the case law or outline how it arrived at the conclusion that the common law represented this shareholder value approach. While the CLRSG was correct to attempt to remove the erroneous perception that the common law required short term increases in shareholder wealth, its view that the common law represented shareholder value was also based on a misunderstanding. There was insufficient evidence in the case law to legislatively redefine the duty to act in the interests of the company into a duty to promote the success of the company for the benefit of the members. As Bavoso argues, the assumption from the CLRSG that the interests of the company meant the interests of the shareholders does not reflect what the courts have suggested.<sup>56</sup> Many of the cases which equated the duty to act in the interests of the company with a duty to act in the shareholders' benefit came from contexts other than directors' duties.<sup>57</sup> Several cases indicated that that wider interests than simply shareholders could be considered if it benefited the company as an entity to do so.<sup>58</sup> While there is some evidence to suggest that in a directors' duties context the duty to act in the interests of the company can mean a duty to act for the shareholders<sup>59</sup> it has also been held to mean duty to act for the benefit of the separate entity, even at the expense of shareholders.<sup>60</sup> The introduction of the legislative requirement to promote the success of the company for the benefit of the members introduces a clear shareholder value approach and ESV currently possesses what the common law never did, a clear corporate objective of running the company for the benefit of the shareholders. As Alcock states, 'there is no longer any room for a distinction between the interests of the shareholders and those of the company as a separate entity'<sup>61</sup> and that defining company success in terms of a benefit to the shareholders amounts to a 'strident affirmation of shareholder value'.<sup>62</sup>

The description of ESV during the reform process leaves it in little doubt that the CLRSG were in favour of implementing shareholder value. In its initial explanation of ESV, the CLRSG accepted that

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<sup>54</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.12.

<sup>55</sup> *Ibid* para 5.1.5.

<sup>56</sup> Vincenzo Bavoso, 'The Global Financial Crisis, the Pervasive of Shareholder Value and the Unfulfilled Promise of Anglo-American Corporate Law' (2014) *International Company and Commercial Law Review* 213, 216.

<sup>57</sup> *Brady v Brady* [1988] 3 BCC 535; *Greenhalgh v Ardenne Cinemas Ltd* [1950] 2 All ER 1120.

<sup>58</sup> See *Evans v Brunner Mond & Co Ltd* [1921] 1 Ch. 359; *Lonrho v Shell Petroleum* [1980] 1 WLR 627; *Fulham Football Club v Cabra Estates* [1994] 1 BCLC 363; *Re Welfab Engineers* [1990] BCLC 833.

<sup>59</sup> *Parke v Daily News Ltd* [1962] Ch 927; *Heron International Ltd* [1983] BCLC 244.

<sup>60</sup> See *Re BSB Holdings Ltd* [1996] 1 BCLC 155; *Dawson International Plc v Coats Platon plc* [1989] BCLC 233.

<sup>61</sup> Alastair Alcock, 'An Accidental Change to Directors' Duties' (2009) 30 *Company Lawyer* 362, 367.

<sup>62</sup> *Ibid*.

the theory is based on ‘shareholder wealth maximisation’<sup>63</sup> and described the overriding interest of members as central to the concept of ESV.<sup>64</sup> Under ESV, directors’ duties were intended to have a proper balanced view of the short and long term as well as the need to sustain effective on-going relationships with employees, consumers, suppliers and others and to consider the impact on the community and environment.<sup>65</sup> However the CLRSG was anxious to point out that that the listed stakeholders are subordinate to the objective of success on behalf of the shareholders and are to be regarded as being of value only to the extent that they contribute to that objective,<sup>66</sup> thus making it clear that priority is to be given to shareholders’ interests. In an address to the Parliament Lord Goldsmith, Attorney General at the time of the debates of the Companies Bill 2005, gave an insight into what it might mean to promote the success of the company for the benefit of the members, ‘for most people who invest in companies, there is never any doubt about it—money. That is what they want’.<sup>67</sup> As a consequence of the heavy focus on members’ interests in determining what success is to be under section 172(1) directors will typically define success in commercial terms<sup>68</sup> and have little consideration of stakeholders when it comes to determining the objective of the company.

The first trial draft of the updated directors’ duties included a duty to promote the success of the company for the benefit of members.<sup>69</sup> The CLRSG rejected omitting the reference to the members as it believed referencing success only in terms of the ‘company’ would leave it to the good faith discretion of the directors to determine what is in the best interests of the company.<sup>70</sup> The Group disagreed with such an outcome as it would allow directors too much discretionary power to set any interest above that of shareholders whenever their view of what constituted company success required it.<sup>71</sup> This statement highlights just how shareholder focused ESV is. The CLRSG were against any scenario where a stakeholder interest could be placed above the shareholders’ interests. The prioritisation of the shareholders would seem to apply even if giving priority to a stakeholder would be the better outcome for the company as a separate legal entity. As a result the shareholders’ interests take priority over the company’s if the two interests do not align. The issue is that the shareholder value model does not always meet the CLRSG’s goal of maximising wealth for all constituents. Instead, it is submitted that, the best way to achieve the goal of increased benefit for all constituents is to promote the company’s interests as an entity. As will be discussed in detail in chapter five, the legal

<sup>63</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) 5.1.17.

<sup>64</sup> CLRSG, *Modern Company Law for a Competitive Economy: Completing the Structure* (DTI, 2000) para 3.16.

<sup>65</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.19.

<sup>66</sup> *Ibid* para 3.55.

<sup>67</sup> Lords Grand Committee, 6th February 2006, col 256.

<sup>68</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law*, 8<sup>th</sup> Edition, (8th edn, Sweet and Maxwell, 2008), 511.

<sup>69</sup> For the trial draft see CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 3.40.

<sup>70</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 3.52.

<sup>71</sup> *Ibid*.

framework to allow this entity focused approach has been implemented in Ireland through a general duty to act in the interests of the company. A similar legislative duty in the UK would have allowed directors to act for the benefit of stakeholders, even ahead of shareholders, when it was best for the company to do so. It would also allow the continuation of the common law cases where a shareholder value was not implemented. The duty could have included a reference to the long term which would have clarified the misunderstanding that the common law required a short term shareholder value approach. The issue that the CLRSG seemed to have with taking such an approach is that it would give directors too much discretion to determine what is in the interests of the company. Surely it is the directors who are best placed to make the determination as to what is in the best interests of the company.

In its final report the CLRSG summarised the need for a legislative restatement on directors' duties by stating that it will 'it will provide greater clarity on what is expected of directors and make the law more accessible'.<sup>72</sup> The trial draft on directors' duties was almost unanimously welcomed by respondents<sup>73</sup> and the British Government also agreed with the CLRSG on the topic of directors' duties and by stating in its white paper and that the question of 'scope' of the company was to be answered by:

[Embedding] in statute the concept of Enlightened Shareholder Value by making clear that directors must promote the success of the company for the benefit of its shareholders, and this can only be achieved by taking due account of both the long-term and short-term, and wider factors such as employees, effects on the environment, suppliers and customers....The Government agrees that directors' duties are fundamental to company law, and that it is very important that the duties are widely known and understood.<sup>74</sup>

ESV was to be the solution to the scope issue. A statutory, more inclusive, set of directors' duties was to be introduced into the Companies Act 2006. However, as far as the CLRSG were concerned, this was the first element of a two-tier model of ESV, the second element coming in the form of an increased reporting requirement, the OFR.

#### **4.04 The Operating and Financial Review**

The CLRSG believed that the problem of ESV being overly shareholder focused would be offset by the requirement to have regard to the stakeholder interests and the increased reporting standards required by the OFR. The CLRSG viewed increased reporting, disclosure and transparency as central to the concept of ESV. When outlining its proposed way forward on the scope issue, it described the

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<sup>72</sup> CLRSG, *Modern Company Law for a Competitive Economy: Final Report* (DTI, 2001) para 3.7.

<sup>73</sup> Ibid para 3.10.

<sup>74</sup> DTI, *Company Law Reform* (White Paper, Cm5553-1, 2005) para 3.3.

key components of ESV as the updated directors' duties and broader accountability, 'in particular the inclusive operating review'.<sup>75</sup> It saw the OFR not simply as increasing the transparency of companies but a way of increasing the likelihood that directors would consider the listed interests in the updated directors' duties. The CLRSG believed that mandatory reporting, operating within a legal structure of the updated directors' duties would have the capacity to achieve the objectives of a more stakeholder orientated approach.<sup>76</sup> The legislative directors' duties required directors to take into account a wider range of interests and by requiring companies to publish detailed information on stakeholder issues the transparency element was intended to provide the information needed to underpin this approach.<sup>77</sup> The CLRSG stated that an effective reporting regime was capable of achieving a more pluralist approach by allowing the public at large to evaluate its performance and thereby bring pressure on the company to satisfy wider social interests.<sup>78</sup> The group felt the increased reporting would reduce short term pressures on directors from shareholders<sup>79</sup> and would enable shareholders and the community to monitor performance by directors which would affect its reputation.<sup>80</sup> The CLRSG stated that the OFR would enable 'shareholders and the community as a whole to monitor performance by directors of the broadly expressed inclusive duty and for all concerned to develop flexible and responsive standards for reporting on the matters covered and to provide appropriate feedback to the company. This in turn would affect its reputation'.<sup>81</sup> The CLRSG seemed to take the view that the duty to consider stakeholder interests would acquire its force through corporate disclosure requirements rather than the threat of litigation<sup>82</sup> and that increased reporting and transparency were better methods to ensure compliance with section 172(1) than private mechanisms such as derivative actions.

During the consultation, the OFR was widely welcomed by the respondents<sup>83</sup> and was supported by a 'very large majority'.<sup>84</sup> A minority of the responses from business and professionals preferred a less mandatory approach, not wanting the OFR to be implemented by statute.<sup>85</sup> In rejecting this argument the CLRSG stated 'We regard OFR reporting as a matter of such fundamental importance and so integral to a balanced approach to the scope issue, that the basic regime should be underpinned by

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<sup>75</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.22.

<sup>76</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.44.

<sup>77</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.22.

<sup>78</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.44.

<sup>79</sup> *Ibid.*

<sup>80</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.20.

<sup>81</sup> *Ibid.*

<sup>82</sup> John Lowry, 'The Duty Of Loyalty of Company Directors; Bridging the Accountability Gap Through Efficient Disclosure' (2009) 68 *Cambridge Law Journal* 607, 621.

<sup>83</sup> CLRSG, *Modern Company Law for a Competitive Economy: Final Report* (DTI, 2001) para 3.43.

<sup>84</sup> CLRSG, *Modern Company Law for a Competitive Economy: Completing the Structure* (DTI, 2000) para 3.7.

<sup>85</sup> *Ibid* para 3.9.

statute.<sup>86</sup> The CLRSG continued to stress the importance of the OFR by stating ‘before leaving the subject we would emphasise that we regard OFR disclosure as of central importance for the future’<sup>87</sup> and the OFR was also supported by the British government in its white paper.<sup>88</sup>

On the 21<sup>st</sup> of March 2005 the OFR was introduced into legislation by the UK Companies Act 1985 (Operating and Financial Review and Directors Report etc.) regulations 2005.<sup>89</sup> Schedule 7ZA(1) of the regulations required a ‘balanced and comprehensive analysis’ of the development and performance of the company; the position of the company at end of year and the main trends and factors underlying the development, performance and position of the business as well as the main factors likely to affect it in the future.<sup>90</sup> The review was also to include a statement of the business objectives and strategies of the company, a description of its resources, principal risks and uncertainties as well as outlining its capital structure and liquidity.<sup>91</sup> The OFR was intended to cover all that is material to achieve a proper assessment of the performance and future plans and prospects of the business.<sup>92</sup> The main stakeholder elements of the regulations were set out as follows:

4. (1) The review must include—

- (a) information about environmental matters (including the impact of the business of the company on the environment), .
- (b) information about the company’s employees, and .
- (c) information about social and community issues. .

4.(2) The review must, in particular, include —

- (a) information about the policies of the company in each area mentioned in sub-paragraph (1), and .
- (b) information about the extent to which those policies have been successfully implemented.<sup>93</sup>

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<sup>86</sup> Ibid.

<sup>87</sup> CLRSG, *Modern Company Law for a Competitive Economy: Final Report* (DTI, 2001) para 3.45.

<sup>88</sup> DTI, *Company Law Reform* (White Paper, Cm5553-1, 2005), 38.

<sup>89</sup> UK Companies Act 1985 (Operating and Financial Review and Directors Report etc.) Regulations 2005 Statutory Instrument No. 1011 Part 3.

<sup>90</sup> UK Companies Act 1985 (Operating and Financial Review and Directors Report etc.) Regulations 2005 Statutory Instrument No. 1011 Part 3 Schedule 7ZA (1).

<sup>91</sup> Ibid Part 3 Schedule 7ZA (2).

<sup>92</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.19.

<sup>93</sup> UK Companies Act 1985 (Operating and Financial Review and Directors Report etc.) Regulations 2005 Statutory Instrument No. 1011 Part 3 Schedule 7ZA (4).

The OFR did not just require information about company policy in relation to stakeholder groups but also required information about the company's successful implementation of those policies. The OFR regulations further provided for disclosure on stakeholder matters by requiring that the 'review must include analysis using financial and, where appropriate, other key performance indicators, including information relating to environmental matters and employee matters.'<sup>94</sup> The OFR would need to be audited and the auditors would have had to state whether the information contained in the OFR was consistent with the company's annual accounts and whether any matters have come to their attention that is inconsistent with the information in the OFR.<sup>95</sup> From a practical viewpoint the CLRSG believed that the OFR would not be unduly burdensome on companies. It believed the information involved would already be a matter of concern for the directors and much of the material would be covered in the annual report through the chairman's or chief executive's report.<sup>96</sup> The Group were eager to highlight that many companies already compiled a report similar to the proposed OFR and were keen to raise all companies to this standard.<sup>97</sup> The important point was that under the OFR regulations disclosures would have been mandatory. The information would also need to be prepared in accordance with relevant reporting standards and give reasons for any departures from such standards.<sup>98</sup> The relevant standard came from the Accounting Standards Board who released a detailed specific reporting statement and provided details on what directors were to include in their OFR.<sup>99</sup> These two elements were what set the OFR apart from its latter replacements, the Business Review and the Strategic Report, as neither required mandatory disclosure on stakeholder issues or had a requirement to comply with an accompanying reporting standard.

#### **4.05 The Repeal of the OFR, the Business Review and the Strategic Report**

Despite the continual emphasis on the importance of the OFR by the CLRSG after just a few months after its enactment into law the OFR was withdrawn<sup>100</sup> on the basis that it imposed a disproportionate and unnecessary burden on companies.<sup>101</sup> In a speech to the Confederation of British Industry in November 2005, the then Chancellor of the Exchequer, Gordon Brown withdrew the OFR on the basis that it was unnecessary red tape. In the speech, Brown stated that OFR amounted to

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<sup>94</sup> Ibid Part 3 Schedule 7ZA (6).

<sup>95</sup> Ibid Part 3 Schedule 7ZA (10).

<sup>96</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 5.91.

<sup>97</sup> Ibid para 5.92.

<sup>98</sup> UK Companies Act 1985 (Operating and Financial Review and Directors Report etc.) Regulations 2005 Statutory Instrument No. 1011 Part 3 Schedule 7ZA (8).

<sup>99</sup> Accounting Standards Board, Reporting Statement: Operating and Financial Review, January 2006 available at <http://www.frc.org.uk/Our-Work/Publications/ASB/UITF-Abstract-24-Accounting-for-start-up-costs/Reporting-Statement-Operating-and-Financial-Review.aspx>.

<sup>100</sup> UK Companies Act 1985 (Operating and Financial Review)(Repeal) Regulations 2005 Statutory Instrument No. 3442.

<sup>101</sup> Explanatory Memorandum to The UK Companies Act 1985 (Operating and Financial Review)(Repeal) Regulations 2005 Statutory Instrument No. 3442 para. 7.2.

‘unnecessary burdens’ and stated ‘we will abolish this (OFR) requirement and will reduce the burden placed on you’.<sup>102</sup> The reversal sparked widespread dissatisfaction from within stakeholder communities<sup>103</sup> culminating in a court action taken by the Friends of the Earth. The Friends of the Earth sought judicial review of Brown’s decision claiming it was ‘procedurally unfair, irrational, perverse, a breach of legitimate expectations and based upon material errors of fact and that it was also in breach of the British Government’s code of practice on consultation’.<sup>104</sup> The action was ultimately settled out of court when the Government agreed to a consultation about the future of corporate disclosure and paid the legal expenses of the Friends of the Earth.<sup>105</sup> The decision to remove the OFR was seen as a blow to those advocating stakeholder interests and the inclusion of the OFR had led members of the CLRSG who had favoured pluralism into agreeing to the recommendation of ESV.<sup>106</sup> While there are reasons to be sceptical about whether the OFR would have worked as planned, any possibility of corporate disclosure increasing stakeholder consideration was greatly reduced when the Business Review became the standard of corporate reporting. While there are broad similarities between the Business Review and the OFR, the main difference is in relation to disclosure of information relevant to stakeholders. While the OFR was aimed at benefiting stakeholders and fulfilling the enlightened aspect of ESV, the Business Review is focused on providing information to shareholders.<sup>107</sup> The reporting requirements contained in the Business Review are not designed to promote social responsibility but rather for their value to the business, which is in keeping with the overall theme of ESV, promoting shareholder primacy.<sup>108</sup>

Immediately after the withdrawal of the OFR there was no longer any requirement for companies to disclose information on stakeholder issues. However as a result of the legal action taken by the Friends of the Earth and the subsequent settlement out of court, the British Government began a new consultation on whether the OFR should be reinstated.<sup>109</sup> The result of the consultation was not to reintroduce the OFR but include in the Business Review some of the provisions that existed under the OFR. The Business Review was introduced through section 417 of the Companies Act 2006 and

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<sup>102</sup> Gordon Brown, *Speech to the Confederation of British Industry Interactive Conference* (29 May, 2009) available at <http://www.ft.com/intl/cms/s/2/9073a120-600d-11da-a3a6-0000779e2340.html#axzz3Zipnc8eC>.

<sup>103</sup> Sarah Kiarie, ‘At Crossroads: Shareholder Value and Enlightened Shareholder Value: Which Road Should the United Kingdom Take?’ (2006) 17(11) *International Company and Commercial Law Review* 329, 340.

<sup>104</sup> Friends of the Earth, ‘Brown Faces Legal Challenge after Scrapping OFR’ (8 December 2005) <http://www.naturalmatters.net/newsview.asp?print=1&news=808>. The code of practice in question was the Better Regulation Executive, *Code of Practice on Consultation* (London: Cabinet Office, 2005).

<sup>105</sup> Friends of the Earth Press Release ‘Friends of the Earth Forces Chancellor to Cave in on Environmental Reporting’ available at [http://www.foe.co.uk/resource/press\\_releases/friends\\_of\\_the\\_earth\\_force\\_02022006.html](http://www.foe.co.uk/resource/press_releases/friends_of_the_earth_force_02022006.html)

<sup>106</sup> Andrew Keay, ‘Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom’s Enlightened Shareholder Value Approach’ (2007) 20 *Sydney Law Review* 577, 604.

<sup>107</sup> Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge, 2012), 171.

<sup>108</sup> Robert Goddard, ‘Modernising Company Law: The Governments White Paper’ (2003) 66 *Modern law Review* 402, 418.

<sup>109</sup> DTI, *A Consultation on Narrative Reporting Requirements for Companies* (February 1, 2006).



states 'In the case of a quoted company the Business Review must, to the extent necessary for an understanding of the development, performance or position of the company's business

(b) information about—

- (i) environmental matters (including the impact of the company's business on the environment)
- (ii) the company's employees, and
- (iii) social and community issues,

The Business Review was also to include information about any policies of the company in relation to the above stakeholder matters and the effectiveness of those policies. However in comparison to the OFR, the Business Review requires much less detailed reporting.<sup>110</sup> The most notable change is that the disclosures on stakeholder issues are no longer mandatory and are now only to be reported to the extent that directors deem them relevant for an understanding of the business. There is no requirement for directors to say why particular matters are not necessary for an understanding of the company<sup>111</sup> thus allowing directors to freely decide whether or not to disclose information relating to stakeholder issues.<sup>112</sup> Any incentive for directors to improve stakeholder consideration due to the requirement to report their policies on stakeholder issues has been removed due to the non-mandatory nature of disclosure. As Johnston states voluntary disclosure by companies is not a sufficient basis to anticipate the enlightenment of shareholder value.<sup>113</sup> The other primary change in the Business Review is that compliance with the Accounting Standards Boards reporting standard is no longer mandatory. As a result there is no longer a legal requirement to comply with the detail set out in the standard and there will not be uniformity of information disclosed between companies. This lack of a requirement to comply with a reporting standard has the potential to undermine the Business Review's practical effectiveness.<sup>114</sup>

A Statutory Instrument<sup>115</sup> in 2013 has altered some elements of the Business Review which is now referred to as the Strategic Report. However the Strategic Report maintains identical requirements on

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<sup>110</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law*, (8<sup>th</sup> edn, Sweet and Maxwell, 2008), 740.

<sup>111</sup> Andrew Keay, 'Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's Enlightened Shareholder Value Approach' (2007) 20 *Sydney Law Review* 577, 604.

<sup>112</sup> Shuangge Wen, 'Exploring the Rationale of Enlightened Shareholder Value (ESV) in the Realm of UK Company Law – The Path Dependence Perspective' (2011) 14 *International Trade and Business Law Review* 153, 163.

<sup>113</sup> Andrew Johnston, 'After the OFR: Can UK Shareholder Value still be Enlightened?' (2006) 7 *European Business Organization Law Review* 817, 841.

<sup>114</sup> David Williamson and Gary Lynch-Wood, 'Social and Environmental Reporting in UK Company Law and the Issue of Legitimacy' (2008) 8 *Corporate Governance* 128, 137.

<sup>115</sup> UK Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 (SI 2013/1970).

matters of stakeholder disclosure. While there is an accompanying standard to the Strategic Report,<sup>116</sup> which outlines what directors are to include in the Strategic Report, compliance is at a voluntary level.<sup>117</sup> The Statutory Instrument which introduced the Strategic Report stated that ‘[t]he purpose of the Strategic Report is to inform members of the company and help them assess how the directors have performed their duty under section 172’.<sup>118</sup> Hence, like the Business Review, the purpose of the information disclosed is to benefit shareholder rather than achieve a more stakeholder focused approach under ESV. The Financial Reporting Council’s standard would back up such back view as it states ‘the Strategic Report should only contain information which is material to shareholders’.<sup>119</sup>

#### **4.06 Issues with Corporate Disclosure and Stakeholder Consideration.**

It seems that the CLRSO and the British government had two very different intentions for the role of corporate disclosure within ESV. The CLRSO hoped that the OFR would ensure that directors would comply with extended duties in section 172(1) and thereby ensure a more stakeholder orientated approach.<sup>120</sup> While initially agreeing with this view, the British government have since been unwilling to implement a similarly prescriptive reporting regime to the one recommended by the CLRSO. However, the degree to which a more pluralist business environment can be established through corporate disclosure is questionable, even if the OFR was still in force.<sup>121</sup> There are limits to the extent corporate disclosure can work to ensure a more stakeholder orientated approach from directors. The CLRSO hoped increased reporting would ensure a more stakeholder orientated approach in two ways; firstly by reducing short term pressure on directors to pursue shareholder value<sup>122</sup> and secondly by the OFR having the ability to affect the company’s reputation.<sup>123</sup>

The CLRSO hoped the OFR would reduce short term pressures on directors by fulfilling an educative function for shareholders, increasing their understanding of the company which would allow

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<sup>116</sup> Financial Reporting Council, Exposure Draft: Guidance on the Strategic Report available at <https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Exposure-Draft-Guidance-on-the-Strategic-Report.aspx>

<sup>117</sup> Ibid, 3.

<sup>118</sup> UK Companies Act 2006 (Strategic Report and Directors’ Report) Regulations 2013 (SI 2013/1970) Chapter 4A s 414C(1)

<sup>119</sup> Financial Reporting Council, Exposure Draft: Guidance on the Strategic Report available at <https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Exposure-Draft-Guidance-on-the-Strategic-Report.aspx>, 15.

<sup>120</sup> CLRSO, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.44.

<sup>121</sup> See Charlotte Villiers, ‘Narrative Reporting and Enlightened Shareholder Value under the Companies Act 2006’ in Joan Loughrey (ed), *Directors’ Duties and Shareholder Litigation in the Wake of the Financial Crisis* (Elgar 2013).

<sup>122</sup> CLRSO, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.44.

<sup>123</sup> CLRSO, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.20.

shareholders to become more patient.<sup>124</sup> However the issue with this reasoning is that, as rational apathy theory holds, there is very little pressure on directors from shareholders to do anything.<sup>125</sup> This is particularly the case in public companies where shareholders are generally passive<sup>126</sup> and much more likely to sell their shares rather than participate in the internal management of companies.<sup>127</sup> In the quoted companies to which the OFR, Business Review and Strategic Report apply, there is likely to be a lack of shareholder interference in management<sup>128</sup> so any short term pressure to pursue short term shareholder value is likely to be rare.

In the rare event that short term pressures are being placed on directors the extent to which increased disclosure could change this behaviour is questionable.<sup>129</sup> Meeting the standards required to shape shareholder behaviour is very difficult<sup>130</sup> and this was recognised by the CLRSO who said there is a danger ‘that reporting duties without real content will lead to perfunctory, “boilerplate” compliance’.<sup>131</sup> Johnston argues that the OFR did not demand a high enough standard to provide adequate disclosure on stakeholder issues to influence investor behaviour.<sup>132</sup> What can be said with certainty is that the Business Review or the Strategic Report will not provide the standard of information necessary to alter shareholder behaviour. The Business Review and Strategic Report are likely to foster the boiler plate reporting that the CLRSO were keen to avoid. In Keay’s view there is nothing in the Business Review to stop directors making quite ‘neutral statements which give little detail about their thinking and discussions at board level’.<sup>133</sup> Davies is also concerned with this issue and states that there is a risk the review will produce a ‘self-serving and vacuous narrative rather than analytical material which is of genuine use’.<sup>134</sup> The conclusion of the Department of Business, Innovation and Skills is that when it comes to disclosures on stakeholder issues such as their relations

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<sup>124</sup> Andrew Johnston, ‘After the OFR: Can UK Shareholder Value still be Enlightened?’ (2006) 7 *European Business Organization Law Review* 817, 833.

<sup>125</sup> See Blanaid Clarke, ‘Corporate Responsibility in Light of the Separation of Ownership and Control (1997) 1 *Dublin University Law Journal* 57, 57; James McConville, ‘The Separation of Ownership and Control under a Happiness-Based Theory of the Corporation (2005) 26(2) *Company Lawyer* 35, 36.

<sup>126</sup> James McConville, ‘The Separation of Ownership and Control under a Happiness-Based Theory of the Corporation (2005) 26(2) *Company Lawyer* 35, 36.

<sup>127</sup> See Dalia Mitchell, ‘Shareholders as Proxies: The Contours of Shareholder Democracy’ (2006) 63 *Washington and Lee Law Review* 1502, 1564.

<sup>128</sup> Iris Chiu, ‘Institutional Shareholders as Stewards: Towards a New Concept of Corporate Governance’ (2012) *Brooklyn Journal of Corporate, Financial and Commercial Law* 387, 387.

<sup>129</sup> See Iris Chiu, Reviving Shareholder Stewardship: Critically Examining the Impact of Corporate Transparency Reforms in the UK (2013) 28 *Delaware Journal of Corporate Law* 984, 1010-1015.

<sup>130</sup> Andrew Johnston, ‘After the OFR: Can UK Shareholder Value still be Enlightened?’ (2006) 7 *European Business Organization Law Review* 817, 834.

<sup>131</sup> CLRSO, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.46.

<sup>132</sup> Andrew Johnston, ‘After the OFR: Can UK Shareholder Value still be Enlightened?’ (2006) 7 *European Business Organization Law Review* 817, 835.

<sup>133</sup> Andrew Keay, ‘The Duty to Promote the Success of the Company: Is It Fit for Purpose’ University of Leeds, Centre for Business Law and Practice, Working Paper at 21 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1662411](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1662411) last accessed 05/11/2014.

<sup>134</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law*, (8<sup>th</sup> edn, Sweet and Maxwell, 2008), 740.

employees and the environment companies will insert generic boilerplate material in the Business Review.<sup>135</sup> The fears of boiler plate reporting would seem to have played out in practice as empirical evidence gathered in 2011 found that the Business Review has made little difference to the quality of reports.<sup>136</sup> Therefore corporate disclosure as contained in the Business Review and Strategic Report will be unlikely to remove any pressure that is being placed on directors.

Secondly the CLRSG believed that the increased reporting would have the effect of allowing stakeholders and the public at large to evaluate company performance and which in turn would affect its reputation.<sup>137</sup> This could make directors more likely to consider the listed stakeholders in order to not negatively impact the company's reputation. This belief was shared by some academics. Arden claimed that OFR would ensure that the interests of stakeholders would be considered as directors would become accountable in a wider sense through peer pressure of the OFR.<sup>138</sup> Arsalidou stated that the OFR would have allowed similar companies to be compared on issues like community concerns and employee welfare, and set the standards within a particular industry allowing a name and shame style enforcement.<sup>139</sup> While a company's reputation is widely regarded to be one of its most important intangible assets<sup>140</sup> it is difficult how such information disclosure would significantly affect the company's reputation. It is dependent on extremely detailed reporting and competing companies being objectively compared. The legal requirement<sup>141</sup> to comply with the Accounting Standards Board's standard was on a comply or explain basis which has had its own problems of non-compliance in the context of corporate governance codes.<sup>142</sup> Relying on comply or explain to ensure uniform reporting between companies and complete compliance with the Accounting Standards Board's reporting standard was unlikely to have ensured perfect comparison between companies. Under the Strategic Report disclosure on stakeholder issues is no longer mandatory and leaving it to

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<sup>135</sup> Department of Business, Innovation and Skills, *A Long-Term Focus for Corporate Britain – A Call for Evidence* (2010) para 2.8; Department of Business, Innovation and Skills, *The Future of Narrative Reporting* (2011) para 3.2.

<sup>136</sup> Olajo Aiyegbayo and Charlotte Villiers, 'The Enhanced Business Review: Has it made Corporate Governance More Effective' (2011) 7 *Journal of Business Law* 699, 713.

<sup>137</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 2.20.

<sup>138</sup> Mary Arden, 'Reforming the Companies Acts The Way Ahead' (2002) *Journal of Business Law* 570, 598.

<sup>139</sup> Demetra Arsalidou, 'The Withdrawal of the Operation and Financial Review of the Companies Bill 2006: Progression or Regression?' (2007) *Company Lawyer* 131, 133.

<sup>140</sup> Steve Letza X. Sun Kirkbride, 'Shareholding and Stakeholding: A Critical Review of Corporate Governance' (2004) 12 *Corporate Governance* 242, 255; Janice Dean, *Directing Public Companies: Company Law and the Stakeholder Society* (Cavendish 2001), 107.

<sup>141</sup> UK Companies Act 1985 (Operating and Financial Review and Directors Report etc.) Regulations 2005 Statutory Instrument No. 1011 Part 3 Schedule 7ZA (8).

<sup>142</sup> See Andrew Keay, 'Comply or Explain in Corporate Governance Codes; In Need of Greater Regulatory Oversight?' (2014) 34(2) *Legal Studies* 279.

companies whether or not to disclose stakeholder information will reduce the possibility of uniformly comparing companies' performance across the board.<sup>143</sup>

While there are question marks as to the OFR working as planned by the CLRSG, non-mandatory reporting under the Business Review or the Strategic Report has no chance of achieving such goals. The Business Review is weak by comparison to the OFR<sup>144</sup> and Johnston notes that the Business Review will 'be considerably less prescriptive and will offer even less guidance than the OFR about what should be disclosed.'<sup>145</sup> Davies seems to agree that the Business Review is not going to be an equal replacement to the OFR and the Business Review contains 'far from all of the substance of the OFR requirements...and the quality of what is disclosed under the Business Review may be less than would have been the case with the OFR.'<sup>146</sup> Ultimately, when it comes to stakeholder disclosure it is highly debateable whether the Business Review, because of its vagueness will be able to provide any verification as to whether directors have discharged their duties under section 172(1).<sup>147</sup>

#### **4.07 The Impact of ESV on Employees**

Section 172(1) requires directors to promote the success of the company for the benefit of the members and in doing so have regard (amongst other matters) to—

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

The first point to note about the listed factors in section 172(1) is the term 'amongst other matters' which demonstrates that the factors mentioned in section 172(1) are non-exhaustive. The explanatory notes to the Companies Act 2006 state that the list is non-exhaustive but 'highlights areas of particular

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<sup>143</sup> Final Regulatory Impact Statement on the Operating and Financial Review and Directors' Report Regulations (2006) available at <http://www.bis.gov.uk/files/file21361.pdf>.

<sup>144</sup> Demetra Arsalidou, 'The Withdrawal of the Operation and Financial Review of the Companies Bill 2006: Progression or Regression?' (2007) *Company Lawyer* 131, 133.

<sup>145</sup> Andrew Johnston, 'After the OFR: Can UK Shareholder Value still be Enlightened?' (2006) 7 *European Business Organization Law Review* 817, 842.

<sup>146</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law*, (8<sup>th</sup> edn, Sweet and Maxwell, 2008), 738.

<sup>147</sup> Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge, 2012), 175.

importance which reflect wider expectations of responsible business behaviour'.<sup>148</sup> Therefore the factors mentioned in section 172(1) are deemed the most important but other interest groups can be considered. In relation to what directors are actually to do in having regard to the listed interests Margaret Hodge MP, Minister for Industry and the Regions, at the time of the enactment, stated in a speech to the House of Commons that 'have regard to' simply means 'to think about' and 'to give proper consideration to'.<sup>149</sup> She also commented on how she believed the directors were to satisfy this duty to have regard to the listed factors,

We believe that a director should be required to give proper consideration to the list of factors, so far as it is relevant to the decisions that he is taking. That is the essence of enlightened shareholder value. At the same time, a director will not be required to consider any of the factors beyond the point at which to do so would conflict with the overarching duty to promote the success of the company.<sup>150</sup>

A more comprehensive guide as to how directors are to act under section 172(1) comes in the explanatory notes which state, 'It will not be sufficient to pay lip service to the factors, and, in many cases the directors will need to take action to comply with this aspect of the duty. At the same time, the duty does not require a director to do more than good faith'.<sup>151</sup> Despite the claim that directors will have to do more than simply pay lip service the difficulties with enforcement means there is nothing preventing directors doing exactly that. The problems with ESV can be highlighted through a discussion of the potential impact of ESV on employees. Prior to the enactment of section 172(1), employees were owed a similar duty to be had regard to by directors. The requirement for directors to have regard to employee interests came from section 309 of the UK Companies Act 1985. Section 309 provided:

- (1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.
- (2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.<sup>152</sup>

As under section 172(1), the duty to have regard to employees under section 309 was owed to the company and not to the employees and as such, employees could not enforce the duty directly.

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<sup>148</sup> Explanatory Notes to the UK Companies Act 2006, note 326.

<sup>149</sup> Commons Report, 17 October 2006, col 789.

<sup>150</sup> HC Standing Committee D, 15th sitting, 11th July 2006, col 591.

<sup>151</sup> Explanatory Notes to the UK Companies Act 2006, note 328.

<sup>152</sup> Companies Act 1985 s 309.

Because of the unenforceable nature of the duty, section 309 became widely regarded as an ineffectual provision<sup>153</sup> with even the CLRSG acknowledging the lack of effective means to enforce the provision.<sup>154</sup> Due to its lack of benefit to employees, Sealy describes section 309 as ‘either one of the most incompetent or one of the most cynical pieces of drafting on record’.<sup>155</sup> The inference being that section 309 gave the impression that directors were to have regard to employees but its unenforceable nature rendered the duty as merely lip service. The parallels with section 172(1) are obvious, with enforcement of the stakeholder provisions proving to be a significant difficulty with ESV.

The only legal function section 309 actually served was to dilute shareholders’ power over directors rather than confer any actual power to employees.<sup>156</sup> This was because directors were able to invoke the section when being sued by shareholders.<sup>157</sup> If the board of directors decided to take a decision for the benefit of the employees rather than that of the shareholders, the directors could claim that it was taken for employee’s interests under section 309 and so would provide a defence to directors. This set of circumstances arose in *Saul D. Harrison and Sons Plc*<sup>158</sup> where the directors acted to protect the jobs of over 100 employees and section 309 played a central role in the directors escaping liability.<sup>159</sup> The case provides an example of how directors might use section 172(1) to render themselves immune from suit from shareholders.<sup>160</sup> Protecting directors from suits taken by shareholders has the potential to be one of the very few advantages of ESV from a stakeholder point of view. Section 172(1) extends this function from just employees to encompass community interests, the environment, customers, suppliers and long term planning. There is a possibility that this immunity from suit may increase the possibility of directors considering stakeholder interests by removing the possibility of being found in breach of duty for doing so. The CLRSG viewed this as a benefit of section 172(1) and it believed it would ‘confer an immunity on the directors, who would be able to resist legal actions by

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<sup>153</sup> See Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge 2012), 111; Lee Roach, ‘The Traditional Justification for Exclusive Shareholders Governance Protection: Expanding the Pluralist Approach’ (2001) 22 *The Company Lawyer* 9, 15; Len Sealy, ‘Directors’ Wider Responsibilities – Problems Conceptual Practical and Procedural’ (1987) 13 *Monash University Law Review* 164, 177; Andrew Keay, ‘Section 172(1) of the Companies Act 2006: An Interpretation and an Assessment’ (2007) *Company Lawyer* 106, 109.

<sup>154</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.1.

<sup>155</sup> Len Sealy, ‘Directors’ Wider Responsibilities – Problems Conceptual Practical and Procedural’ (1987) 13 *Monash University Law Review* 164, 177.

<sup>156</sup> Irene Esser and Jean du Plessis, ‘The Stakeholder Debate and Directors’ Fiduciary Duties’ (2007) 19 *South African Mercantile Law Journal* 346 at 354. Alastair Alcock, ‘An Accidental Change to Directors’ Duties’ (2009) 30 *Company Lawyer* 362, 364.

<sup>157</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law* (8<sup>th</sup> edn, Sweet and Maxwell, 2008), 519.

<sup>158</sup> *Saul D. Harrison and sons Plc* [1995] 1 BCLC 475.

<sup>159</sup> *Ibid*, 499.

<sup>160</sup> Elaine Lynch, ‘Section 172: A Ground Breaking Reform of Directors’ Duties, or the Emperor’s new Clothes?’ (2010) *Company Lawyer* 196, 200.

the shareholders based on the ground that the directors had neglected their normal fiduciary duty to them.<sup>161</sup>

However the importance of this function should not be overstated. If directors do not take decisions to promote the overall success of the company for the benefit of the members then they will be liable for a breach of duty.<sup>162</sup> Under section 172(1) any stakeholder consideration would have to ultimately benefit the members. This is where ESV represents the more shareholder approach in comparison to the common law and section 309. The difference between section 309 and section 172(1) is that under section 172(1) members' interests are given priority over all others. Section 309 stated that directors were to have regard to the 'interests of the company's employees in general, as well as the interests of the members'. Neither the members nor the employees were given priority over one another. It is this reason why section 309 represented an effective barrier for directors whereas under section 172(1) should the directors' act in favour of employee interests at the expense of the members they will have failed to promote the success of the company for the benefit of the members.

This difference between section 172(1) and section 309 can be highlighted by reference to *Re Wellfab Engineers Ltd*.<sup>163</sup> In this case the directors were subject to a suit from a liquidator after choosing not to sell the company to the highest bidder. Accepting the lower bid allowed the company to continue in business and the bidder had agreed to preserve the jobs of the employees and the directors whereas the higher bidder planned on not continuing the company as a going concern. The liquidator's case was that the directors were in breach 'because they gave priority to the preservation of the business and the jobs of the employees'<sup>164</sup> however it was held that the directors were not liable for a breach because they accepted the lower offer. While section 309 was not expressly mentioned in the case it has been suggested section 309 played a part in the deciding of the case.<sup>165</sup> What this case demonstrates is that directors, under the common law, were not in breach of their duties if they prioritising employees and the company as an entity ahead of increasing financial return. The common law allowed such decisions to be reached, however it is submitted ESV does not, due to the prioritisation of the members and therefore the implementation of shareholder value. Lynch argues that this case would have been decided in the same way under section 172(1) as she believes maintaining the company as a going concern will always benefit the members. However this is not always the case. Three months after accepting the lower bid, Wellfab Ltd entered liquidation. The members may well have been worse off from the liquidation three months later than if the directors had accepted the higher offer and immediately went into liquidation. If that was the case, and this was foreseen by the directors,

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<sup>161</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic framework* (DTI, 1999) para 5.1.21.

<sup>162</sup> Andrew Keay, 'Tackling the Issue of the Corporate Objective: An Analysis of the UK's Enlightened Shareholder Value Approach' (2007) 29 *Sydney Law Review* 577, 600.

<sup>163</sup> *Re Wellfab Engineers Ltd* [1990] BCLC 833 Ch D.

<sup>164</sup> *Ibid*, 836.

<sup>165</sup> Alastair Alcock, 'An Accidental Change to Directors' Duties' (2009) 30 *Company Lawyer* 362, 364.



then under section 172(1) the directors would have to be in breach of the duty to promote the success for the benefit of the members as the directors would have prioritised the entities and employee interests above that of the shareholders. Whereas, under the common law, free from the requirement to promote the members' interests or under section 309 where employees interests were on an equal footing to that of the members, it would have been possible to act for the benefit of the company as an entity or act for the benefit of the employees.

Section 309 was also invoked in the Scottish case of *Dawson International Plc v Coats Platon plc*<sup>166</sup> which also dealt with how directors are to act when the company is subject to takeover bid. This case held that, in general, the interests of the company do not automatically equate with the interests of the shareholders, and section 309 was used as part of the rationale for such a finding.<sup>167</sup> Again under ESV it is unlikely that the courts could reach the same conclusion post the 2006 act due to the prioritisation of the shareholders. This discussion represents the difference between a shareholder value model and the entity focused approach. Even the potential for section 172(1) to provide immunity from suit for directors is undermined by the prioritisation of the members and any stakeholder consideration must take place in the context of promoting the shareholders' interests.

#### **4.08 The Position of the Creditors**

The argument of this chapter is that instead of defining company success in terms of the members, the common law duty to act in the interests of the company should have been given the scope to be developed by the courts. This would provide the courts with the latitude to potentially define the company as an entity which would allow shareholder interests to not to be prioritised over all other interests groups in every circumstance. This is the approach taken in Ireland<sup>168</sup> and allowing the common law to develop is exactly what section 172(3) did in relation to creditors' interests. Section 172(3) provides that 'The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company'. The rule of law which section 172(3) refers to is the body of case law which provides that directors owe duties to creditors when a company is insolvent and when a company is nearing insolvency. Section 172(3) allows scope in this area of the common law for directors' duties to continue to develop under the Companies Act 2006. The explanatory notes state that section 170(3) 'recognises that the duty to promote the success of the company is displaced when the company is insolvent'.<sup>169</sup> The notes also makes reference to the case law concerning when a company is nearing insolvency and states that section 172(3) will 'leave the law to develop in this area.'<sup>170</sup> Clearly the

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<sup>166</sup> *Dawson International Plc v Coats Platon plc* [1989] BCLC 233.

<sup>167</sup> *Ibid* 243.

<sup>168</sup> Companies Act 2014 s 228(1)(a).

<sup>169</sup> UK Companies Act 2006 Explanatory Notes Chapter 2 note 331.

<sup>170</sup> *Ibid* note 332.

legislative intention is to maintain the common law position in relation to directors' duties to creditors and is the reason why creditors are not mentioned in section 172(1).

Under the common law when a company becomes insolvent the duty to act in the best interests of the company subsides and instead there is a duty to act in the creditors' interests.<sup>171</sup> Yet there is also a duty owed to creditors when the company is approaching insolvency. The predominant view of the case law is that the directors must give special consideration to the company's creditors if the company is in a state of financial difficulty.<sup>172</sup> The English courts in *Re Horsely & Weight Ltd*<sup>173</sup>, following Australia's lead,<sup>174</sup> made the existence of a pre-insolvency duty to creditors very clear.

If the company had been doubtfully solvent at the date [of the grant of the pension] to the knowledge of the directors, the grant would have been both a misfeasance and a fraud on the creditors for which the directors would remain liable.<sup>175</sup>

There is a very strong rationale for the application of the duty, primarily the duty is one of fairness and tries to ensure that creditors receive some fiduciary protection when the company is financially distressed.<sup>176</sup> The case of *Ultraframe Ltd. v Fielding*<sup>177</sup> provided a conclusive statement on the issue in England

when a company, whether technically insolvent or not, is in financial difficulties to the extent that its creditors are at risk, the duties which the directors owe to the company are extended so as to encompass the interests of the company's creditors as a whole (not to any individual), as well as those of the shareholders.<sup>178</sup>

Due to section 172(3), the common law rules will continue to apply under ESV. Directors will owe a duty to consider creditors' interest when the company is approaching insolvency allowing the common law to continue to develop. A similar approach to give the courts appropriate scope in relation to the duty to act in the interests of the company would have been superior to ESV.

#### 4.09 An Evaluation of ESV

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<sup>171</sup> *West Merica Safety Wear v Dodd* (1988) 4 BCLC 252.

<sup>172</sup> Andrew Keay, 'The Director's Duty to take into Account the Interests of Company Creditors: When is it Triggered?' (2001) 25 *Melbourne University Law Review* 315, 317.

<sup>173</sup> *Re Horsely & Weight Ltd* [1982] Ch 442.

<sup>174</sup> *Walker v Wimborne* (1976) 137 CLR 1; *Ring v Sutton* (1980) 6 ACLC 546.

<sup>175</sup> *Re Horsely & Weight Ltd* [1982] Ch 442, 455.

<sup>176</sup> Mark Van Der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1997) 21 *Delaware Journal of Corporate Law* 27, 31.

<sup>177</sup> *Ultraframe (UK) Ltd. v Fielding* [2005] EWHC 1638.

<sup>178</sup> *Ibid*, 1304.

There are some positive aspects of ESV which are worth highlighting. Firstly one possible benefit is that it will give directors' immunity from suit from derivative action when directors take decisions in the interests of stakeholders. However, as discussed in the context of employees above, this effect is undermined by the prioritisation of the shareholders. Secondly, it is possible that section 172(1) could serve as a tool for educating directors and shareholders in the importance of stakeholders in achieving the long term sustainability and success of the company.<sup>179</sup> Similarly section 172(1) could have a declaratory effect and serve a normative function in encouraging directors to take a long term approach.<sup>180</sup> Section 172(1)(a) clarifies any confusion that the common law required a short term approach as it expressly provides that directors should have regard to the 'likely consequences of any decision in the long term'. Short term and long term strategies differ significantly<sup>181</sup> and it was the main problem of the common law from the UK was that directors misunderstood that it required short term shareholder value. Directors seemed to be under the impression that they were legally required to maximise short term shareholder benefits at the expense of the long term interests of the company itself.<sup>182</sup> While the CLRSG mistakenly believed that the common law required a shareholder value approach, the group did recognise that the common law did not require a focus on short term shareholder value. There was no actual legal requirement from the English common law to run the company for short term benefits to shareholders<sup>183</sup> and the CLRSG put particular emphasis on the need to break the perception that directors must increase shareholder value in the short term<sup>184</sup> and this was the reason for the inclusion of section 172(1)(a). While ESV embraces shareholder value to a greater degree than the common law from the UK, section 172(1)(a) should remove the perception that ESV requires a short term approach. However, the reference to the long term contained in section 172(1) will not prevent directors from focusing on the short term if they believe that it will promote the success of the company for the benefit of the members.<sup>185</sup> Directors are not prevented from managing for short term gains, it is left to their commercial judgment to evaluate what is in the members' interests.<sup>186</sup> The problem is that ESV represents such a strong endorsement of shareholder value that the requirement to consider the long term interests of the company may have little effect. While logically shareholder value should not necessarily lead to short-termism in practice, this is

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<sup>179</sup> David Kershaw, *Company Law in Context: Cases and Materials* (Oxford University Press 2009), 350.

<sup>180</sup> John Lowry, 'The Duty Of Loyalty of Company Directors; Bridging the Accountability Gap Through Efficient Disclosure' (2009) 68 *Cambridge Law Journal* 607, 621.

<sup>181</sup> Henry Hu 'Risk, Time and Fiduciary Principles in Corporate Investment' (1990) 38 *University of California Los Angeles Law Review* 277.

<sup>182</sup> See Institute of Directors, *Good Boardroom Practice: Company Law Review, The Stakeholder Debate* (1999).

<sup>183</sup> John Birds, 'The Reform of Directors' Duties' in John de Lacy, *The Reform of United Kingdom Company Law* (Cavendish, 2003), 159.

<sup>184</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.10.

<sup>185</sup> Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge, 2013), 117.

<sup>186</sup> Andrew Keay, *Directors' Duties* (2nd edn, Jordan 2014), 150.

often what occurs<sup>187</sup> and shareholder value has long been linked to a short term approach.<sup>188</sup> Because ESV is so shareholder focused directors may feel they have no option that in order to promote the success for the company for the benefit of the members requires them to take a short term approach.

In an overall evaluation of ESV the relevant question is: does ESV represent the best model of the corporate objective to achieve the aim of the CLRSg to generate efficient creation of wealth and other benefits for all participants in the enterprise?<sup>189</sup> Under ESV any possible benefit to stakeholders is undermined by the legislative prioritisation of the members and any consideration of the factors listed in section 172(1) must be such that it does not impinge on the shareholders' interests.<sup>190</sup> Company success is always couched in terms of benefits for the members<sup>191</sup> and even if a course of action might benefit a number of stakeholders but will not benefit the shareholders, it should not be embraced under ESV.<sup>192</sup> An analysis of ESV can only result in the conclusion that ESV implements a model of shareholder value. And as discussed at length in chapter two, shareholder value does not represent the best model to maximise benefit to all constituents. Adopting a legislative duty to act in the interests of the company and introducing a requirement to have due regard to the long term sustainability of the entity would have been a superior choice. It would have removed the misconception among directors that the common law required a short term shareholder value approach. It would have allowed courts the scope to be more flexible in their judgments and allowed them to view the company as an entity. It would also allow stakeholders to be considered when it benefited the company as an entity to do so. The CLRSg allowed the common law to continue to develop in respect of the duty to have regard to creditors' interests when the company is nearing insolvency. A similar approach in regard to the duty to promote the success of the company would have been much likelier to attain the CLRSg's original goal of maximising benefits to all participants.

#### 4.10 Conclusion

The CLRSg's and ultimately the UK's solution to the issue of the corporate objective was to prioritise the members' interests but also to require directors to consider a list of non-shareholder interest groups and the long term interests of the company. Davies sums up the eventual legal position by stating

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<sup>187</sup> Ibid, 148.

<sup>188</sup> Steven Wallman, 'The Proper Interpretation of Corporate Constituency Statutes and Formulation of Directors' Duties' (1991) 21 *Stetson Law Review* 163, 176; Martin Lipton and Steven Rosenblum 'A New System of Corporate Governance: The Quinquennial Election of Directors' (1991) 58 *University of Chicago Law Review* 187, 205-215; Mark Van Der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27, 51.

<sup>189</sup> CLRSg, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.8.

<sup>190</sup> Andrew Keay, *Directors' Duties* (2nd edn, Jordan 2014), 145.

<sup>191</sup> Ibid, 141.

<sup>192</sup> Andrew Keay, 'Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's Enlightened Shareholder Value Approach' (2007) 20 *Sydney Law Review* 577, 597.

The best view is probably that a section like 309 of the 1985 Act a more broadly-formulated pluralist section cannot itself operate so as to alter the decision making process of a board, unless coupled with further changes in company law, such as board level representation for the relevant stakeholder groups.<sup>193</sup>

This statement represents why the recommendations of the CLRSG were never likely to be a success. A duty to consider wider interests without institutional reform is going to render those duties very difficult to enforce. The very system of requiring directors to have regard to stakeholder interests is unsatisfactory because of its unenforceable nature.<sup>194</sup> The potential means available to enforce the duty to have regard to stakeholders are discussed in chapter six but are unlikely to provide a regular means to ensure directors consider the interest in section 172(1). The significant reforms considered under pluralism were extremely unlikely to ever be implemented given the resistance from the UK in relation to the draft Fifth Directive. Instead of recommending reforms to the compositions of company boards the ESV aimed to ensure directors would consider stakeholder interests through increased corporate reporting. However after significant dilution of the reporting requirement proposed by the CLRSG there is very little chance of corporate reporting ensuring directors do consider stakeholder interests. Information disclosure on stakeholder issues is no longer mandatory the result of which will be the legal system enforcing a model indistinguishable from shareholder value.<sup>195</sup> What would have been a much simpler and more effective solution to the issue of the corporate objective would have been allow the jurisprudence to continue under the duty to act in the interests of the company. No institutional reforms would have been necessary. There would have been no unenforceable duty to have regard to a wide range of stakeholders yet the courts would still have had the power to rule in favour of stakeholder interests when it was in the company's interests to do so. This approach has been selected by the Irish reform of directors' duties and allows for the possibility of the imposition of the entity maximisation model.

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<sup>193</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law* (8<sup>th</sup> edn, Sweet and Maxwell, 2008), 519

<sup>194</sup> Nicholas Grier, 'Enlightened Shareholder Value: Did Directors Deliver' (2014) 2 *Juridicial Review* (2012) 95, 95.

<sup>195</sup> Andrew Johnston, 'After the OFR: Can UK Shareholder Value still be Enlightened?' (2006) 7 *European Business Organization Law Review* 817, 841.

## Chapter 5 The Irish Corporate Objective

### 5.01 Introduction

The issue of the corporate objective first came to prominence in the 1930's with the well-known debate between Adolf Berle and Merrick Dodd. Berle argued that all powers granted to the directors of a company are at all times exercisable only for the benefit of shareholders, for whom money is to be made.<sup>1</sup> He believed that because the power to run a company has been delegated from the shareholders, directors had the sole responsibility to run the corporation in the interests of those shareholders.<sup>2</sup> Dodd argued that a corporation becomes a distinct legal entity upon incorporation.<sup>3</sup> He viewed the company as representing more than just shareholder interests and that companies should be obligated to fulfil a social service role.<sup>4</sup> Dodd stated that the law was in favour of treating the company 'as an institution directed by persons who are fiduciaries for the institution rather than for its members'.<sup>5</sup> Some 85 years on and it is this same debate that is relevant in Ireland. The Companies Act 2014 codifies directors' fiduciary duties and requires directors to act in 'the interests of the company'.<sup>6</sup> It is the meaning attributed to this phrase which has a major role in determining the Irish approach to the corporate objective. The common law has generally two interpretations of what it means to act in the interests of the company.<sup>7</sup> The first equates the interests of the company with the interests of the shareholders thus requiring directors to run the company in the interests of the shareholders.<sup>8</sup> The second is that acting in the interests of the company means the directors acting in the interests of the company as a separate legal entity.<sup>9</sup> This approach recognises that the interests of the company and the shareholders may well diverge<sup>10</sup> and in such cases it is the entities interests which should take priority. It would also require directors to take decisions in favour of stakeholder interests, where such action would benefit the company,<sup>11</sup> therefore allowing a more stakeholder orientated approach to business.

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<sup>1</sup> Adolf Berle, 'Corporate Powers as Powers in Trust' (1930) 44 *Harvard Law Review* 1049, 1049.

<sup>2</sup> John Macintosh, 'The Issues, Effects and Consequences of the Berle-Dodd Debate' (1999) 24 *Accounting, Organizations and Society* 139, 144.

<sup>3</sup> Merrick Dodd, 'For Whom are Managers Trustees?' (1932) 45 *Harvard Law Review* 1145.

<sup>4</sup> *Ibid*, 1148.

<sup>5</sup> *Ibid*, 1162, 1163.

<sup>6</sup> Companies Act 2014 s 228(1)(a).

<sup>7</sup> Thomas Courtney, *The Law of Companies*, (3rd edn, Bloomsbury 2012), 121; Deirdre Ahern, *Directors' Duties: Law and Practice* (Roundhall 2009), 152.

<sup>8</sup> *Parke v Daily News Ltd* [1962] Ch 927, 963; *Brady v Brady* [1988] 3 BCC 535, 552; *Heron International Ltd* [1983] BCLC 244, 265; *Greenhalgh v Ardenne Cinemas Ltd* [1950] 2 All ER 1120, 1126; *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC, 22; *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported) 77; *Re Frederick Inns Ltd.* [1994] 1 ILRM 387, 396.

<sup>9</sup> See *Re BSB Holdings Ltd* [1996] 1 BCLC 155; *Dawson International Plc v Coats Platon plc* [1989] BCLC 233; *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656.

<sup>10</sup> As was recognised in *Dawson International plc v Coats Platon plc* [1989] BCLC 233, 243; *Re BSB Holdings Ltd* [1996] 1 BCLC 155, 249.

<sup>11</sup> Examples of such an approach can be seen in: *Lonhro v Shell Petroleum* [1980] 1 WLR 637; *Fulham Football Club v Cabra Estates* [1994] 1 BCLC 363; *Re Welfab Engineers* [1990] BCLC 833.

It is at this point where the debate becomes relevant to the impact that companies have on society as a whole and the potential benefits that can be conferred on a company's constituents. The first interpretation leads to a shareholder value approach which dictates that directors are to manage the assets of the company and take decisions based on the objective of maximising shareholder gain.<sup>12</sup> As discussed in detail in chapter two, shareholder value has many drawbacks such as an undue focus on short term shareholder wealth which can potentially be damaging to the company, its stakeholders and society generally. It is submitted that interpreting the duty to act in the interests of the company as meaning a duty to act in the interests of the company as a separate legal entity is the superior approach. It is also a more accurate reflection of the legal reality that a company is an entity in its own right, distinct from its shareholders.<sup>13</sup> Further, directors owe their duties directly to the company and not to shareholders and are under no direct obligation to further the interests of the shareholders.<sup>14</sup> However Irish law seems to embrace the shareholder value model with the reported cases on this topic stating that acting in the interests of the company is synonymous with the acting in the shareholders' interests.<sup>15</sup>

However there is evidence to suggest that should a case come before the courts under the Companies Act 2014 the Irish courts would alter the current shareholder value approach. In recent years there has been a greater focus on directors' duties serving a public interest function.<sup>16</sup> This is evidenced by the introduction of the restriction regime, the main aim of which is to protect the public from persons who are deemed unfit to be directors.<sup>17</sup> The Companies Act 2014 has placed a new fiduciary duty on directors, taken from the rules on restriction, to 'act honestly and responsibly in relation to the conduct of the affairs of the company'.<sup>18</sup> While this duty is a new fiduciary duty, it has a very well defined meaning in the context of directors seeking to avoid restriction. Acting honestly and responsibly is the only available defence to avoid restriction for a director of an insolvent company

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<sup>12</sup> Daniel Attenborough, 'How Directors Should Act When Owing Duties to the Companies' Shareholders: Why We Need to Stop Applying Greenhalgh' (2009) 20(10) *International Company and Commercial Law Review* 339, 340.

<sup>13</sup> See *Salomon v A Salomon & Co Ltd* [1897] AC 22; *A L Underwood Ltd v Bank of Liverpool* [1924] 1 KB 775; *Macura v Northern Insurance Co Ltd* [1925] AC 619; *Roberts v Coventry Corporation* [1947] 1 All ER 308; *Wallersteiner v Moir (No 2)* [1975] QB 373; *Credit Suisse v Allerdale Borough Council* [1997] QB 309; *Johnson v Gore Wood & Co (A Firm)* [2002] 2 AC 1; *Re Frederick Inns Ltd* [1991] ILRM 582; *Attorney General v Jameson* [1904] 2 IR 644; *Allied Irish Coal Supplies Ltd. v Powell Duffryn International Fuels Ltd* [1998] 2 IR 519; *Redfern v O' Mahony and McFeely, Carroll, Tafica Ltd and Aifca Ltd* [2010] IEHC 253.

<sup>14</sup> See *Smith v Cork and Bandon Railway Co* (1870) 5 IR EQ 63; *Percivil v Wright* [1902] 2 Ch 421. *Dawson International plc v Coats Platon plc* [1989] BCLC 233; *Re A Company (No. 004415)* [1997] BCLC 479 Ch D 491; *Crindle Investments et al v Wymes et al* [1998] 2 ILRM 275.

<sup>15</sup> *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC, 22; *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported), 77; *Re Frederick Inns Ltd.* [1994] 1 ILRM 387, 396

<sup>16</sup> Deirdre Ahern, 'Directors' Duties: Broadening the Focus Beyond Current Context to Examine the Accountability Spectrum' (2011) 33 *Dublin University law Journal* 116, 140.

<sup>17</sup> See *La Moselle Clothing Ltd and Rosegem Ltd* [1998] 2 ILRM 345; *Duignan v Carway* [2002] IEHC 1; *Re Colm O'Neil Engineering Services Ltd* [2004] IEHC 83.

<sup>18</sup> Companies Act 2014 s 228(1)(b).

and has been subject to numerous examinations by the courts.<sup>19</sup> It is likely that when assessing the fiduciary duty to act honestly and responsibly the courts will rely on the interpretation given to the duty in the restriction context and there is some evidence to suggest that acting contrary to stakeholder interests is a breach of the duty to act honestly and responsibly.<sup>20</sup> The inclusion of the duty to act honestly and responsibly is further indication that the law on directors' duties is moving towards a more stakeholder and public interest focused approach. The changing context of Irish law in relation to directors' duties makes it more likely that the courts will alter their current shareholder value focused interpretation of the duty to act in the interests of the company. There is also case law from other jurisdictions which provide persuasive authority to follow an entity focused approach. Scottish and English case law has advocated an entity based approach prior to the implementation of Enlightened Shareholder Value (ESV).<sup>21</sup> There are also a number of cases from Canada, a jurisdiction which has very similar legislation to Ireland on this topic, which have strongly advocated an entity focused approach to directors' duties.<sup>22</sup> Therefore there is precedent supporting a reinterpretation of what it means to act in the interests of the company.

This chapter will first outline the Irish common law approach to the issue of the corporate objective. Secondly it will discuss the reform processes which led to the enactment of the Companies Act 2014 and the rationale used for not following ESV from the UK Companies Act 2006. Thirdly it will argue for a reinterpretation from the Irish courts of what it means to act in the interests of the company. Finally the chapter will discuss the possible impact of the duty to act honestly and responsibly and the reasons why the entity focused approach is superior to other models of the corporate objective.

## 5.02 The Irish Common Law Approach

The Irish common law judgments on the corporate objective have focused on the directors' fiduciary duty to act in the best interests of the company. The foundations of the duty come from the English case of *Hutton v West Cork Railway*<sup>23</sup> and the duty has been applied by the Irish courts on numerous occasions.<sup>24</sup> When examining what it actually means to act in the interests of the company, the Irish courts have equated the company's interests with the shareholders' interests. This interpretation stems

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<sup>19</sup> See for example *Re Outdoor Advertising Services Ltd* (28 January 1997, unreported) HC; *La Moselle Clothing Ltd and Rosegem Ltd* [1998] 2 ILRM 345; *Kavanagh v Delaney* [2004] IEHC 283; *In Re Squash (Ireland) Ltd* [2001] 3 IR 35; *Duignan v Carway* [2002] IEHC 1; *Re Usit World* [2005] IEHC 285; *Re Tralee Beef and Lamb Ltd* [2008] 3 IR 347; *Mitek Ltd: Grace V Kachkar* [2010] 3 IR 374.

<sup>20</sup> *Re Outdoor Advertising Services Ltd* (28 January 1997, unreported) HC, 11; *Duignan v Carway* [2002] IEHC 1; *Re Usit World* [2005] IEHC 285, 84.

<sup>21</sup> *Dawson International Plc v Coats Platon plc* [1989] BCLC 233; *Re BSB Holdings Ltd* [1996] 1 BCLC 155.

<sup>22</sup> *Peoples Department Stores Inc. (Trustee of) v Wise* [2004] 3 SCR 461; *BCE Inc v 1976 Debentureholders* [2008] SCR 560.

<sup>23</sup> *Hutton v West Cork Railway* (1883) 23 Ch D 654.

<sup>24</sup> See for example *Re North City Milling Co Ltd* [1909] 1 IR 179; *Nash v Lancegaye Safety Glass (Ireland) Ltd* (1958) 92 ILTR 11; *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC; *Re PMPA Garage (Longmile) Ltd* [1992] 1 IR 315; *Banfi Ltd v Moran* [2006] IEHC 257; *Bloxham (in Liquidation) v The Irish Stock Exchange Ltd* [2014] IEHC 93.



from *G&S Doherty v Doherty*<sup>25</sup> which dealt directly with the duty for directors to exercise their power in the interests of the company. Henchy J in the High Court stated that ‘directors are in a fiduciary position, and must exercise their power *bona fide* for the benefit of the company as a whole, that is to say, the shareholders as a whole: See *Greenhalgh v Ardene Cinemas Ltd*’.<sup>26</sup> Henchy J cited *Greenhalgh v Ardene Cinemas Ltd*<sup>27</sup> as persuasive authority despite the case dealing with shareholders’ power to alter the articles and not the fiduciary duties of directors. This interpretation of the duty was echoed in *Irish Press v Ingersoll*<sup>28</sup> where Barron J stated that ‘acting in the interests of the company is no more than acting in the interests of all its shareholders’.<sup>29</sup> In *Re Frederick Inns Ltd*<sup>30</sup> the Supreme Court also seemed to follow this interpretation of the duty. Blaney J quoted with approval from the Australian case of *Kinsela v Russell Kinsela Pty Ltd*<sup>31</sup> which stated ‘[i]n a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise’. Although *Re Frederick Inns Ltd* dealt with the duties of directors to creditors on insolvency, endorsing the statement would seem to advocate a shareholder value view of the duty to act in the interests of the company. More recently the High Court in the case of *Bloxham (in Liquidation) v The Irish Stock Exchange Ltd*<sup>32</sup> cited with approval the decision of *G&S Doherty v Doherty* as evidence of the duty to act in the interests of the company. The *Bloxham* case is evidence that *G&S Doherty v Doherty* is still a persuasive authority in Ireland on the subject of directors’ duties however the case itself did not deal with how the duty was to be interpreted. The above cases would suggest that Irish law follows a shareholder value approach, as Ahern states, the interests of the company being equated with the collective interests of the shareholders results in the application of shareholder primacy.<sup>33</sup>

### 5.03 The Reform of Irish Law

The Companies Act 2014 has generally consolidated and modernised the law bringing together 33 previous enactments into a single piece of legislation. The Act came into force on 1 June 2015<sup>34</sup> and has reformed a number of areas of company law including introducing an encoded set of directors’ fiduciary duties for the first time in Irish law.<sup>35</sup> Section 228(1)(a) states that ‘A director of a company shall act in good faith in what the director considers to be the interests of the company’. While the legislative duty is new, section 227(5) provides that the legislative fiduciary duties will be interpreted

<sup>25</sup> *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC.

<sup>26</sup> *Ibid*, 22.

<sup>27</sup> *Greenhalgh v Ardene Cinemas Ltd* [1950] 2 All ER 1120.

<sup>28</sup> *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported) HC.

<sup>29</sup> *Ibid*, 77.

<sup>30</sup> *Re Frederick Inns Ltd*. [1994] 1 ILRM 387, 396.

<sup>31</sup> *Kinsela v. Russell Kinsela Pty. Ltd. (in liquidation)* [1986] 4 NSWLR 722.

<sup>32</sup> *Bloxham (in Liquidation) v The Irish Stock Exchange Ltd* [2014] IEHC 93.

<sup>33</sup> Deirdre Ahern, *Directors’ Duties: Law and Practice* (Roundhall 2009), 152.

<sup>34</sup> Companies Act 2014 (Commencement) Order 2015 (SI 169 of 2015).

<sup>35</sup> Companies Act 2014 s 228.

and applied in the same way as the common law rules. As a result, the common law interpretation of the duty to act in the interests of the company is likely to be carried forward under the new Companies Act thus ensuring the continuing application of the cases which advocate the shareholder value principle. Given the difficulties with a shareholder value approach, there does seem to be reluctance from jurisdictions to expressly endorse a shareholder value. Instead, broadly speaking, there are three legal frameworks which are introduced to deal with the corporate objective.

Firstly, a model can be introduced where shareholders interests are expressly prioritised but there is a legislative requirement placed on directors to consider stakeholder interests. This approach is in operation in the UK through ESV and in the US, where the vast majority of states have constituency statutes which, generally speaking, give authority to directors to consider stakeholder interests.<sup>36</sup> The primary issue with this approach is finding a way to effectively enforce the requirement to consider the stakeholder interests. A direct legal duty to stakeholders cannot be introduced as it opens directors up to a potentially never ending list of actions,<sup>37</sup> which would not be beneficial to company. To provide stakeholders with a legally enforceable right would require a fundamental change in company affairs<sup>38</sup> and is very unlikely to happen in common law jurisdictions in the short to medium term.<sup>39</sup> Therefore actual enforcement of the stakeholder element is very difficult, as can be seen in the discussion of enforcement under ESV in chapter six. Similar difficulties have been found in the US with the general view being that the statutes are ‘toothless’.<sup>40</sup> This problem with enforcement is aggravated in the UK and US due to the clear prioritisation of shareholder interests. Similar to ESV, any consideration of the stakeholder interests under the constituency statutes ‘must be rationally related to the interests of stockholders’.<sup>41</sup> In addition the courts have not interpreted the statutes in a way to supplant shareholder primacy.<sup>42</sup> What this type of model requires is considering stakeholders to the extent that they contribute to shareholder wealth which is completely consistent with shareholder value.<sup>43</sup> The difficulties with enforcement with such a statutory obligation mean that

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<sup>36</sup> See Eric Orts, ‘Beyond Shareholders: Interpreting Corporate Constituency Statutes’ (1993) 61 *George Washington Law Review* 14; James Hanks, ‘Playing With Fire: Nonshareholder Constituency Statutes in the 1990s’ (1991) 21 *Stetson law Review* 97; Kathleen Hale, ‘Corporate Law and Stakeholders; Moving Beyond Stakeholder Statutes’ (2003) 45 *Arizona Law Review* 823; Anthony Bisconti, ‘The Double Bottom Line: Can Constituency Statutes Protect Socially Responsible Corporations Stuck in Revlon Land?’ (2009) 42 *Loyola Los Angeles Law Review* 765.

<sup>37</sup> Nicholas Grier, ‘Enlightened Shareholder Value: Did Directors Deliver’ (2014) 2 *Juridical Review* 95, 99.

<sup>38</sup> Larry Mitchell, ‘The Fairness Rights of Bondholders’ (1990) 65 *New York University Law Review* 1165, 1225.

<sup>39</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 239.

<sup>40</sup> Thomas Bamonte, ‘The Meaning of the Corporate Constituency Provision of the Illinois Business Corporation Act’ (1996) 27 *Loyola University Chicago Law Review* 1, 22.

<sup>41</sup> James Hanks, ‘Playing with Fire: Nonshareholder Constituency Statutes in the 1990s’ (1991) 21 *Stetson law Review* 97, 102.

<sup>42</sup> Anthony Bisconti, ‘The Double Bottom Line: Can Constituency Statutes Protect Socially Responsible Corporations Stuck in Revlon Land?’ (2009) 42 *Loyola Los Angeles Law Review* 765, 784.

<sup>43</sup> Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge 2012), 193.

shareholder value is the outcome of such a model and the reference to stakeholders represents mere lip service to wider interests. The main benefit of this approach is that it provides express legitimacy to the practice of directors considering stakeholder interests.<sup>44</sup> However this can also be achieved through judicial statements in case law.

During the Irish reform process the Company Law Review Group (CLRG) did consider implementing ESV. The Irish codification of directors' fiduciary duties is generally similar to the one imposed by the UK Companies Act 2006 with both encoding common law duties into statutory form.<sup>45</sup> However the CLRG were strongly opposed to introducing ESV stating it was 'not convinced' by the UK Companies Act 2006 statement of directors' duties and believed it to be 'susceptible to fossilisation'.<sup>46</sup> The CLRG believed that the UK reform sought to impose 'additional duties' while the Irish reform was aiming for a 'consolidation of duties that have been well established in the Irish courts'.<sup>47</sup> The CLRG stated that it preferred a more general statement of directors' duties which would give the judiciary 'interpretational latitude'.<sup>48</sup>

However despite the reluctance of the CLRG to implement ESV, a statutory obligation to consider one particular stakeholder interest does exist in Irish law. Employee interests are to be had regard to by directors under section 224(1) of the Companies Act 2014 which states,

The matters to which the directors of a company are to have regard in the performance of their functions shall include the interests of the company's employees in general, as well as the interests of its members.<sup>49</sup>

Section 224(1) re-enacts section 52(1) of the Companies Act 1990 and is identical to section 309 of the UK Companies Act 1985 discussed in chapter four.<sup>50</sup> What is notable is that priority is not given to either interest group as employees interests are to be had regard to as well as the interests of shareholders. Despite the equal ranking of the two interest groups, section 52(1) was generally seen to be of little practical benefit when it came to ensuring directors considered employee interests<sup>51</sup> and section 52(1) was often dealt with by companies in a cursory fashion.<sup>52</sup> This was most likely the case because the duty was not directly enforceable by employees<sup>53</sup> and there was no other available method of enforcement. The only positive effect from an employee point of view is that it legitimises

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<sup>44</sup> Andrew Keay, 'Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's Enlightened Shareholder Value Approach' (2007) 29 *Sydney Law Review* 577, 600.

<sup>45</sup> See UK Companies Act 2006 s 170-177.

<sup>46</sup> Company Law Review Group, First Report, (Department of Jobs, Enterprise and Innovation, Dublin, December 2011) available at <http://www.clrg.org/1streport/first.asp> para 11.3.6.

<sup>47</sup> Ibid.

<sup>48</sup> Ibid.

<sup>49</sup> Companies Act 2014 s 224(1).

<sup>50</sup> See text to chapter 4 at 4.07.

<sup>51</sup> Thomas Courtney, *The Law of Companies* (3rd edn, Bloomsbury 2012), 874.

<sup>52</sup> Deirdre Ahern, *Directors' Duties: Law and Practice* (Roundhall 2009), 178.

<sup>53</sup> Companies Act 2014 s 224(2); The Companies Act 1990 s 52(2).

directors considering employee interests and protects directors from being subject to a derivative action for considering employee interests. However, as is the trend with this kind of duty, there is nothing to ensure directors do have regard to employee interests. Even if directors completely disregard regard employee interests they are unlikely to face any penalty. The net effect of section 224(1), like section 52(1), is that it will prove to be little benefit to employees and identical criticisms can be made in relation to ESV. Applying ESV in Ireland would have meant simply paying lip service to a longer list of stakeholder interests instead of just employees. It would have also meant giving legislative priority to shareholders, something which is not done in either section 224 or 228 of the Companies Act 2014. Given the issues with the stakeholder element of ESV and the prioritisation of shareholders it amounts to a clear application of shareholder value. Given the issues attached with shareholder value the CLRG were correct not to adapt ESV in Ireland and there is an argument to be made that including section 224(1) was futile as it is unlikely to confer any benefit on employees.

The second model which can be introduced is the imposition of a two-tiered management structure which gives stakeholders a direct say in the management of the company. As discussed in chapter three, a two-tiered board model was intended to be implemented across all EU Member States through the draft Fifth Directive.<sup>54</sup> However the attempt was unsuccessful, primarily due to resistance from the UK<sup>55</sup> and the difficulties associated in applying the German model in common law jurisdictions.<sup>56</sup> The CLRG did briefly consider implementing a two-tiered board model similar to the draft Fifth Company Law Directive. The group ultimately declined such a reform as it believed there to be little desire in Ireland to change the makeup of board structure.<sup>57</sup>

The third alternative is to adopt a general duty to act in the interests of the company. While this can lead to the application of shareholder value, the courts can instead take the view that the company's interests are not to be equated with the interests of shareholders and apply an entity focused view of the duty. The entity focused approach to this general duty has been taken in Canada,<sup>58</sup> where the duty to act in interests of the company is seen as a duty to act for the benefit of the separate entity. This allows directors the scope to act in favour of stakeholder interests to the extent that it benefits the company, even if such action does not benefit the shareholders. It is submitted that it is this model that is the optimal method to ensure maximum benefits for all constituents and also a model which is

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<sup>54</sup> Concerning the structure of the Public Limited Companies and the Powers and Obligations of their Organs 15 OJ EUR. COMM. (No. C131) 49 (1972).

<sup>55</sup> Jean Du Plessis and Janet Dine, 'The Fate of the Draft Fifth Directive on Company Law: Accommodation instead of Harmonisation' (1997) *Journal of Business Law* 23, 35; Otto Sandrock and Jean du Plessis, 'The German Corporate Governance Model in the Wake of Company Law Harmonisation in the European Union' (2005) 26(3) *Company Lawyer* 88, 91.

<sup>56</sup> See Detlev Vagts, 'Reforming the "Modern Corporation": Perspectives from the German' (1966) 80 *Harvard Law Review* 76, 78.

<sup>57</sup> Company Law Review Group, First Report, (Department of Jobs, Enterprise and Innovation, Dublin, December 2011) available at <http://www.clrg.org/1streport/first.asp> para 11.8.13.

<sup>58</sup> *Peoples Department Stores Inc. (Trustee of) v Wise* [2004] 3 SCR 461. *BCE Inc v 1976 Debentureholders* [2008] SCR 560.

possible to apply in Ireland. The UK reform group, The Company Law Review Steering Group (CLRSG), were unwilling to provide a simple duty to act in the interests of the company, believing that it would give directors a discretionary power to set any interest above that of shareholders whenever their view of ‘company success’ required it.<sup>59</sup> As a result of this reluctance to allow any interest be prioritised ahead of the shareholders, the UK have implemented an excessively shareholder focused model. Commendably, the Irish reform group were willing to recommend a broad duty to act in the interests of the company. The issue in the Irish context is that, the courts have given a flawed interpretation of what it means to act in the interests of the company. Not only is equating the interests of the company with the shareholders’ interests legally flawed but it is also an inferior approach in relation to the goal of achieving maximum benefits for all company constituents. In order to achieve an entity focused view of the corporate objective it is necessary for the Irish courts to reinterpret what it means to act in the interests of the company.

#### **5.04 The Correct Interpretation of the ‘Best Interests of the Company’**

While the Companies Act 2014 maintains the common law duty to act in the interests of the company, the shareholder value interpretation does not have to be the judicial approach taken. As was discussed in greater detail in chapter two, interpreting the duty to act in the interests of the company as simply meaning the shareholders is contrary to two very well established legal doctrines. Firstly, it is one of the fundamental principles of company law that the company is a separate legal entity, distinct from its shareholders.<sup>60</sup> The case which laid down this principle of separate legal personality was *Salomon v A Salomon & Co Ltd* where Lord MacNaughton said that the corporation at law is a different person entirely from the subscribers to the memorandum of the company.<sup>61</sup> Since the judgment in *Saloman* there has been widespread common law support of this separation between the company and its shareholders.<sup>62</sup> The Irish courts have also consistently applied the principle laid down in *Salomon*<sup>63</sup> with McGovern J in *Redfern v O’ Mahony* providing a conclusive statement on the issue.

The legal consequences of incorporating a limited liability company are that the company assumes a separate legal identity as distinct from its owners. This is not a fiction. The rule in

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<sup>59</sup> CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, 1999) para 3.52.

<sup>60</sup> See Arthur Machen, ‘Corporate Personality’ (1911) 24 *Harvard Law Review* 253; Paddy Ireland, Ian Grigg-Spall and Dave Kelly, ‘The Conceptual Foundations of Modern Company Law’ (1987) 14(1) *Journal of Law & Society* 149, 150. Gregory Mark, ‘The Personification of the Business Corporation in American Law’ (1987) 54 *University of Chicago Law Review* 1441, 1468.

<sup>61</sup> *Salomon v A Salomon & Co Ltd* [1897] AC 22, 51. .

<sup>62</sup> See for example *A L Underwood Ltd v Bank of Liverpool* [1924] 1 KB 775; *Macura v Northern Insurance Co Ltd* [1925] AC 619; *Roberts v Coventry Corporation* [1947] 1 All ER 308; *Wallersteiner v Moir (No 2)* [1975] QB 373; *Credit Suisse v Allerdale Borough Council* [1997] QB 309; *Johnson v Gore Wood & Co (A Firm)* [2002] 2 AC 1.

<sup>63</sup> For example see *Re Frederick Inns Ltd* [1991] ILRM 582; *Attorney General v Jameson* [1904] 2 IR 644. *Allied Irish Coal Supplies Ltd. v Powell Duffryn International Fuels Ltd* [1998] 2 IR 519.

*Salomon v Salomon & Co Ltd* [1897] AC 22 is still the law in this jurisdiction. The company and its shareholders are separate legal entities.<sup>64</sup>

Secondly directors owe their fiduciary duties to the company itself and not to any individual shareholder or group of shareholders.<sup>65</sup> The doctrine was first applied in Ireland in *Smith v Cork and Bandon Railway Co*<sup>66</sup> in 1870 when Christian LJ said that idea that directors were trustees for the shareholders was ‘a proposition which presents itself to my mind with all the effect of novelty’. It has since continued to be applied, for example in *Crindle Investment v Wymes*<sup>67</sup> it was stated that, ‘[t]here can be no doubt that, in general, although the directors of a company occupy a fiduciary position in relation to the company, they do not owe a fiduciary duty, merely by a virtue of their offices, to the individual members’.<sup>68</sup> More recently Chareltion J in *Bloxham (in Liquidation) v The Irish Stock Exchange Ltd*,<sup>69</sup> in quoting with approval Ussher’s *Company law in Ireland*, stated that it is ‘well established that the director owes the duties arising out of his office to the company itself, the separate person, and to no one else’.<sup>70</sup>

MacCann states that the refusal for the Irish courts to find a direct duty to shareholders is ‘based on the fact that the company is a separate legal person’.<sup>71</sup> He also believes that the correct legal approach is to view the company as an entity stating that directors must consider the shareholders’ interests and the creditors in determining what is in the interests of the company but that ‘the company as a whole means the company as a separate legal entity’.<sup>72</sup> Yet when it comes to a directors’ duty to act in the interests of the company, the Irish courts hold that the company’s interests are the same as the shareholders’. Given that the company is a separate legal entity, the fact that directors owe their duties to the company there is no legal basis to automatically equate the interests of the company with the interests of the shareholders. As Attenborough argues, this interpretation of what it means to act in the best interests of the company is wide of the mark.<sup>73</sup> There is also support to be found in Scottish and English case law for taking the entity focused approach. Several cases advocate directors taking

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<sup>64</sup> *Redfern v O’ Mahony and McFeely, Carroll, Tafica Ltd and Aifca Ltd* [2010] IEHC 253, para 87.

<sup>65</sup> *Smith v Cork and Bandon Railway Co* (1870) 5 IR EQ 63; *Percivil v Wright* [1902] 2 Ch 421. *Dawson International plc v Coats Platon plc* [1989] BCLC 233; *Re A Company (No. 004415)* [1997] BCLC 479 Ch D, 491.

<sup>66</sup> *Smith v Cork and Bandon Railway Co* [1870] 5 IR 63.

<sup>67</sup> *Crindle Investments et al v Wymes et al* [1998] 2 ILRM 275.

<sup>68</sup> *Ibid*, 288.

<sup>69</sup> *Bloxham (in Liquidation) v The Irish Stock Exchange Ltd* [2014] IEHC 93.

<sup>70</sup> *Ibid*, 3 quoting Patrick Ussher, *Company Law in Ireland* (Sweet & Maxwell, 1986), 203.

<sup>71</sup> MacCann L, ‘Directors’ Duties: To Whom are they Owed? Part 1’ (1991) 9 *Irish Law Times* 3, 4.

<sup>72</sup> Lydonn MacCann, ‘Directors’ Fiduciary Duties’ (1991) 9 *Irish Law Times* 104, 107.

<sup>73</sup> Daniel Attenborough, ‘How Directors Should Act When Owning Duties to the Companies’ Shareholders: Why We Need to Stop Applying Greenhalgh’ (2009) 20(10) *International Company and Commercial Law Review* 339, 339.

stakeholder interests into account<sup>74</sup> and others view the company as a completely separate legal entity which has priority over shareholders' interests.<sup>75</sup>

The point is that there is persuasive precedent for a different interpretation that the one currently taken by the Irish courts. In the UK context, the debate regarding the two different interpretations of the best interests of the company has been made redundant through ESV as section 172(1) of the UK Companies Act 2006 requires directors to 'promote the success of the company for the benefit of its members'. In an Irish context however, the Companies Act 2014 maintains the duty to act in the interests of the company and the debate around the interpretation of this phrase is still relevant. What the above discussion highlights is that there are alternatives to taking a shareholder value approach and that there is a strong legal basis for avoiding such an approach. The doctrine of separate legal personality, the nature of directors' fiduciary duties and several cases from Scotland and England all support the view that the company is a distinct entity, separate from its shareholders.

### 5.05 The Proposed Solution

To implement a more legally accurate framework and to take a superior approach to the corporate objective in Ireland, a reinterpretation of what it means to act in the interests of the company is required. The duty to act in the interests of the company should be interpreted to mean the interests of the company as a separate legal entity. In this regard inspiration can be drawn from Canadian law. The Canada Business Corporations Act 1985 states that directors have duty to act 'in good faith with a view to the best interests of the corporation'.<sup>76</sup> The provision is almost identical to the duty contained in section 228(1)(a) of the Companies Act 2014. Traditionally, like Ireland, Canada seemed to favour a shareholder value approach to corporate governance.<sup>77</sup> Although the case of *Teck Corp v Millar*<sup>78</sup> would suggest that Canada has not always supported strict adherence to shareholder value. In this case Berger J stated

If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting *bona fide* in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to that

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<sup>74</sup> *Lonhro v Shell Petroleum* [1980] 1 WLR 637; *Fulham Football Club v Cabra Estates* [1994] 1 BCLC 363; *Re Welfab Engineers* [1990] BCLC 833.

<sup>75</sup> *Dawson International Plc v Coats Platon plc* [1989] BCLC 233; *Re BSB Holdings Ltd* [1996] 1 BCLC 155.

<sup>76</sup> The Canada Business Corporations Act 1985 s 122(1).

<sup>77</sup> See *Palmer v Carling O' Keeffe Breweries of Canada Ltd* (1989) 67 OR 161; *Hercules Management Ltd v Ernst & Young* [1997] 2 SCR 165; *Maple Leaf Foods Inc v Schneider Corp* (1998) 42 OR 177.

<sup>78</sup> *Teck Corporation v Miller* [1972] 33 DLR 288, 314.

policy as a result, it could not be said that they had not considered *bona fide* the interests of the shareholders.<sup>79</sup>

While the decision in *Teck Corp v Millar* allowed for the consideration of stakeholder interests, more recent judgments have advocated viewing the company as a separate legal entity. The Canadian duty to act in the interests of the company came under examination in *Peoples Department Stores Inc. (Trustee of) v Wise*<sup>80</sup> with the Supreme Court holding that the duty to act in the best interests of the company is not to be simply equated with acting in interests of the shareholders.

Insofar as the statutory fiduciary duty is concerned, it is clear that the phrase the ‘best interests of the corporation’ should be read not as simply the ‘best interests of the shareholders’. From an economic perspective, the ‘best interests of the corporation’ means the maximisation of the value of the corporation. However, the courts have long recognized that various other factors may be relevant in determining what directors should consider in soundly managing with a view to the best interests of the corporation.<sup>81</sup>

The only interpretation of this passage is that the court is prioritising the interests of the entity. The court first states that the best interests of the corporation are not to be equated with the interests of the shareholders. Secondly the court held that from an economic perspective the interests of the corporation means maximising the ‘the value of the corporation’. The focus on increasing the value of the corporation and not on shareholder value is very similar to the normative models based on entity maximisation model and sustainability as advocated by Keay<sup>82</sup> and Attenborough.<sup>83</sup> The *Peoples Department Stores* case went on to acknowledge that doing what is best for the company, even from an economic perspective, includes considering stakeholder interests.

We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider *inter alia*, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.<sup>84</sup>

This acknowledges that for company to be successful stakeholders must be taken into account. This statement appears to be identical to ESV, which has been criticised in this thesis for being essentially shareholder value under a different name, but there is one important difference. Under ESV the

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<sup>79</sup> Ibid, 314.

<sup>80</sup> *Peoples Department Stores Inc. (Trustee of) v Wise* [2004] 3 SCR 461.

<sup>81</sup> Ibid, 481.

<sup>82</sup> Andrew Keay, ‘Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model’ (2008) 71(5) *The Modern Law Review* 663; Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 173-230.

<sup>83</sup> Daniel Attenborough ‘Giving Effect to the Corporate Purpose Debate: An Equitable Maximisation and Viability Principle’ (2012) 32(1) *Legal Studies* 4.

<sup>84</sup> *Peoples Department Stores Inc. (Trustee of) v Wise* [2004] 3 SCR 461, 482.



success of the company is framed exclusively in terms of the shareholders. As a result any consideration of stakeholder interests are only in the context of yielding benefit to shareholders and in the event of a clash of interests between stakeholders and shareholders the shareholders' interests always take priority. The difference under the entity based approach is that stakeholder interests are considered to the extent in which they benefit the company as an entity. Conflicts between shareholder interests and stakeholder interests are resolved by determining acting in favour of which group would be most likely to benefit the company as an entity. This allows directors to sacrifice shareholder value if the good of the company requires it. Similarly it allows directors to sacrifice shareholder value if a particular decision was damaging to a stakeholder interest, and the damage to that stakeholder would negatively impact the company as an entity. It is submitted that director acting in the interests of the entity is more likely to foster company success in the long term and most likely to confer the greatest benefit for all company constituents and the first passage quoted from *Peoples Department Stores* does seem to advocate this approach.

The decision in *BCE Inc v 1976 Debentureholders*<sup>85</sup> continued the focus on the company as an entity. The court first recognised 'that a corporation is an entity that encompasses and affects various individuals and groups, some of whose interests may conflict with others'.<sup>86</sup> The court did not view the company's interests as the same as the shareholders' and stated that the directors should take into account stakeholder interests when determining what is in the best interests of the corporation<sup>87</sup> and directors may even be obliged to do so.<sup>88</sup> However the most notable statement is when the Supreme Court added 'There is no principle that one set of interests – for example the interests of the shareholders – should prevail over another set of interests. Everything depends on the particular situation faced by the directors'.<sup>89</sup> This statement supports viewing the company as an entity and that, in particular circumstances, shareholder value is not what is best for the corporation. The interest group which should receive preference is the one which most benefits the entity given the particular set of facts. The Canadian case law recognises this fact and is in direct contrast to the approach in the UK where shareholders enjoy complete priority in all scenarios.

However, the judgments of the Canadian Supreme Court in *BCE Inc* and *Peoples Department Stores* have been criticised for applying stakeholder theory.<sup>90</sup> This view can be backed up from the statements in from the statements in *BCE Inc* that directors should not treat stakeholders unfairly<sup>91</sup> and that directors should act in the interests of the company as a good corporate citizen.<sup>92</sup> Similarly

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<sup>85</sup> *BCE Inc v 1976 Debentureholders* [2008] SCR 560.

<sup>86</sup> *Ibid*, [64].

<sup>87</sup> *Ibid*, [40].

<sup>88</sup> *Ibid*, [66].

<sup>89</sup> *Ibid*, [84].

<sup>90</sup> James Tory, 'A Comment on *BCE Inc*' (2010) 48 *Canadian Business Law Review* 285, 286.

<sup>91</sup> *BCE Inc v 1976 Debentureholders* [2008] SCR 560, [64].

<sup>92</sup> *Ibid*, [66].

the above statements that no one interest group should be prioritised over any other provide very little guidance for directors and could be interpreted to advocate stakeholder theory as well as advocating an entity approach. Requiring directors to focus on the entity's success removes the problems of balancing competing interests<sup>93</sup> which is the primary difficulty with stakeholder theory.<sup>94</sup> However the Canadian Supreme Court did not expressly advocate taking such an approach. As a result, the decisions have also been criticised for viewing the company as a collection of stakeholders rather than a distinct legal entity.<sup>95</sup> Keay states there is no suggestion from the Canadian courts that directors are to focus on the success of the entity and argues that the courts seem to look past the entity and view the company as being made up of a group of stakeholders.<sup>96</sup> It is asserted that despite the courts not expressly stating they were in favour of the entity based approach, their statements fit much better with an entity focused approach as opposed to stakeholder theory. The court in *BCE Inc* emphasised that directors' duties were owed to the corporation and not directly to any stakeholder<sup>97</sup> and in *Peoples Department Stores* it was stated that 'at all times directors and officers owe their fiduciary duties to the corporation. The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholder'.<sup>98</sup> This demonstrates that the company's interests are to prevail over the interests of individual stakeholders. The statements from *Peoples Department Stores* that the best interests of the corporation means the 'maximisation of the value of the corporation' and the emphasis on considering stakeholders to the extent it benefits the company represents what can only be interpreted as an entity focused approach. Stakeholder theory demands that benefits to stakeholders is the objective of directors however the Canadian courts are instead focused on maximising the value of the company and considering stakeholder interests to the extent which it benefits the company. Success of the company is the ultimate goal rather than providing benefits to stakeholders. While *BCE Inc* could be interpreted as representing a model closer to stakeholder theory as well as an entity based approach, when interpreted in light of *Peoples Department Stores*, it can be said that Canada does follow an entity focused view of the corporate objective.

It is submitted that there is sufficient scope afforded to the Irish courts under the Companies Act 2014 to follow the above Canadian Supreme Court decisions and apply an entity focused approach. When assessing the UK's reform of directors' fiduciary duties, the CLRG stated that it preferred 'a more

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<sup>93</sup> Daniel Attenborough 'Giving Effect to the Corporate Purpose Debate: An Equitable Maximisation and Viability Principle' (2012) 32(1) *Legal Studies* 4, 16.

<sup>94</sup> See Elaine Sternberg, 'The Defects of Stakeholder Theory' (1997) 5(1) *Corporate Governance* 3, 4; Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' 14 *Journal of Applied Corporate Finance* 8, 10.

<sup>95</sup> Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge 2012), 271.

<sup>96</sup> *Ibid.*

<sup>97</sup> *BCE Inc v 1976 Debentureholders* [2008] SCR 560, [66].

<sup>98</sup> *Peoples Department Stores Inc. (Trustee of) v Wise* [2004] 3 SCR 461, 482.

general statement which gives the judiciary interpretational latitude’.<sup>99</sup> Unlike the UK legislation, which defines company success in terms of the shareholders, the Irish courts have been given significant ‘interpretational latitude’ and so can follow example set by the Canadian Supreme Court and the strand of English and Scottish case law which views the company as an entity distinct from its shareholders.

### 5.06 The Duty to Act Honestly and Responsibly

Section 228 of the Companies Act 2014, as well as containing the duty to act in the best interests of the company, also contains a duty to ‘act honestly and responsibly in relation to the conduct of the affairs of the company’.<sup>100</sup> This is a new fiduciary duty for directors but a duty which has a very well defined meaning in the context of restriction orders. Under section 819 of the Companies Act 2014 the liquidators of insolvent companies are required to make a restriction application against the directors of that company.<sup>101</sup> The effect of restriction is that a restricted person cannot be appointed as a director for a five year period unless the company meets certain capitalisation requirements.<sup>102</sup> The rationale behind the restriction regime is to protect the public from directors whose past records as directors of insolvent companies have shown them to be a danger to other interest groups, particularly creditors.<sup>103</sup> In *La Moselle Clothing Ltd*<sup>104</sup> Shanley J stated the purpose of restriction orders were for ‘the protection of the public from persons who, by their conduct have shown themselves unfit to hold the office of, and discharge the duties of, a director of a company’.<sup>105</sup> In order to avoid restriction the director must prove that they have ‘acted honestly and responsibly in relation to the conduct of the affairs of the company in question, whether before or after it became an insolvent company’.<sup>106</sup> The aim of the defence is to protect directors from being restricted when they were not culpable for the insolvent liquidation.<sup>107</sup> Under section 228(1)(b) of the Companies Act 2014 all directors are now under a positive duty to act honestly and responsibly rather than the duty being just a defence to avoid restriction. What it means to act honestly and responsibly has been the subject of numerous examinations by the courts in the context of directors avoiding restriction and what it will mean to comply with the duty is likely to draw heavily from the restriction case law.

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<sup>99</sup> Company Law Review Group, First Report, (Department of Jobs, Enterprise and Innovation, Dublin, December 2011) available at <http://www.clrg.org/1streport/first.asp> p239 paragraph 11.3.6.

<sup>100</sup> Companies Act 2014 s 228(1)(b).

<sup>101</sup> Companies Act 2014 s 819; Company Law Enforcement Act 2001 s 56.

<sup>102</sup> Companies Act 2014 s 819(3) states that for a company to have a restricted director on its board the company shall have an allotted share capital of nominal value not less than €500,000 for public companies and €100,000 for private companies.

<sup>103</sup> Deirdre Ahern, *Directors’ Duties: Law and Practice* (Roundhall 2009), 483.

<sup>104</sup> *La Moselle Clothing Ltd and Rosegem Ltd* [1998] 2 ILRM 345.

<sup>105</sup> *Ibid*, 350-351. See also *Re Colm O’Neil Engineering Services Ltd* [2004] IEHC 83; *Duignan v Carway* [2002] IEHC 1.

<sup>106</sup> Companies Act 2014 s 819(2)(b); Company Law Enforcement Act 1990 s 150(2).

<sup>107</sup> Thomas Courtney, *The Law of Companies*, (3rd edn, Bloomsbury 2012), 1811.

The main test for acting honestly and responsibly comes from *La Moselle Clothing Ltd*<sup>108</sup> which set out a number of elements which the court should have regard in whether or not directors should be able to avail themselves of the defence and included:

- A. The extent to which the director has or has not complied with any obligation imposed on him by the Companies Acts
- B. The extent to which his conduct could be regarded as so incompetent as to amount to irresponsibility
- C. The extent of the director's responsibility for the insolvency of the company.

In *Kavanagh v Delaney*<sup>109</sup> part A of this test was further expanded to include all common law based directors' duties, the expansion later being upheld by the Supreme Court.<sup>110</sup> Whether the director acted in the interests of the company is a significant factor in determining whether the director acted honestly and responsibly. McGuinness J stated in *Re Squash (Ireland) Ltd*<sup>111</sup> that the directors had acted honestly and responsibly and so would not be restricted because they 'put the interests of the company in the forefront of their minds, even insofar as losing their own money in an effort to assist the continuation of the company'.<sup>112</sup> However a duty to act in the interests of the company is already included in section 228(1)(a) and it is unlikely that acting honestly and responsibly under section 228(1)(b) simply requires directors to act in the interests of the company. While there is obvious overlap,<sup>113</sup> acting honestly and responsibly is likely to extend a greater responsibility on directors than simply acting in the interests of the company otherwise there would have been no reason to include the new duty in the codification of fiduciary duties.

There is some evidence to suggest that a director will not be deemed to have acted honestly and responsibly if they act to the detriment of certain stakeholders. In *Re Outdoor Advertising Services Ltd*<sup>114</sup> Costello J held that two directors who deliberately sought to benefit themselves personally at the expense of company creditors, had not acted honestly.<sup>115</sup> Directors were also restricted for acting against the interests of employees in *Duignan v Carway*.<sup>116</sup> McCracken J stated that 'to try to justify trading by using what is in effect its employees' money without their knowledge or consent, is to me

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<sup>108</sup> *La Moselle Clothing Ltd and Rosegem Ltd* [1998] 2 ILRM 345.

<sup>109</sup> *Kavanagh v Delaney* [2004] IEHC 283.

<sup>110</sup> *Re Tralee Beef and Lamb Ltd* [2008] 3 IR 347.

<sup>111</sup> *Re Squash (Ireland) Ltd* [2001] 3 IR 35.

<sup>112</sup> *Ibid*, 41.

<sup>113</sup> There is likely to be multiple scenarios where both duties would be breached, for example a director personally profiting from his fiduciary position at the expense of the company.

<sup>114</sup> *Re Outdoor Advertising Services Ltd* (28 January 1997, unreported) HC.

<sup>115</sup> *Ibid*, 11.

<sup>116</sup> *Duignan v Carway* [2002] IEHC 1.

quite bizarre and totally irresponsible.<sup>117</sup> McCracken J also stated that continuing to trade at the expense of the company's creditors amounted to acting irresponsibly. The courts have also found that reckless risk taking which is likely to damage stakeholder or shareholder interests will amount to irresponsible behaviour. In *Re Usit World*<sup>118</sup> Peart J addressed the issue of reckless risk taking which damages stakeholder interests. He stated that directors should engage in calculated risk taking which 'lacks recklessness or carelessness, or wilful disregard of the interests of others, whether creditor or shareholder or employee, which would classify it as irresponsible'.<sup>119</sup> These cases demonstrate that acting honestly and responsibly under Irish law goes beyond simply acting in the interests of the company or acting in the interests of the shareholders and negatively impacting creditors or employees can amount to a failure to act honestly or responsibly. In this regard the exact wording of section 228(1)(b) is particularly interesting. The duty requires directors to act honestly and responsibly 'in relation to the conduct of the affairs of the company'. In Griers's view, the inclusion of the 'affairs of the company' means that the duty to act honestly and responsibly applies to 'all those party to the affairs of the company'.<sup>120</sup> If his interpretation is correct then the duty to act honestly and responsibly applies to a much greater number of interest groups than simply shareholders as potentially all stakeholders are party to the affairs of the company.

Lowry argues that the more modern approach of the courts is to require directors to go beyond the narrow objective of shareholder wealth maximisation.<sup>121</sup> It is possible that this more modern approach is recognised in Ireland through the duty to act honestly and responsibly. Ahern argues that the introduction of restriction into Irish law has occurred within an overall context of viewing compliance with directors' duties as serving a public interest function rather than protecting the interests of shareholders.<sup>122</sup> She states that enforcement of duties owed to the company in Ireland is based on a 'public enforcement, public interest model rather than private enforcement at the behest of a company or its minority shareholders'.<sup>123</sup> The inclusion of a legislative fiduciary duty to act honestly and responsibly could be seen as further evidence of Ahern's view. Undoubtedly the courts' view is that the purpose of restriction regime is to protect the public.<sup>124</sup> The courts have deemed directors' behaviour to be dishonest or irresponsible when directors have acted to the detriment of employees,<sup>125</sup>

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<sup>117</sup> Ibid, 7.

<sup>118</sup> *Re Usit World* [2005] IEHC 285.

<sup>119</sup> Ibid, 84.

<sup>120</sup> Nicholas Grier, 'Enlightened Shareholder Value: Did Directors Deliver' (2014) 2 *Juridicial Review* (2012) 95, 111.

<sup>121</sup> John Lowry, 'The Duty Of Loyalty of Company Directors; Bridging the Accountability Gap Through Efficient Disclosure' (2009) 68 *Cambridge Law Journal* 607, 617.

<sup>122</sup> Deirdre Ahern, 'Directors' Duties: Broadening the Focus Beyond Current Context to Examine the Accountability Spectrum' (2011) 33 *Dublin University law Journal* 116, 140.

<sup>123</sup> Ibid, 141.

<sup>124</sup> See *La Moselle Clothing Ltd and Rosegem Ltd* [1998] 2 ILRM 345; *Duignan v Carway* [2002] IEHC 1; *Re Colm O'Neil Engineering Services Ltd* [2004] IEHC 83.

<sup>125</sup> *Duignan v Carway* [2002] IEHC 1, 17.

creditors<sup>126</sup> or if directors have engaged in reckless risk taking likely to harm stakeholders.<sup>127</sup> Including the duty to act honestly and responsibly as a directors' fiduciary duty does implicitly signal that the legislature wished to protect interests broader than just shareholders. It is possible that the Irish courts could view the inclusion of the duty to act honestly and responsibly as indication that directors' duties purpose encompasses more than simply a duty to protect the interests of the shareholders. If the courts did come to this conclusion the next logical step would be to stop viewing the company's interests as synonymous with the shareholders and to reinterpret the duty to act in the interests of the company as a duty to act for the benefit of the entity.

## 5.07 Conclusion

The argument of this thesis is that the best model to deal with the question of the corporate objective is for directors to seek to maximise the wealth and sustainability of the company as a separate legal entity. It is possible to legally apply this model in Ireland. The Companies Act 2014 has introduced a statutory duty to act in the interests of the company free from any reference to success of the shareholders. However the common law interpretation of this duty is to equate this duty with a duty to act for the shareholders' benefit. This approach is to be carried forward under the new act as the new duties are to be interpreted in light of the common law.<sup>128</sup> However, unlike the corresponding UK reform, there is sufficient scope in the Companies Act 2014 for the Irish Courts to reinterpret this duty as a duty to act in the interests of the company as a separate legal entity. Based on the well-established legal doctrine of separate legal personality and the nature of directors' fiduciary duties, in addition to English<sup>129</sup> and Canadian<sup>130</sup> case law, this chapter has asserted that there is a significant legal basis for the Irish courts to reinterpret this duty. The introduction of the duty to act honestly and responsibly also suggests that there is a general movement away from directors' duties functioning simply to serve the interests of the shareholders. Viewing the company as an entity would not only provide a much truer reflection of the legal nature of a company but also provides a chance to better promote both private and social wealth through company law.

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<sup>126</sup> *Re Outdoor Advertising Services Ltd* (28 January 1997, unreported) HC, 11.

<sup>127</sup> *Re Usit World* [2005] IEHC 285, 84.

<sup>128</sup> Companies Act 2014 s 227(5).

<sup>129</sup> *Lonhro v Shell Petroleum* [1980] 1 WLR 637; *Fulham Football Club v Cabra Estates* [1994] 1 BCLC 363; *Dawson International Plc v Coats Platon plc* [1989] BCLC 233; *Evans v Brunner Mond & Co Ltd* [1921] 1 Ch. 359.

<sup>130</sup> *BCE Inc v 1976 Debentureholders* [2008] SCR 560. *Peoples Department Stores Inc. (Trustee of) v Wise* [2004] 3 SCR 461.

## Chapter 6 Enforcement

### 6.01 Introduction

For any legal model to fulfil its intended function it must be possible to enforce the legal rules and duties operating within that model. In order for duty-based controls to be effective there must be a realistic chance of enforcing those duties.<sup>1</sup> Therefore, if breaches of directors' duties are not subject to an efficient and effective enforcement methods they will prove to be of little use.<sup>2</sup> For the entity approach to offer a viable solution to the issue of the corporate objective it must be possible to enforce the requirements that are placed on directors. Therefore it must be possible to hold directors to account in situations where they fail to act in the best interests of the company as an entity. When it comes to acting in the interests of the company as an entity the main standard of behaviour imposed on directors is the duty to act in good faith, previously known under the common law as the duty to act *bona fide* in the interests of the company. Under the Companies Act 2014 a director must 'act in good faith in what the director considers to be the interests of the company'.<sup>3</sup> It is submitted that the duty to act in good faith can be used as a means to ensure directors do comply with their duty to act in the interests of the company. The basis for this argument is that good faith is primarily assessed on objective grounds, which makes it possible for directors to be found in breach of the duty. Several cases have shown directors to have breached the duty on the basis that their actions were not in line with reasonable standards.<sup>4</sup> Other cases have set out a clear requirement for directors to meet reasonable standards before the courts will hold the duty to have been satisfied.<sup>5</sup>

While the objective standard of good faith allows for directors to be found in breach of the duty, the derivative action, an action from a liquidator or public enforcement mechanisms allows directors to be held to account for their breach. Because the derivative action is designed for correcting wrongs committed against the company, it is the most obvious means for enforcing a breach of duty. However practical difficulties make the derivative action unlikely to provide a regular and effective means of enforcement. In Ireland shareholders taking a derivative claim are still subject to the common law rules and must establish an exception to the rule in *Foss v Harbottle* which is a difficult task.<sup>6</sup> Instead

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<sup>1</sup> John Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Clarendon Press, 1993), 73.

<sup>2</sup> Roman Tomasic, 'The Challenge of Corporate Law Enforcement: Future Directions for Corporations Law in Australia' (2006) 10 *University of Western Sydney Law Review* 1, 2.

<sup>3</sup> Companies Act 2014 s 228(1)(a).

<sup>4</sup> *Item Software Ltd (UK) Ltd v Fassihi* [2004] EWCA Civ 1244; *Re Coroin Ltd* [2012] EWHC 2343 (Ch); *Breitenfeld UK Ltd v Harrison* [2015] EWHC 399 (Ch); *Re Genosysis Technology* [2006] EWHC 989 Ch.

<sup>5</sup> *Wallach v Secretary of State for Trade and Industry* [2006] EWHC 989; *Citico Banking Corp NV v Puszers Ltd* [2007] 2 BCLC 638; *Howard Smith v Ampol Petroleum Limited* [1974] AC 821; *Bloxham (in Liquidation) v The Irish Stock Exchange Ltd* [2014] IEHC 93; *Heron International v Lord Grade* [1983] BCLC 638.

<sup>6</sup> Julia Tang, 'Shareholder Remedies: Demise of the Derivative Claim' (2012) 1(2) *UCL Journal of Law and Jurisprudence* 178, 180. David Kershaw, 'The Rule in *Foss v Harbottle* is Dead: Long Live the Rule in *Foss v Harbottle*' (2015) 3 *Journal of Business Law* 274, 274; Deirdre Ahern 'Directors' Duties: Broadening the Focus

of relying on private enforcement mechanisms to ensure directors comply with their duties to act in the interests of the company it is submitted that public or quasi-public means of enforcement are more likely to be successful, primarily through the Office of the Director for Corporate Enforcement (ODCE) and the restriction of directors. These mechanisms could act as a deterrent for directors breaching their duties and so act as a means to ensure that directors, in practice, act in the interests of the company.

In order for good faith to work as an enforcement mechanism a clarification of the standard necessary to satisfy the duty is required. The issue is that the duty to act in good faith is seen to be judged by a subjective standard<sup>7</sup> which is relatively easy for directors to satisfy. For example Davies believes that disproving a director's assertion that they have acted in good faith is almost impossible except in the most obvious of cases.<sup>8</sup> If this were indeed the case then it would be very difficult to hold directors in breach of the duty. While it is true that good faith is subjective in so far as what is relevant is the directors' state of mind, an examination of the case law indicates that the test in operation for good faith is much more akin to an objective test. A wholly subjective test would allow directors to claim they have acted in good faith and their submission would be almost impossible to disprove and would yield irrational results. Because of the application of a more objective test, a director's assertion that he acted or is acting in good faith is not unassailable. The objectivity relates to the honesty of the directors rather than examining whether his eventual decision actually benefited the company or not and so does not interfere with the well-established business judgment rule. In this regard *Royal Brunei Airlines v Tan*<sup>9</sup> should be seen as an example of how to achieve the requisite clarity for a test of honesty. The case clarified a similar issue of law pertaining to dishonest assistance in the law of trusts and clearly established that the test for honesty is an objective one.

However despite an objective test often being applied by the courts the problem is that the good faith duty is perceived to be a subjective test which is easy to satisfy. This perception can lead to directors believing it is unlikely they will be held to account for a breach of their good faith duty to act in the interests of the company and so will be less likely to comply with the duty. It is submitted that clarifying the duty in a way similar to *Royal Brunei Airlines v Tan* will have a declaratory effect on director behaviour as well as allowing directors to be subject to an action for a breach of duty.

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Beyond Current Context to Examine the Accountability Spectrum' (2011) 33 *Dublin University law Journal* 116, 128.

<sup>7</sup> See Richard Williams, 'Enlightened Shareholder Value in UK Company Law' (2012) 35(1) *University of New South Wales Law Journal* 360, 365; Davy Wu, 'Managerial Behaviour, Company Law and the Problem of the Enlightened Shareholder Value' (2010) 31(2) *Company Lawyer* 53, 54; Shuangge Wen, 'Exploring the Rationale of Enlightened Shareholder Value in the Realm of UK Company Law – The Path Dependence Perspective' 14 *International Trade and Business Law Review* 153, 158; Brenda Hannigan, *Company Law* (2<sup>nd</sup> edn, Oxford University Press 2009) 206; Irene Esser & Jean du Plessis, 'The Stakeholder Debate and Directors' Fiduciary Duties' (2007) 19 *South African Mercantile Law Journal* 346, 353.

<sup>8</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law* (8<sup>th</sup> Edn, Sweet and Maxwell, 2008), 510.

<sup>9</sup> *Royal Brunei Airlines Sdn Bhd v Tan Kok Ming* [1995] 2 AC 378.



Enforcement in this context does not mean that directors should be subject to a never ending list of litigations. Instead, enforcement should provide a realistic threat of legal action to ensure that directors comply with their duties. Enforcement must act as incentive to adhere to the objective of entity maximisation and a deterrent from engaging in non-compliant action.<sup>10</sup> Therefore the importance of having an effective enforcement mechanism is that it acts as a deterrent to avoid non-compliant action in the first place.<sup>11</sup> Therefore the aim of clarifying the standard required in complying with good faith is that it will act as an incentive to comply with the duty to act in the interests of the company.

In the UK context enforcing the stakeholder element of Enlightened Shareholder Value (ESV) is made extremely difficult due to the prioritisation of the members' interests. Section 172(1) of the UK Companies Act 2006 states that directors '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 the members' and in doing so have regard to the list of stakeholder interests. As argued in chapter four, ESV is a model which represents a shareholder value approach and in the absence of legislative reforms any attempt to move away from shareholder value in the UK must come from an enforcement of the stakeholder element of ESV and ensure directors consider the listed interests. It is possible the duty of good faith could be breached if a director fails to have regard to the listed interests in a way in which harms the company's ability to promote the success of the members. For example, disregarding employee interests to such an extent that it would have a negative effect on the company.<sup>12</sup> If such a breach were to exist an action could be taken under several grounds. The UK statutory derivative claim has removed the requirement to prove an exception to the rule in *Foss v Harbottle* and allows claimants to take action for any breach of duty.<sup>13</sup> Despite widening the grounds under which a derivative claim can be taken, there have still been relatively few claims taken<sup>14</sup> which indicates that the derivative claim is unlikely to provide an effective means of enforcing directors' duties. Liquidators can also take action against an errant director for a breach of duty<sup>15</sup> and disqualification orders can also be sought by the courts where there is evidence of a breach of duty.<sup>16</sup> There is also a provision in the UK Company Directors Disqualification Act 1986 which allows for the Secretary of State to disqualify a director of an insolvent company if it is in the public interest to do so.<sup>17</sup> However, it is submitted that

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<sup>10</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar, 2011), 232.

<sup>11</sup> Charles Hill and Thomas Jones, 'Stakeholder-Agency Theory' (1992) 29 *Journal of Management Studies* 131, 141.

<sup>12</sup> David Gibbs, 'Has the Statutory Derivative Claim Fulfilled its Objectives? The Hypothetical Director and CSR: Part 2' (2011) 32(3) *Company Lawyer* 76, 81.

<sup>13</sup> UK Companies Act 2006 s 260(3).

<sup>14</sup> Andrew Keay, 'An Assessment of Private Enforcement Actions for Directors' Breaches of Duty' (2014) 33(1) *Civil Justice Quarterly* 76, 84. Keay states that from October 1, 2007 to October 1, 2012 there was an average of 3.2 cases taken per annum.

<sup>15</sup> Insolvency Act 1986 s 165(3) and s 167(1)(a) and schedule 4 para 4.

<sup>16</sup> UK Company Directors Disqualification Act 1986 s 9(1)(A) and schedule 1(7).

<sup>17</sup> UK Company Directors Disqualification Act 1986 s 7(1) and s 8(1).

none of these mechanism will ensure the consideration of stakeholders under ESV. Instead, it is proposed that an entity focused approach coupled with the public enforcement of directors' duties is much more likely to yield the effective enforcement of directors' duties.

This chapter will first draw a distinction between the business judgment rule and the duty to act in good faith. Secondly it argues that it is an objective test which is in operation for assessing compliance with the good faith duty. Thirdly it argues that the law of dishonest assistance from the law of trusts provides an excellent example of how the test for good faith should be perceived. Fourthly the chapter outlines possible applications of an objective test for good faith in the UK and examine whether an objective test could ensure a greater degree of compliance with the requirement that directors should have regard to the stakeholder interests. Finally the chapter discusses the options available of enforcement when directors breach their duty to act in good faith in the interests of the company.

## **6.02 The Good Faith Duty and the Business Judgment Rule**

The first thing to note about the duty to act in good faith contained in the Companies Act 2014 and the UK Companies Act 2006 is that it is identical to its common law predecessor the duty to act *bona fide* in the interests of the company. Generally, the interpretation of the legislative fiduciary duties under both English and Irish law is highly dependent on the common law for guidance. Section 227(5) of the Companies Act 2014 and section 170(4) of the UK Companies Act 2006 Act provide that directors' legislative fiduciary duties are to be interpreted and applied in the same way as the common law rules. As a result, it is unlikely that any reform has been implemented by the change from a duty to act *bona fide* in the interests of the company to the duty to act in good faith in the interests of the company. Keay states there is nothing to suggest that the legislative duty to act in good faith will be interpreted any differently from the common law duty to act *bona fide*.<sup>18</sup> The UK case law would seem to back up such a view. It has been stated in *Cobden Investments v RWM Langport Ltd*<sup>19</sup> that the good faith duty and the *bona fide* duty 'come to the same thing'.<sup>20</sup> Both *Madoff Securities International Ltd (in liquidation) v Raven*<sup>21</sup> and *Hellard v Carvalho*<sup>22</sup> have held that the good faith duty simply represents a codification of the duty to act *bona fide*. While there have been no cases taken in Ireland since the enactment of the Companies Act 2014, the Company Law Review Group (CLRG) did not propose that the good faith duty should be interpreted differently to the duty to act *bona fide* and it is reasonable to assume that in Ireland the good faith duty will be interpreted in the same way as its predecessor.

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<sup>18</sup> Andrew Keay, 'Good Faith and Directors' Duty to Promote the Success of Their Company' (2011) 35(2) *Company Lawyer* 138, 143.

<sup>19</sup> *Cobden Investments v RWM Langport Ltd* EWHC 2810 Ch.

<sup>20</sup> *Ibid*, 52.

<sup>21</sup> *Madoff Securities International Ltd (in liquidation) v Raven* [2013] EWHC 3147, 260.

<sup>22</sup> *Hellard v Carvalho* [2013] EWHC 2876 Ch [2014 BCC 227, 88.

Despite its widespread use throughout company law<sup>23</sup> there is no clear and common definition of the meaning of good faith<sup>24</sup> with Eisenberg believing it to be easier to characterise an act which is lacking good faith rather than to say what good faith actually is.<sup>25</sup> While it is difficult to formulate any precise definition of good faith, the broad concept behind the duty can be articulated. A duty to act in good faith is generally based on the notion of acting honestly<sup>26</sup> and the good faith duty to act in the interests of the company is grounded in honesty and loyalty rather than in competence.<sup>27</sup> Throughout the *bona fide* and good faith case law the phrase ‘the directors honestly held beliefs’ (or a derivative of that phrase) appears frequently during the judicial reasoning in determining whether the directors breached their duty.<sup>28</sup> Therefore in assessing whether a director has complied with the good faith duty what is relevant is the honesty of the beliefs of the director rather than whether the impugned decision did or did not benefit the company. In other words the question is: did the director honestly believe that he was acting to promote the success of the company?

It is important to distinguish this question of honesty from the application of the business judgment rule. The business judgment rule<sup>29</sup> refers to the common law rule, derived from English cases, that a court will not substitute its own views in the place of those of an individual director. For the purposes of this thesis the business judgment rule refers to the English form of the rule and not the American rule which is stricter in its application and results in directors’ business judgments only being reviewed in extraordinary circumstances.<sup>30</sup> Under the English business judgment rule the courts will never deem a director to have breached their duties simply because the court would have taken a different business decision in the same set of circumstances. Similarly, under the rule directors will not be in breach of good faith simply because a decision did not work as intended.

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<sup>23</sup> See Noel McGrath, ‘Good Faith: A Puzzle for the Commercial Lawyer’ (2014) *UCD Working Papers in Law, Criminology & Socio-Legal Studies Research Paper* available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2500105](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2500105).

<sup>24</sup> Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge 2012), 93.

<sup>25</sup> Melvin Eisenberg, ‘The Duty of Good Faith in Corporate Law’ (2006) 31 *Delaware Journal of Corporate Law* 1, 21.

<sup>26</sup> See Sean Griffith, ‘Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence’ (2005) 55 *Duke Law Journal* 1; Len Sealy, ‘“Bona Fides” and “Proper Purposes” in Corporate Decisions’ (1989) *Monash University Law Review* 265; John O’ Connor, *Good Faith in English law* (Dartmouth Publishing 1990); Melvin Eisenberg, ‘The Duty of Good Faith in Corporate Law’ (2006) 31 *Delaware Journal of Corporate Law* 1; Andrew Keay, *Directors’ Duties* (2nd edn, Jordan 2014), 130.

<sup>27</sup> Davy Wu, ‘Managerial Behaviour, Company Law and the Problem of the Enlightened Shareholder Value’ (2010) 31(2) *Company Lawyer* 53, 53.

<sup>28</sup> See for example, *Howard Smith v Ampol Petroleum Limited* [1974] AC 821, 842; *Citco Banking Corp NV v Pussers Ltd* [2007] 2 BCLC 638 (Ch), 649; *Regentcrest plc v Cohen* [2001] 2 BCLC 80, 124, *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598, 90; *Re Smith and Fawcett Ltd.* [1924] Ch.304, 308.

<sup>29</sup> For a discussion on the business judgment rule see Dennis Block, Nancy Barton and Stephen Raidin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* (Aspen Law and Business 2002); Len Sealy, ‘“Bona fides” and “Proper Purposes” in Corporate Decisions’ (1989) *Monash University Law Review* 265, 277; John Birds et al, *Boyle and Birds’ Company Law* (7<sup>th</sup> edn, Jordan, 2007), 615; Derek French et al, *Mayson, French and Ryan on Company Law* (24<sup>th</sup> edn, Oxford University Press, 2007), 455.

<sup>30</sup> See David Rosenberg, ‘Galactic Stupidity and the Business Judgment Rule’ (2006) 32 *Journal of Corporation Law* 301.

Several good rationales underlie the application of the business judgment rule. First of all it is a matter for the directors, not the courts, to decide what is in the best interests of the company.<sup>31</sup> There is also an argument to be made that the courts would lack the expertise and information necessary to substitute their view of a business decision in place of that of the directors.<sup>32</sup> It would also be inhibiting for directors if their every decision was subject to the prospect of review by the courts which could well make directors unduly hesitant when making decisions or unwilling to take any action. The business judgment rule also prevents courts relying on hindsight to reach unduly harsh conclusions on directors. The application of the business judgment rule is very well established and stretches as far back as 1812 when Lord Elson LC, in *Carlen v Drury*, stated that the court is not required ‘to take the management of every playhouse and brewhouse in the Kingdom’.<sup>33</sup> Other cases such as *Re Smith and Fawcett*<sup>34</sup> demonstrated an unwillingness to interfere in business decisions. Lord Greene MR speaking in the Court of Appeal observed that ‘directors must act, *bona fide*, in what they consider - not what the court considers - is in the best interests of the company’,<sup>35</sup> a statement which was quoted with approval in the Irish case of *Banfi ltd v Moran*.<sup>36</sup> In *Regentcrest plc v Cohen*,<sup>37</sup> Parker J in the Chancery Division gave a definitive statement on the business judgment rule.

The question is not whether, viewed objectively by the court the particular act or omission which is challenged was in fact in the interests of the company; still less is the question whether the court, had it been in the position of the director at the relevant time, might have acted differently.<sup>38</sup>

Parker J also emphasised the importance of not engaging in hindsight to second guess the directors decision and that he would place himself ‘so far as possible in their shoes’.<sup>39</sup> Further evidence of the business judgment rule in operation can be seen in the Privy Council of *Howard Smith v Ampol Petroleum*.<sup>40</sup> There Lord Wilberforce stated, ‘There is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at’.<sup>41</sup> These statements highlight that questions pertaining to whether a director acted *bona fide* will not be decided on the basis of whether the impugned decision did or did not in fact prove ultimately beneficial for the company. Instead it is the honesty of the director at the time of the decision that will be in question.

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<sup>31</sup> Andrew Keay, *Directors’ Duties* (2nd edn, Jordan 2014), 128.

<sup>32</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law* (8<sup>th</sup> Edn, Sweet and Maxwell, 2008), 512.

<sup>33</sup> *Carlen v Drury* (1812) 1 Ves & B 154, 158.

<sup>34</sup> *Re Smith and Fawcett Ltd*. [1924] Ch. 304.

<sup>35</sup> *Ibid*, 306.

<sup>36</sup> *Banfi v Moran et al* [2006] IEHC 257.

<sup>37</sup> *Regentcrest plc v Cohen* [2001] 2 BCLC 80.

<sup>38</sup> *Ibid*, 120.

<sup>39</sup> *Ibid*, 147.

<sup>40</sup> *Howard Smith v Ampol Petroleum Limited* [1974] AC 821.

<sup>41</sup> *Ibid*, 842.

### 6.03 The Nature of the Duty to Act in Good Faith

The true nature of the duty to act in good faith in the interests of the company is obscured by an uncertainty as to whether the test for the duty is subjective, objective, or subjective with objective elements. One thing that is certain from the case law is that surrounding evidence can be used to establish if the director has acted in good faith.<sup>42</sup> For example both *Howard Smith v Ampol Petroleum*<sup>43</sup> and the Irish case of *Clark v Workman*<sup>44</sup> cited with approval the following statement from *Hindle v John Cotton Ltd.*<sup>45</sup>

Where the question is one of abuse of powers, the state of mind of those who acted, and the motive on which they acted, are all important, and you may go into the question of what their intention was, collecting from the surrounding circumstances all the materials which genuinely throw light upon that question of the state of mind of the directors so as to show whether they were honestly acting in discharge of their powers in the interests of the company.<sup>46</sup>

In Ireland several cases have found directors to be in breach of their duty to act *bona fide* in the interests of the company based on surrounding evidence.<sup>47</sup> For example in *Banfi Ltd v Moran*<sup>48</sup> the plaintiff company was the beneficial owner of shares in a company called Emerald Group Holdings Ltd. The shares were presented for registration but the directors of Emerald Group Holding Ltd refused. At the same time there was an action pending for minority oppression taken by Banfi Ltd against the directors of Emerald Group Holdings Ltd. One of the defences used in this litigation was that the Banfi Ltd did not have standing to take such an action because the company was not a shareholder. Laffoy J stated that ‘the real reason for the refusal to register the plaintiff as a member was to ensure the plaintiff would never have the standing to prosecute such proceedings’. She held the decision to refuse to register shares was held to be ‘motivated by self-interest, not the interest of the company as a whole’ despite affidavit evidence from the defendants claiming they had acted in the interests of the company.

While there is no doubt that surrounding circumstances can be used in an evaluation of a directors’ good faith there is significant confusion as to the standard actually required for directors to satisfy the duty. The test being applied to good faith in the majority of the cases states that the test is a subjective one. But despite the fact that no judgment explicitly refers to the test as being objective, it is

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<sup>42</sup> Thomas Courtney, *The Law of Companies* (3rd edn, Bloomsbury 2012), 881.

<sup>43</sup> *Howard Smith v Ampol Petroleum Ltd* [1974] AC 821, 835.

<sup>44</sup> *Clark v Workman* [1920] 1 IR 107, 117.

<sup>45</sup> *Hindle v John Cotton Ltd* (1919) 56 Sc LR 625.

<sup>46</sup> Ibid 630 – 631, per Viscount Finlay.

<sup>47</sup> See *Nash v Lancegaye Safety Glass (Ireland) Ltd* (1958) 92 ILTR 11; *Re Hafner* [1943] IR 426; *Banfi v Moran et al* [2006] IEHC 257.

<sup>48</sup> *Banfi v Moran et al* [2006] IEHC 257.

submitted that the test being applied by the courts is much closer to an objective standard. A subjective test would mean that once a director honestly believes they are acting in the interests of the company they will comply with the duty. This is regardless of whether the belief is reasonably held or whether the decision itself could be reasonably viewed as being in the interests of the company.<sup>49</sup> The problem with the subjective test is that it would yield irrational results. The problem was identified first by Bowen LJ in *Hutton v West Cork Railway* speaking of a subjective test ‘*bona fides* cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly *bona fide* yet perfectly irrational’.<sup>50</sup> The problem is that if a director was capable of holding an unreasonable belief then under a subjective test they could act in a way which is completely unreasonable and yet still be deemed to be acting in good faith. This would be the case even if it was abundantly clear that such an act was not in the interests of the company and was not a belief which any reasonable director would hold. So, for example, the surrounding evidence could show that a director regularly held unreasonable beliefs and these beliefs were honestly held, then under a subjective test the director would satisfy a subjective test for good faith. Despite this problem the duty is regularly referred to as a subjective duty without any reference to a base level of objectivity or reasonableness both by the courts<sup>51</sup> and by academics.<sup>52</sup>

As well as the potential for irrational results labelling the test as subjective is also misleading for directors. It provides a sense that it is impossible for directors to be found in breach of the good faith duty. This view is articulated by Davies who argues that a finding of a lack of good faith will be difficult to establish ‘except in egregious cases or where the directors, obligingly, have left a clear record of their thought processes up to the challenged decision’.<sup>53</sup> This would be the case if the test for good faith was evaluated on subjective grounds, however, despite referring to the test as subjective, when it comes to application of the test, it is often assessed on objective grounds with a strong focus on the reasonableness of the decision. As Sealy notes, the use of *bona fide* has led to a ‘contention that a subjective honesty of purpose was all that is needed to be shown in order to repeal a

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<sup>49</sup> Rosemary Langford and Ian Ramsey, ‘Directors’ Duties to act in the Best Interests of the Company – Subjective or Objective’ (2015) 2 *Journal of Business Law* 173, 174.

<sup>50</sup> *Hutton v West Cork Railway* (1883) 23 Ch D 654, 671;

<sup>51</sup> *Madoff Securities International Ltd (In Liquidation) v Raven* [2013] EWHC 3147, 190. *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598, 619. *Regentcrest plc v Cohen* [2001] 2 BCLC 80, 124.

<sup>52</sup> See Richard Williams, ‘Enlightened Shareholder Value in UK Company Law’ (2012) 35(1) *University of New South Wales Law Journal* 360, 365; Davy Wu, ‘Managerial Behaviour, Company Law and the Problem of the Enlightened Shareholder Value’ (2010) 31(2) *Company Lawyer* 53, 54; Shuangge Wen, ‘Exploring the Rationale of Enlightened Shareholder Value in the Realm of UK Company Law – The Path Dependence Perspective’ 14 *International Trade and Business Law Review* 153, 158; Brenda Hannigan, *Company Law* (2<sup>nd</sup> edn, Oxford University Press 2009) 206; Irene Esser & Jean du Plessis, ‘The Stakeholder Debate and Directors’ Fiduciary Duties’ (2007) 19 *South African Mercantile Law Journal* 346, 353; Ronan Keane, *Company Law* (4<sup>th</sup> edn, Tottel 2007), [27.90].

<sup>53</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law* (8<sup>th</sup> Edn, Sweet and Maxwell, 2008), 510.

challenge to the exercise of discretion. This has never been the case'.<sup>54</sup> 'There has always been a bottom line, an objective threshold of reasonableness below which *bona fides* will not itself be sufficient for a decision to stand'.<sup>55</sup>

This objective element of good faith is more difficult to define as the test could be objective in different ways. First an objective test could mean that the courts could assess what was in the interests of the company and evaluate if the directors acted accordingly with their determination. However it is submitted that this is not a test for good faith as it in no way relates to the honestly held beliefs of the director. As good faith is based on honesty such a test could not be applied to good faith and it would contravene the business judgment principle. The objective element of the test is only applied when considering whether a director honestly believed he was acting in the interests of the company. The criterion of reasonableness cannot be applied to assess whether a director's decision actually benefitted the company.<sup>56</sup> Instead an objective test would be applied if surrounding evidence was used to show that the belief of the director could not be reasonably held and so the director would be in breach of their good faith duty. This test would impose an objective standard in relation to honesty of the beliefs of the director and would only be subjective in the sense that what is relevant is the director's own state of mind. An objective test could be implemented by reference to a reasonable director i.e. would a reasonable director have honestly believed the decision was taken for the benefit of the company.<sup>57</sup> This test allows the court to determine that if an action taken by a director was unreasonable they can determine it to be a belief which was not honestly and reasonably held and so the director would be in breach of the good faith duty. This objective test has been used by the courts on several occasions and any act taken by a director which is deemed unreasonable by the courts is seen to be a view which could not be honestly held with the result that the directors are found in breach of the *bona fide* duty.<sup>58</sup> As Keay states, the 'courts can come to the conclusion that a director was not acting in good faith when he or she took a particular action, not only from a consideration of the evidence of the director, but also from an examination of objective matters, such as the reasonableness of what the director did or did not do'.<sup>59</sup> What follows is a discussion of the case law relating to the test for good faith, the aim of which is to demonstrate that while the courts regularly

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<sup>54</sup> Len Sealy, "'Bona fides" and "Proper Purposes" in Corporate Decisions' (1989) *Monash University Law Review* 265, 269.

<sup>55</sup> *Ibid*, 277.

<sup>56</sup> Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge 2012), 104.

<sup>57</sup> Rosemary Langford and Ian Ramsey, 'Directors' Duties to act in the Best Interests of the Company – Subjective or Objective' (2015) 2 *Journal of Business Law* 173, 174.

<sup>58</sup> See *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598; *Item Software Ltd. (UK) Ltd v Fassihi* [2004] EWCA Civ 1244; *Re Coroin Ltd* [2012] EWHC 2343 (Ch); *Breitenfeld UK Ltd v Harrison* [2015] EWHC 399 (Ch); *Re Genosyis Technology* [2006] EWHC 989 Ch.

<sup>59</sup> Andrew Keay, 'Good Faith and Directors' Duty to Promote the Success of Their Company' (2011) 35(2) *Company Lawyer* 138, 141.

refer to the test as subjective, application of the test nearly always involves the comparison to reasonable standards.

#### **6.04 Case Law Relating to *Bona Fide* and Good Faith**

A leading case on the appropriate test for good faith is *Regentcrest plc v Cohen*.<sup>60</sup> This case centred on a clawback claim which Regentcrest, a property development company, made in respect of two of the firm's directors. The two directors had sold shares in a company called Greenground to Regentcrest. The agreement provided for additional remuneration to be paid to these directors if the value of the shares had gone up by an agreed date but if the investment had lost money then the two directors were liable to pay any shortfall. The latter proved to be the case and the shortfall amounted to £1.5 million. The board of Regentcrest decided to waive this clawback provision at a board meeting. The two directors in question declared their interest at the meeting and took no part in the proceedings. Subsequently, the company went into liquidation and, on winding up, the liquidators claimed that the board had acted in breach of the duty to act in the best interests of the company by waiving the £1.5 million clawback. The issue was whether the board of directors had acted *bona fide* in the interests of the company in waiving the clawback claim. Parker J ruled that the test to be applied was a subjective one:

The question is whether the director honestly believed that his act or omission was in the interests of the company. The issue is to the directors' state of mind. No doubt where it is clear that the act or omission under challenge resulted in substantial detriment to the company, the director will have a harder task persuading the court that he honestly believed it to be in the company's best interests; but that does not detract from the subjective nature of the test.<sup>61</sup>

This test suggests that if the director truly believes he is acting in the interests of the company the director will comply with the duty to act in good faith. Surrounding evidence may make it harder to prove the director believed he was acting for the company's benefit but if there was a genuine subjective belief from the directors they would satisfy the duty regardless if the decision or belief was reasonable or not. The board of directors believed that the company could continue trading<sup>62</sup> and provided several reasons why they believed that it was in the best interests of Regentcrest to accept the waiver such as retaining the skills of the two directors and the need to maintain a united board in the face of pressure from creditors. Ultimately, Parker J decided that there was no reason to doubt that the managing directors honestly believed that they were acting in the best interests of Regentcrest and, hence, satisfied the *bona fide* duty.<sup>63</sup> Parker J stated the reasons offered by the directors 'could

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<sup>60</sup> *Regentcrest plc v Cohen* [2001] 2 BCLC 80.

<sup>61</sup> *Ibid*, 124.

<sup>62</sup> *Ibid*, 140.

<sup>63</sup> *Ibid*, 158.



reasonably have led a businessman in the position of the Richardson brothers [managing directors] on the 5th of September 1990 to conclude that the waiver of the claim on the terms proposed was in the best interests of Regentcrest'.<sup>64</sup> Therefore the directors showed that their subjective belief was reasonably held. However, what if this was not the case, what would have been the decision of the court if the reasons offered by the managing directors could not have 'reasonably led a businessman' to the same decision? While this question is not answered in Regentcrest, other authority<sup>65</sup> supports the view that if there were no reasonable grounds for their belief that they were acting in the company's best interests, it would not have mattered what the directors actually believed themselves and they would be found in breach of the duty to act *bona fide*.

One of the most frequently cited cases in support of the subjective test is *Re Smith and Fawcett*<sup>66</sup> where Lord Greene states, 'directors must act, *bona fide*, in what they consider – not what the court considers - is in the best interests of the company.'<sup>67</sup> Many judgments<sup>68</sup> approve the passage as conclusive evidence for a subjective test on the basis that it is what they, the directors, consider to be in the best interests of the company. However, Lord Greene at no point in his judgment suggests that the issue of whether the directors consider their action to be in the best interests of the company cannot be judged on objective grounds. The statement alone is proof of that the business judgment rule is being applied but not that a subjective test need be applied when evaluating whether a belief was held *bona fide*.

However support for a completely subjective test can be found in *Extrasure Travel v Scattergood*.<sup>69</sup> Extrasure had paid a sum of money, which amounted to the majority of its funds, to its holding company in a corporate group arrangement. Extrasure went into insolvency and was later sold. The buyer, along with Extrasure, took an action against the two former directors who had been responsible for the payment to the holding company on the basis that they were not acting *bona fide* in the best interests of Extrasure when the money was transferred. In response to the defendant directors' claims that they were acting in the best interests of Extrasure by transferring the money Jonathan Crow QC (sitting as a deputy Judge of the High Court) outlined the test as follows:

The fact that a director's alleged belief is unreasonable may provide evidence that it was not honestly held at the time: but if having considered all the evidence, it appears that the director did honestly believe that he was acting in the best interests of the company, then he is not in

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<sup>64</sup> Ibid, 153.

<sup>65</sup> See *Citico Banking Bank Corp NV v Pussers Ltd* [2007] 2 BCLC 638; *Item Software Ltd. (UK) Ltd v Fassihi* [2004] EWCA Civ 1244; *Heron International v Lord Grade* [1983] BCLC 638; *Re Coroin Ltd* [2012] EWHC 2343 (Ch).

<sup>66</sup> *Re Smith and Fawcett Ltd.* [1924] Ch. 304.

<sup>67</sup> Ibid 306.

<sup>68</sup> *Regentcrest plc v Cohen* [2001] 2 BCLC 80, 121; *Extrasure Travel Insurances ltd v Scattergood* [2003] 1 BCLC 598; *Cobden Investments v RWM Langport Ltd* EWHC 2810 Ch, 53.

<sup>69</sup> *Extrasure Travel Insurances ltd v Scattergood* [2003] 1 BCLC 598.

breach of his fiduciary duty merely because that belief appears to be the trial judge to be unreasonable, or because his actions happen, in the event, to cause injury to the company.<sup>70</sup>

This statement endorses a completely subjective test. It states that once a director believed that what he was doing was in the best interests of the company, no matter how unreasonable that belief, he will not be in breach of his *bona fide* duty. However, Crow QC's statement is deeply flawed and, as will be highlighted below, is in conflict with most other case law on the subject. It is difficult to imagine a court concluding that a belief that was manifestly unreasonable was, nonetheless, one that was honestly held. For example, could a director demonstrate that he honestly held an unreasonable belief, by proving himself to be an unreasonable person or, at the very least, proving himself to be capable of honestly holding unreasonable beliefs? Such an attempt was made in a similar area of trusts law and was rejected by the court.<sup>71</sup> However if such a claim had been made and the test applied was Crow QC's above, then the director would have to be deemed as acting *bona fide*. This highlights the problem with the subjective test for good faith, in order to avoid irrational outcomes there must be an objective element applied to the test for good faith. Ultimately in *Extrasure*, in an apparent contradiction of the passage quoted above, Crow QC refused to believe the directors when they claimed that they were acting in the company's best interests because their claims were unreasonable, '[i] have found that there was an absence of any honest belief that the transfer was in Extrasure's best interests.....I do not consider that they acted reasonably'.<sup>72</sup> Because the directors acted unreasonably, Crow QC refused to accept that the directors honestly believed that they were acting in the best interests of the company.<sup>73</sup> In this case there appears to be a disconnect between the test stated and the test applied however the remainder of the case endorses the objective test and require the belief to be reasonable before deeming it one which is honestly held.

Support for an objective application of the *bona fide* test can be found in the Court of Appeal case *Fassihi v ItemSoftware*.<sup>74</sup> In this case one of ItemSoftware's directors attempted to personally take over one of the company's contracts and ItemSoftware then sued him for breach of his *bona fide* duty. The court had to determine if the director had breached his *bona fide* duty by failing to inform ItemSoftware about his intentions to acquire the contract for himself. Arden LJ stated, '[o]n the facts of the case, there is no basis on which Mr Fassihi could reasonably have come to the conclusion that it was not in the interests of Item to know of his breach of duty'.<sup>75</sup> If the test was decided on subjective grounds, as envisaged in Crow QC's statement in *Extrasure*,<sup>76</sup> then, at this point, Arden LJ should

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<sup>70</sup> Ibid, 619.

<sup>71</sup> An excellent example of such an attempt to prove an unreasonable belief was honestly held takes place in *Barlow Clowes v Eurotrust* see text to note 127.

<sup>72</sup> *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598, 636.

<sup>73</sup> Ibid, 623.

<sup>74</sup> *Item Software Ltd. (UK) Ltd v Fassihi* [2004] EWCA Civ 1244.

<sup>75</sup> Ibid, [44].

<sup>76</sup> *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598, 619.

have investigated whether this unreasonable action was genuinely believed by the director to be in the best interests of the company. If this question was answered in the affirmative then he would be found to have discharged his *bona fide* duty. But, once Arden LJ determined the director's actions were unreasonable, she deemed that the director had breached his *bona fide* duty. The only interpretation one can draw from this case is that the court applied an objective test based on the unreasonableness of the action of the director.

Cogent support for the objective nature of the good faith test is demonstrated in *Heron International Ltd v Lord Grade*.<sup>77</sup> The Court of Appeal dealt with the directors of a broadcasting company ACC plc. The directors preferred one bidder over another rival bidder who had offered a higher price for the shares of ACC. Although the subjective good faith of the directors was not even in question yet this was not sufficient in the eyes of the court to conclude that they had satisfied their duty to act in the best interests of the company. Lawton LJ asked the following question:

The good faith of the directors not being impugned, it follows that the directors on 13 January 1982 genuinely believed that it was in the interests of ACC....The question is whether that genuine belief was a belief that could reasonably be held. In order to succeed on this part of the case, the plaintiffs must prove that no reasonable board of directors could have come to the conclusion that it was necessary in the interests of ACC.<sup>78</sup>

There can be no doubt that Lawton LJ is applied an objective test in order to determine if the directors had acted *bona fide*. It was accepted by the court that the directors did honestly believe they were acting for the company's best interests. Nonetheless the court required it to be shown that a reasonable board could have been of the same belief prior to the *bona fide* duty was complied with. While the directors of ACC were found to have acted *bona fide*<sup>79</sup> this does not alter the fact that they had to satisfy an objective standard.

Additional evidence that the test is objective in nature is provided by *Re Genosysis Technology Ltd*<sup>80</sup> where two directors were disqualified for entering into a settlement agreement which resulted in a significant loss of earnings for the company. Lindsay J found that the two directors would need to breach the *bona fide* duty both on subjective and objective grounds. However Lindsay J ruled that even if the directors had passed the subjective test, their claim would still have failed on objective grounds, '[t]here is no evidence drawn to my attention that the appellant did believe that the English company benefited from the transaction, and even if there had been, I would have been unable to

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<sup>77</sup> *Heron International v Lord Grade* [1983] BCLC 638.

<sup>78</sup> Ibid 266.

<sup>79</sup> Ibid 271.

<sup>80</sup> *Re Genosysis Technology Ltd* [2006] EWHC 989 Ch.

characterise the belief as reasonable'.<sup>81</sup> More recently in *Re Coroin Ltd*<sup>82</sup> it was alleged that the dismissal of an officer was not taken in the interests of the company. In deciding whether the termination was in the company's interests Richards J stated '[l]ooked at objectively, it was in my judgment a view which a director could reasonably come to that the expense of continuing to engage Mr Hennebry was no longer justified'.<sup>83</sup> Again there can be little doubt that an objective test is in operation. A similar test was outlined in *Cobden Investments v RWM Langport Ltd*<sup>84</sup> where it was stated that 'a breach will have occurred if it is established that the relevant exercise of power is one which could not be considered by any reasonable director to be in the interests of the company'.<sup>85</sup> Australian law also seems to support an objective test for good faith, the Supreme Court of New South Wales recently addressed this issue in the case of *Re Idyllic Solutions Pty Ltd*.<sup>86</sup> There can be no doubt Ward J was applying a completely objective test when he stated:

It is to be noted that the test as to whether a director or officer has contravened [the statutory duty to act in the interests of the company] is an objective test, having regard to what a comparable person, having the same knowledge and skills as the relevant director or officer, would reasonably have done in the circumstances.<sup>87</sup>

Judgments such as *Heron International*, *ItemSoftware* and *Re Genosyis Technology* and *Re Coroin* are all supportive of the application of an objective test, yet it continues to be the case that recent judgments<sup>88</sup> and modern academics<sup>89</sup> alike regularly refer to the test as being decided on a subjective basis. This creates the impression for directors that the duty to act in good faith in the interests of the company is a duty which is very easy to satisfy. If this is how the duty is viewed then it is easy to imagine situations where directors will not act in the interests of the company as they are unlikely to be found in breach of the duty and therefore unlikely to be held accountable. The problem is one of perception and the argument here is that the duty to act in good faith should not be seen as a purely subjective test. Even academics who acknowledge the existence of the objective test<sup>90</sup> claim that it is

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<sup>81</sup> Ibid, 21.

<sup>82</sup> *Re Coroin Ltd* [2012] EWHC 2343 (Ch).

<sup>83</sup> Ibid, 535.

<sup>84</sup> *Cobden Investments v RWM Langport Ltd* [2008] EWHC 2810.

<sup>85</sup> Ibid, 52.

<sup>86</sup> *Re Idyllic Solutions Pty Ltd* [2012] NSWSC 1276

<sup>87</sup> Ibid 1487.

<sup>88</sup> *Madoff Securities International Ltd (In Liquidation) v Raven* [2013] EWHC 3147; *Regentcrest plc v Cohen* [2001] 2 BCLC 80; *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598; *Cobden Investments v RWM Langport Ltd* EWHC 2810 (Ch).

<sup>89</sup> Richard Williams, 'Enlightened Shareholder Value in UK Company Law' 2012, 365; Davy Wu, 'Managerial Behaviour, Company Law and the Problem of the Enlightened Shareholder Value' (2010) 31(2) *Company Lawyer* 53, 54; Shuangge Wen, 'Exploring the Rationale of Enlightened Shareholder Value in the Realm of UK Company Law – The Path Dependence Perspective' 14 *International Trade and Business Law Review* 153, 158; Brenda Hannigan, *Company Law* (2nd edn, Oxford University Press 2009) 206;

<sup>90</sup> Len Sealy, "'Bona fides" and "Proper Purposes" in Corporate Decisions' (1989) *Monash University Law Review* 265, 277.

hard to find a single example of the objective test being used.<sup>91</sup> As is evidenced by the cases discussed above a contrary view should be taken, which is that the objective test plays a significant role in deciding how cases are decided. As stated earlier enforcement in this context is about acting as a deterrent rather than requiring constant litigations. A clear objective standard of good faith could ensure that directors are more likely to comply with the duty to act in the interests of the company as they will be more aware of a higher standard involved and the increased likelihood of being held accountable when they fail to act in the interests of the company.

The problem with referring to the test as wholly objective is that it suggests that the test will contravene the business judgment principle. One possible solution to remove the perception and the irrational outcomes of a wholly subjective test and still not interfere with the business judgment principle is to adopt a combined test of subjectivity and objectivity.<sup>92</sup> It is claimed that such a test would promote accountability and would not interfere with the business judgment principle.<sup>93</sup> Langford and Ramsey explain a combined subjective and objective test as follows:

Although the focus of this approach begins with the subjective belief of the relevant director courts can look beyond the director's assertion of such belief to objective factors to assess whether the belief is honestly held and, in order to protect the interest of the company, to test whether the decision in question is one that no reasonable director would consider to be in the interests of the company.<sup>94</sup>

This test has been applied in the recent Irish case of *Bloxham v Irish Stock Exchange*.<sup>95</sup> The case examined, in detail, the test for acting *bona fides* in the interests of the company under Irish law. The Irish Stock Exchange argued that the test for directors acting *bona fide* in the interests of the company was entirely subjective. Charleton J refused to accept their argument. He stated that 'in other branches of the law, entirely subjective principles rarely hold sway'<sup>96</sup> and that 'what a reasonable person would have concluded from a term or condition or from a particular representation or situation is the touchstone from which the law proceeds'.<sup>97</sup> In direct contrast, Bloxham argued that that the test for *bona fides* required an objective determination from the court as to what was in fact in the interests of the company. Charleton J also refused this test on the grounds of the business judgment principle. He stated

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<sup>91</sup> Ibid.

<sup>92</sup> Charles Lam and Say Goo, 'Confucianism and the Duty to Promote the Success of the Company' (2014) 25(12) *International Company and Commercial Law Review* 418, 421; Rosemary Langford and Ian Ramsey, 'Directors' Duties to act in the Best Interests of the Company – Subjective or Objective' (2015) 2 *Journal of Business Law* 173, 182.

<sup>93</sup> Rosemary Langford and Ian Ramsey, 'Directors' Duties to Act in the Best Interests of the Company – Subjective or Objective' (2015) 2 *Journal of Business Law* 173, 182.

<sup>94</sup> Ibid.

<sup>95</sup> *Bloxham (in Liquidation) v The Irish Stock Exchange Ltd* [2014] IEHC 93.

<sup>96</sup> Ibid, [10].

<sup>97</sup> Ibid, [8].

‘For Bloxham, the argument goes the other way; in favour of an objective analysis of every decision made by a board of directors. Here the problem would be that in objectively analysing decisions, the courts might be in danger of stepping into the shoes of directors. This is not appropriate....The court cannot displace a decision simply because it does not like it; and this is what a completely objective principle would tend towards, instead of appropriate deference to the exigencies and pressures of business’.<sup>98</sup>

This demonstrates the problem with referring to the test for good faith as objective as it suggests a contravention of the business judgment rule. Ultimately, Charleton J applied a subjective test with objective elements in relation to the beliefs held by the director, ‘Thus, it seems that the test for the exercise of directors’ duties must involve a scrutiny of...whether the presence or absence of reasonable grounds enables what is said subjectively to be an honest decision to stand as being in the best interests of the company as a whole’.<sup>99</sup>

The problem with the combined subjective and objective tests is that it is unnecessarily complex and does not produce the requisite clarity to change the perception of good faith. There is a simpler solution available. Identify the duty of good faith and the business judgment rule as separate principles. It then would not be necessary to describe the *bona fide* test as subjective simply to avoid conflicting with the business judgment rule. Good faith relates to the honesty<sup>100</sup> of the directors while the business judgment rule relates to courts not determining what was actually in the interests of the company. Once this clarification is made honesty can then be judged on a purely objective scale.

### 6.05 The Proposed Test for Good Faith

The first element of the proposed solution is that the difference between business judgment rule and the test for good faith should be made obvious by the courts. Some courts have made such a distinction, for example, in *Citco Banking Corp v Pussers*,<sup>101</sup> a recent decision of the Privy Council, Lord Hoffman quoted,<sup>102</sup> with approval, from the judgment of Scrutton LJ in the Court of Appeal case of *Shuttleworth v Cox*<sup>103</sup> which stated:

Now when persons, honestly endeavouring to decide what will be for the benefit of the company and to act accordingly, decide upon a particular course, then, provided there are grounds on which reasonable men could come to the same decision, it does not matter whether

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<sup>98</sup> Ibid, [9].

<sup>99</sup> Ibid, [11].

<sup>100</sup> *Howard Smith v Ampol Petroleum Limited* [1974] AC 821, 842; *Citco Banking Corp NV v Pussers Ltd* [2007] 2 BCLC 638 (Ch), 649; *Regentcrest plc v Cohen* [2001] 2 BCLC 80, 124, *Extrasure Travel Insurance Ltd v Scattergood* [2003] 1 BCLC 598, 90; *Re Smith and Fawcett Ltd.* [1924] Ch.304, 308.

<sup>101</sup> *Citco Banking Corp NV v Pussers Ltd* [2007] 2 BCLC 483, 649.

<sup>102</sup> Ibid, 15.

<sup>103</sup> *Shuttleworth v Cox Bros and Co (Maidenhead) LTD* [1927] 2 KB 9.

the Court would or would not come to the same decision or a different decision. It is not the business of the Court to manage the affairs of the company. That is for the shareholders and directors.<sup>104</sup>

The distinction has also been noted in *Cobden Investments v RWM Langport Ltd*<sup>105</sup> under the UK Companies Act 2006 Warren J stated on the test for good faith that '[t]he question is whether the director honestly believed that his act or omission was in the interests of the company. The court does not consider that the duty is broken simply because, in the court's opinion, the particular exercise of power was not to promote the success of the company'.<sup>106</sup> The difference between the two questions has been best described by the Supreme Court of Western Australia in *Westpac Banking Corporation v Bell*<sup>107</sup> where it was stated in respect of the *bona fide* test, 'the objective considerations relate back to the question whether the directors honestly believed the transaction to be in the best interests of the company, not to whether (regardless of what the directors believed) it did benefit the company'.<sup>108</sup> These cases illustrate that the business judgment rule and the test for good faith relate to different concepts. The test for *bona fides* investigates whether the director honestly believed his action was in the best interests of the company; the business judgment rule relates to whether the decision actually benefitted the company.

The second element of the proposed solution is to see honesty as a completely objective standard. In this regard guidance can be drawn from the law of trusts. The law on dishonest assistance has examined, in detail, whether the proper test for honesty is subjective or objective. The cases deal with scenarios where a person dishonestly assists in the misappropriation of trust property and honesty is the key determinant of liability. The trusts case law, although not completely free of complexity, possesses a higher level of refinement and clarity in relation to the test used for honesty. In the UK context, the trusts cases on this topic become all the more relevant after a reading of the explanatory notes of section 172(1) of the UK Companies Act 2006 which provides that the law of trusts and agency are to play a part in the interpretation of the new directors' duties.<sup>109</sup> The most notable statement is that 'developments in the law and trusts and agency should be reflected in the interpretation and application of the duties'.<sup>110</sup> This is likely to be the case because both areas of law deal with fiduciary duties and so the principles involved are transferable.

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<sup>104</sup> Ibid, 23.

<sup>105</sup> *Cobden Investments v RWM Langport Ltd* [2008] EWHC 2810.

<sup>106</sup> Ibid, 52.

<sup>107</sup> *Westpac Banking Corporation v Bell Group Ltd (in Liq)* [2008] WASC 239.

<sup>108</sup> Ibid.

<sup>109</sup> Explanatory Notes to the Companies Act 2006, note 305.

<sup>110</sup> Ibid.

The leading case on the test for dishonest assistance is *Royal Brunei Airlines v Tan*.<sup>111</sup> Prior to *Royal Brunei* the test for a breach of trust in misappropriating trust property focused knowledge and ‘knowing assistance’ rather than dishonest assistance.<sup>112</sup> However Lord Nicholls stated that ‘knowingly’ is a term better avoided<sup>113</sup> and this viewpoint has been seen by subsequent judgments as clarifying the law.<sup>114</sup> Since these judgments the focus on whether a breach of trust has occurred has focused on the test involved for establishing dishonesty. In the *Royal Brunei* case, Royal Brunei contracted an agency agreement with a travel agency called BLT. The agreement provided that BLT was to sell tickets for Royal Brunei and BLT was to hold the money received in trust for Royal Brunei. Money was paid out of this trust account to the managing director of BLT. When BLT went into insolvency, Royal Brunei took an action against the managing director for assisting in the breach of trust. In applying a completely objective, test Lord Nicholls held that ‘in the context of the accessory liability principle acting dishonestly.... means simply not acting as an honest person would in the circumstances. This is an objective standard.’<sup>115</sup> In other words the relevant question here is not what the defendant thought personally, but rather what an honest person would have done if they had been placed in the same circumstances as the defendant.<sup>116</sup> If they fail to live up to this ‘honest person in the circumstances’ standard then they will be deemed to have failed the test. It was held in *Royal Brunei* that Tan did not act honestly and although Lord Nicholls accepted that Tan had ‘hoped, maybe expected, to be able to pay the airline’<sup>117</sup> but this subjective belief was not enough to satisfy the test for honesty. In his summation that the test is completely objective, which is worth quoting in full, he states:

At first sight this may seem surprising. Honesty has a connotation of subjectivity, as distinct from the objectivity of negligence. Honesty, indeed, does have a strong subjective element in that it is a description of a type of conduct assessed in the light of what a person actually knew at the time, as distinct from what a reasonable person would have known or appreciated.....However, these subjective characteristics of honesty do not mean that individuals are free to set their own standards of honesty in particular circumstances. The standard of what constitutes honest conduct is not subjective. Honesty is not an optional scale, with higher or lower values according to the moral standards of each individual. If a person

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<sup>111</sup> *Royal Brunei Airlines Sdn Bhd v Tan Kok Ming* [1995] 2 AC 378.

<sup>112</sup> *Baden v Societe Generale Pour Favousier le Developpement du Commerce et de L’Industrie en France SA* [1993] 1 WLR 509, 575-576.

<sup>113</sup> *Royal Brunei Airlines Sdn Bhd v Tan Kok Ming* [1995] 2 AC 378, 391.

<sup>114</sup> *Twinsectra Ltd v Yardley* [2002] 2 ALL ER 377, 174.

<sup>115</sup> *Ibid* 389.

<sup>116</sup> Alastair Hudson, *Equity and Trusts*, (6th edn, Routledge 2010) 893.

<sup>117</sup> *Royal Brunei Airlines Sdn Bhd v Tan Kok Ming* [1995] 2 AC 378, 393.



knowingly appropriates another's property, he will not escape a finding of dishonesty simply because he sees nothing wrong in such behaviour.<sup>118</sup>

The subtlety of Lord Nicholls's explanation is, by contrast, lacking in relation to the cases on the *bona fide* duty. In this regard he clarifies a point which is often confused in the *bona fide* case law. Honesty is an objective standard and the *bona fide* duty should be seen in the same way. The courts are generally applying such an objective test but often refer to it as a subjective test which causes confusion and is misleading for directors. The Irish courts have yet to address the standard to be applied in relation to dishonest assistance however in Delaney's view the Irish Courts would be very likely to follow Lord Nicholls test in *Royal Brunei*.<sup>119</sup> The judgment in *Twinsectra Ltd v Yardley*<sup>120</sup> seemed to introduce a subjective element into the test for honesty, however the decision of *Barlow Clowes*,<sup>121</sup> approved in *Abou-Rahmah v Abacha*,<sup>122</sup> has made it clear that the test for honesty remains objective. More recently the Court of Appeal case *Starglade Properties Ltd v Nash*<sup>123</sup> Eherton C rejected any element of subjectivity for the test for honesty stating that the subjective understanding of the person concerned, as to whether their conduct is dishonest, is irrelevant.<sup>124</sup>

In the *Barlow Clowes* case, £140 million had been given to Barlow Clowes by investors. Most of that money had been dissipated by the personal ventures of Clowes. Some of the investors' money was paid through a company called ITC and it had been claimed that two of ITC's directors had dishonestly assisted Clowes in misappropriating the investors' funds. Following an appeal by one of the directors to the Privy Council Lord Hoffman stated:

Although a dishonest state of mind is a subjective mental state, the standard by which the law determines whether it is dishonest is objective. If by ordinary standards a defendant's mental state would be characterised as dishonest, it is irrelevant that the defendant judges by different standards.<sup>125</sup>

One of the directors had argued at first instance that he lived by a different moral code and that his own moral standard simply meant following the instructions of his client. Lord Hoffman found that the director had an 'exaggerated notion of dutiful service to his clients, which produced a warped moral approach that it was not improper to treat carrying out clients' instructions as being all important. Mr. Henwood may well have thought this to be an honest attitude, but, if so, he was

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<sup>118</sup> Ibid, 389.

<sup>119</sup> Hilary Delaney, *Equity and The Law of Trusts in Ireland* (4th edn, Round Hall 2007), 250.

<sup>120</sup> *Twinsectra Ltd v Yardley* [2002] 2 ALL ER 377.

<sup>121</sup> *Barlow Clowes International Ltd (in Liquidation) v Eurotrust International Ltd* [2006] 1 WLR 1476.

<sup>122</sup> *Abou-Rahmah v Abacha* [2006] 1 ALL ER 827.

<sup>123</sup> *Starglade Properties Ltd v Nash* [2010] EWCA Civ 1314.

<sup>124</sup> Ibid, [32].

<sup>125</sup> *Barlow Clowes International Ltd (in Liquidation) v Eurotrust International Ltd* [2006] 1 WLR 1476, 1479-1480

wrong'.<sup>126</sup> In querying the judgment of *Extrasure*<sup>127</sup> it was questioned how it would be possible to prove to a court that a person could honestly hold an unreasonable belief.<sup>128</sup> The director in *Barlow Clowes* attempted to prove that he blindly followed every order from his clients, a clearly unreasonable approach for a director to adopt. Yet, seemingly, he genuinely thought this was the honest thing to do. If he could show that this was his approach to business then, under a subjective test, he would be deemed to have acted honestly and there would be every reason to expect that the defence of the director would have been accepted.<sup>129</sup> This example can be extended to *bona fide* duty where, if the director in *Barlow*, had blindly followed orders, even though to do so was obviously damaging to his company, and genuinely believed that it was for the benefit of the company, then under a subjective test he would satisfy the duty. Even though this subjectivist approach would yield irrational results, it is the test that Crow QC appeared to be advocating in *Extrasure*<sup>130</sup> and Parker J in *Regentcrest*.<sup>131</sup>

The pronouncement of an objective test for good faith would not represent any major departure from common law principles. A completely objective test is already in use in one very specific scenario: when a director fails to separately consider the company's best interests. If a director, when taking a decision, fails to consider what is best for the company as a separate legal entity then the test involved for acting *bona fide* becomes wholly objective. This follows the judgment in *Charterbridge v Lloyds Bank*.<sup>132</sup> Under this ruling a director does not breach the *bona fide* duty if he simply fails to consider separately the company's interests. There will only be a breach if a director has acted without separately considering the company's interest and there is no basis upon which a reasonable director could have reasonably concluded that the action was in the company's interests.<sup>133</sup> His Lordship made it very clear that this test was only to be used given that particular set of facts and the test set out in *Charterbridge v Lloyds Bank* only applies where a director fails to consider the company's interests and should be seen as a separate test than the standard one for *bona fides* action, however it does highlight that objective tests are already in operation in this area of law.

## 6.06 The Good Faith Duty as an Enforcement Mechanism

The argument of the above passages is that while the test for good faith is generally perceived to be a subjective test, it is an objective standard which is often being applied by the courts. The description of good faith as being subjective is most likely due to a desire not to interfere with the business

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<sup>126</sup> Ibid.

<sup>127</sup> *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598.

<sup>128</sup> See text to note 70.

<sup>129</sup> Alastair Hudson, *Equity and Trusts*, (6th edn, Routledge 2010), 893.

<sup>130</sup> *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598, 619. Text to note 67.

<sup>131</sup> See *Regentcrest plc v Cohen* [2001] 2 BCLC 80, 124.

<sup>132</sup> *Charterbridge Corporation Ltd v Lloyds Bank Ltd*. [1976] Ch.62.

<sup>133</sup> Derek French, Stephen Mason and Christopher Ryan, *Mayson, French and Ryan on Company Law*, (27th edn Oxford University Press 2010), 479.

judgment rule. The development of new case law providing a clear pronouncement of the objective standard of good faith, in a way similar to that of *Royal Brunei*, could provide the clarity necessary to increase compliance with the duty to act in the interests of the company. Stakeholder theory holds that directors can be trusted to adhere to their fiduciary duties.<sup>134</sup> It is true that even without an enforcement mechanism, many directors will comply with their duties. This is because the very existence of codified directors' duties has a normative and declaratory effect on director behaviour<sup>135</sup> and because most directors do wish to comply with their legal duties. Establishing a clear standard of good faith could amplify this declaratory effect on director behaviour because directors are less likely to breach a clear standard of behaviour as compared to the very complex and confusing statement of the law that currently exists. However, a declaratory effect by itself is not sufficient to ensure directors do comply with the duty to act in the interests of the company and directors' duties should be legally enforceable.<sup>136</sup> It is argued in this thesis that the best solution to the issue of the corporate objective is for directors to focus on the maximisation and sustainability of the company as a separate legal entity. It is submitted that this can be implemented through a general duty on directors to act in good faith in the interests of the company similar to section 228(1)(a) of the Companies Act 2014. However for this to be a workable model it must be possible for directors to be held to account when they fail to act in the interests of the company as an entity. The application of an objective test for good faith makes this possible. The duty to act in good faith in the interests of the company has many broad applications and can be invoked in many situations where directors do not promote the interests of the company.

For example a breach has been found in scenarios ranging from, directors acting in self-interest rather than the company's interests,<sup>137</sup> directors refusing to register shares in order to prevent a challenge to directors' salaries,<sup>138</sup> and directors transferring company funds to a holding company resulting in liquidation.<sup>139</sup> There has also been found to be a breach of the duty where an allotment of shares was in the interests of one shareholder rather than the company's interests as a whole<sup>140</sup> and where directors entered into a settlement agreement which resulted in a significant loss of earnings for the company.<sup>141</sup> In *Item Software Ltd v Fassihi*<sup>142</sup> the duty to act in the interests of the company was used

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<sup>134</sup> See Scott Reynolds, Frank Schultz and David Hekman, 'Stakeholder Theory and Managerial Decision Making: Constraints and Implications of Balancing Stakeholder Interests' (2006) 64 *Journal of Business Ethics* 285; Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar, 2011), 238.

<sup>135</sup> Deirdre Ahern 'Directors' Duties: Broadening the Focus Beyond Current Context to Examine the Accountability Spectrum' (2011) 33 *Dublin University Law Journal* 116, 119.

<sup>136</sup> Ellis Ferran, 'Corporate Law, Codes and Social Norms – Finding the Right Regulatory Combination and Institutional Structure' (2001) 1 *Journal of Corporate Law Studies* 381, 405.

<sup>137</sup> *Banfi v Moran et al* [2006] IEHC 257.

<sup>138</sup> *Re Hafner* [1943] IR 426.

<sup>139</sup> *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598.

<sup>140</sup> *Nash v Lancegaye Safety Glass (Ireland) Ltd* (1958) 92 ILTR 11.

<sup>141</sup> *Re Genosysis Technology* [2006] EWHC 989 Ch.

<sup>142</sup> *Item Software Ltd. (UK) Ltd v Fassihi* [2004] EWCA Civ 1244.

to establish a duty to confess a directors' own misconduct.<sup>143</sup> Arden LJ, in finding the defendant had breached the duty to confess, stated that the good faith duty 'was capable of application in cases where it had not been previously been applied'.<sup>144</sup> The above examples demonstrate that the duty to act in good faith can be used in many different situations where directors fail to act in the interests of the company. However, it is submitted that if the duty was actually perceived as objective it could increase the number of actions being taken because it would be more apparent when a director has actually failed honestly act in the interests of the company.

The aim of enforcement in this context, must act as incentive to adhere to the objective of entity maximisation and a deterrent from engaging in non-compliant action.<sup>145</sup> The most obvious way to initiate proceedings when there is a breach of the good faith is through a derivative action. In Ireland the method most frequently used to hold directors to account is the minority oppression remedy<sup>146</sup> under section 212 of the Companies Act 2014.<sup>147</sup> However this remedy is based on oppression of shareholders' individual rights rather than damage to the company as an entity and therefore remedy is not suited to instances where the directors have acted contrary to the entity's interests. Because the derivative action focuses on wrongs done to the company rather than oppression of a shareholder, it is well placed to enforce entity maximisation.<sup>148</sup> In addition one of the primary purposes of the derivative action is that it deters directors from acting improperly.<sup>149</sup> This deterrent purpose of the derivative action aligns well with the aim of enforcement under the proposed model as it focuses deterrence rather than frequent actions being taken against directors.

The derivative action allows a shareholder to sue a director on behalf of the company for a wrong committed against the company. Under the Companies Act 2014 and the UK Companies Act 2006 directors' fiduciary duties are owed to the company and not directly to shareholders or any other interest group<sup>150</sup> and the same was true at common law.<sup>151</sup> As a consequence, under the rule in *Foss v Harbottle*,<sup>152</sup> if a director breaches their duties to the company then it is the company who is the proper plaintiff.<sup>153</sup> The basis behind this rule is that the company is a separate legal entity which is

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<sup>143</sup> See Lusina Ho and Pey-Woan Lee, 'A Director's Duty to Confess; A Matter of Good Faith?' (2007) 66(2) *Cambridge Law Journal* 348.

<sup>144</sup> *Item Software Ltd. (UK) Ltd v Fassihi* [2004] EWCA Civ 1244, [41].

<sup>145</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar, 2011), 232.

<sup>146</sup> Thomas Courtney, *The Law of Companies*, (3rd edn, Bloomsbury 2012), 619.

<sup>147</sup> Formerly s 205 of the Companies Act 1963.

<sup>148</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar, 2011), 238

<sup>149</sup> Pearlie Koh, 'Directors' Fiduciary Duties: Unthreading the Joints of Shareholder Ratification' (2005) 5 *Journal of Corporate Law Studies* 363, 276.

<sup>150</sup> Companies Act 2014 s 224; UK Companies Act 2006 s 170(1).

<sup>151</sup> See *Percivil v Wright* [1902] 2 Ch 421. *Dawson International plc v Coats Platon plc* [1989] BCLC 233.

<sup>152</sup> *Foss v Harbottle* (1843) 67 ER 189.

<sup>153</sup> For application of the rule see *Connolly v Seskin Properties Ltd* [2012] IEHC 332; *Glynn and McCabe v Owen et al* [2007] IEHC 328; *Prudential Assurance Co Ltd v Newman Industries Ltd No.2* [1982] Ch 204, 210; *Edwards v Halliwell* [1950] 2 ALL ER 1064.

separate from its shareholders<sup>154</sup> and so is capable of taking actions on its own behalf. The second part of the rule in *Foss v Harbottle* is that minority shareholders may not bring proceedings to overturn a decision of the company where that decision is one which a majority of the members may confirm.<sup>155</sup> An explanation of the rule in *Foss v Harbottle* was given in *Edwards v Halliwell*,<sup>156</sup> which was quoted with approval in the Irish case of *Balkanbank v Taher*,<sup>157</sup> '[t]he proper plaintiff in an action in respect of a wrong alleged to be done to a company...is, *prima facie*, the company'.<sup>158</sup> As directors generally hold the powers of management, granted by the articles,<sup>159</sup> it is usually the directors who are charged with the power to litigate any wrong committed against the company. However when it comes to directors having wronged the company, the board of directors are not always best placed to decide whether to litigate. While it is possible for a board of directors to choose to act independently and take action against a director on behalf of the company,<sup>160</sup> a board are often unwilling to take action against fellow directors. As well as the board being unwilling to sue their fellow directors, the errant directors could still exercise control over the board making any legal action extremely unlikely. Boards have often refrained from taking action in such scenarios.<sup>161</sup> In response to this problem the common law developed the derivative action.<sup>162</sup>

For a shareholder to bring a derivative action they have to first establish standing to act on the company's behalf<sup>163</sup> because the shareholders' right to take an action is derived from the company's right to take action.<sup>164</sup> In order to establish standing on behalf of the company the shareholder has to prove that they fall within an exception to the rule of *Foss v Harbottle*. The main exception used for a derivative action is fraud on the minority by those in control. Under this exception the shareholder has to prove that the fraud was incapable of being ratified by the shareholders at a general meeting and that the wrongdoers were still in control of the company.<sup>165</sup> However the concepts of fraud on the minority and wrongdoer control are difficult to define and proving them is fraught with difficulties.<sup>166</sup> This is due to the exceptions to the rule in *Foss v Harbottle* being construed quite narrowly and

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<sup>154</sup> Ibid, 663.

<sup>155</sup> Thomas Courtney, *The Law of Companies*, (3rd edn, Bloomsbury 2012), 664.

<sup>156</sup> *Edwards v Halliwell* [1950] 2 ALL ER 1064.

<sup>157</sup> *Balkanbank v Taher* (January 1995, unreported) SC.

<sup>158</sup> Ibid, 35.

<sup>159</sup> Model Regulation 80, Table A of the First Schedule to the Companies Act 1963.

<sup>160</sup> See for example, *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113.

<sup>161</sup> Andrew Keay, *Directors' Duties* (Jordan 2009), 351.

<sup>162</sup> *Meiner v Hooper's Telegraph* (1874) 9 Ch App 350; *Mason v Harris* (1879) 11 Ch D 97.

<sup>163</sup> Joan Loughrey and Andrew Keay, 'Something Old, Something New, Something Borrowed: An Analysis of the New Derivative Action under the Companies Act 2006' (2008) 124 *Law Quarterly Review* 469, 476.

<sup>164</sup> *Wallersteiner v Moir (No 2)* [1975] 1 QB 373, 390; *Crindle Investments v Wymes* [1998] 4 IR 578, 594.

<sup>165</sup> *Prudential Assurance Co. Ltd v Newman Industries Ltd No.2* [1982] Ch 204, 219; *Connolly v Seskin Properties Ltd* [2012] IEHC 332, para 63.

<sup>166</sup> Demetra Arsalidou, 'Litigation Culture and the New Statutory Derivative Claim' (2009) 30(7) *Company Lawyer* 205, 206.

minority shareholders only being allowed access to the courts on a very limited basis.<sup>167</sup> A derivative action can be refused if it is not being brought in the interests of the company or if there was another remedy available to the shareholder.<sup>168</sup> Generally the courts have taken a restrictive attitude towards derivative actions.<sup>169</sup> Due to the narrow construction of exceptions to the rule in *Foss v Harbottle* very few common law derivative actions have been successful<sup>170</sup> with Ahern describing the exceptions to the rule in *Foss v Harbottle* as being ‘at best arcane, and, at worst, unwieldy and ill-suited to modern corporate life’.<sup>171</sup>

Despite the suitability for the derivative action to act as an enforcement mechanism for an entity focused approach to the corporate objective, the derivative action has proven to be ineffective in enforcing directors’ duties.<sup>172</sup> The Companies Act 2014 has not created a legislative derivative action and so the common law rules still apply. Even if the Companies Act 2014 had established a statutory derivative action and removed the rule in *Foss v Harbottle*, it is unlikely that the derivative action would have provided the means to regularly enforce of the duty to act in good faith. Such a statutory has been implemented under the UK Companies Act 2006 but it has done little to change the effectiveness of the derivative action as an enforcement mechanism to enforce directors’ duties.

### 6.07 The Statutory Derivative Claim and Enforcement under ESV

The difficulties involved in taking derivative actions under the common law rules prompted recommendations of reform in the UK<sup>173</sup> which led to a statutory right to a derivative action being introduced by the UK Companies Act 2006.<sup>174</sup> The 2006 Act completely overrides the common law action and removes the concepts of fraud on the minority and wrongdoer control.<sup>175</sup> The statutory derivative claim is a cause of action which is vested in the company and seeks relief on behalf of the company, but is taken by a member.<sup>176</sup> The grounds for taking a derivative claim have been expanded

<sup>167</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law* (8th Edn, Sweet and Maxwell, 2008), 610.

<sup>168</sup> See *Barret v Duckett* [1995] BCC 362.

<sup>169</sup> Julia Tang, ‘Shareholder Remedies: Demise of the Derivative Claim’ (2012) 1(2) *UCL Journal of Law and Jurisprudence* 178, 180.

<sup>170</sup> Demetra Arsalidou, ‘Litigation Culture and the New Statutory Derivative Claim’ (2009) 30(7) *Company Lawyer* 205, 205; David Kershaw, ‘The Rule in *Foss v Harbottle* is Dead: Long Live the Rule in *Foss v Harbottle*’ (2015) 3 *Journal of Business Law* 274, 274.

<sup>171</sup> Deirdre Ahern ‘Directors’ Duties: Broadening the Focus Beyond Current Context to Examine the Accountability Spectrum’ (2011) 33 *Dublin University Law Journal* 116, 128.

<sup>172</sup> See Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press, 2007), 230 Andrew Keay, ‘An Assessment of Private Enforcement Actions for Directors’ Breaches of Duty’ (2014) 33(1) *Civil Justice Quarterly* 76, 90.

<sup>173</sup> The Law Commission, *Shareholder Remedies* (No. 246, 1997), Part 6 available at [http://lawcommission.justice.gov.uk/docs/lc246\\_Shareholder\\_Remedies.pdf](http://lawcommission.justice.gov.uk/docs/lc246_Shareholder_Remedies.pdf). See also the CLRS, *Modern Company Law for A Competitive Economy: Final Report Volume 1* (DTI, 2001), 18.

<sup>174</sup> UK Companies Act 2006 s 260-269.

<sup>175</sup> Explanatory Notes to the Companies Act 2006 para 491.

<sup>176</sup> UK Companies Act 2006 s 260(1).

to cases of negligence, default, breach of duty or breach of trust by a director.<sup>177</sup> Therefore a breach of the good faith provides sufficient grounds to take a derivative claim. The statutory derivative claim involves two separate hearings. The applicant must first establish *prima facie* case<sup>178</sup> and then seek permission of the court to continue the action.<sup>179</sup> At the second stage the court must refuse the application if a person acting in accordance with section 172 would not seek to continue the claim or the act or omission in question has been either authorised or ratified by the company.<sup>180</sup> If the action is not dismissed on those grounds then the court must consider the following seven factors to allow permission for the action to continue:

- (a) whether the member is acting in good faith in seeking to continue the claim;
- (b) the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it;
- (c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be;
  - (i) authorised by the company before it occurs, or
  - (ii) ratified by the company after it occurs;
- (d) where the cause of action arises from 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;
- (e) whether the company has decided not to pursue the claim; .
- (f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.<sup>181</sup>

Once the director's action has not been and not likely to be authorised or ratified and the action is not being taken in bad faith, the success of the claim is likely to depend whether the action promotes the success of the company in line with section 172. Firstly a claim must be refused permission if a person, acting in accordance with section 172, would not continue the claim.<sup>182</sup> The second examination of section 172 is in determining whether to grant permission to continue the claim the court must consider the importance that a person, acting in accordance with section 172, would attach

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<sup>177</sup> Ibid s 260(3).

<sup>178</sup> Ibid s 261(2).

<sup>179</sup> Ibid s 261 (4).

<sup>180</sup> UK Companies Act 2006 s 263(2).

<sup>181</sup> Ibid s 263(3).

<sup>182</sup> Companies Act 2006 s 263(2).

to the claim.<sup>183</sup> This is a more difficult criterion to pass for potential claimants and is assessed by an objective standard.<sup>184</sup> The standard which the courts have applied in recent cases is whether a hypothetical director, acting in accordance with section 172, would continue to the claim<sup>185</sup> i.e. would a hypothetical director view the action to be in the interests of the company. In order to meet this criterion the claimant must be able to show that the company will stand to benefit from the action.<sup>186</sup> Therefore, harm to the company is unlikely to be enough for the action to be continued and there must be something for the company to gain from the action. In *Franbar Holdings Ltd v Patel*<sup>187</sup> William Tower QC (sitting as a deputy judge of the High Court) considered the requirement that the claim be in the interests of the company stating that it would include considering the prospects of success, the likelihood of the company being able to recover property or money, potential damage to the company's reputation if the action was successful and how disruptive the action would be to the business.<sup>188</sup> These requirements demonstrate that any potential derivative action still has to overcome a significant number of criteria in order to be allowed to proceed.

ESV has been widely criticised for its inability to enforce the requirement for directors to have regard to the various stakeholder interests contained in section 172(1). In the absence of legislative reform, enforcement of the requirement to have regard to stakeholder interests is the obvious method to ensure movement away from the strict application of shareholder value. Is it possible that an objective test for good faith and the statutory derivative claim could ensure directors do actually have regard to the non-shareholder interests? Section 172(1) states '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 to' the listed interests such as employees, suppliers, the community etc. Girvin et al believe the verb 'must' qualifies the entire provision and requires that every non-shareholder interest should always be considered and the result is to make the listed stakeholders 'issues which directors are compelled to consider as part of their duties as directors'.<sup>189</sup> While this overstates the effect of section 172(1), it is submitted, as indicated by the words 'in doing so', that directors are required to consider the non-shareholder interests which are relevant to promoting the success of the company for the benefit of the members. Due to the clear prioritisation of the members, directors will only breach the duty to act in good faith when they fail to

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<sup>183</sup> Ibid 263(3)(a).

<sup>184</sup> Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press, 2007), 156; Joan Loughrey and Andrew Keay, 'Something Old, Something New, Something Borrowed: An Analysis of the New Derivative Action under the Companies Act 2006' (2008) 124 *Law Quarterly Review* 469, 492.

<sup>185</sup> *Sukhpaul Singh v Satpal Singh* [2013] EWHC 2138 (Ch), [43]; *Franbar Holding Ltd v Patel* [2008] EWHC 1534; *Mission Capital Plc v Sinclair* [2008] EWHC 1339.

<sup>186</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law* (8th edn, Sweet and Maxwell, 2008), 605.

<sup>187</sup> *Franbar Holding Ltd v Patel* [2008] EWHC 1534.

<sup>188</sup> Ibid, [36].

<sup>189</sup> Stephn Girvin, Sandra Frisby and Allastair Hudson, *Charlesworth's Company Law* (18th edn, Sweet and Maxwell 2010), 330.



promote the success of the company for the benefit of the members. However it is submitted that directors can breach the duty to act in good faith if they fail to consider a listed interest which was relevant to promoting the success of the company and that failure harms the company's ability to promote success for the members.

Davies is of the opinion that the duty of good faith does offer the potential for directors to be found in breach when they fail to consider the non-shareholder listed factors under section 172(1).<sup>190</sup> The reform of the derivative claim by the Companies Act 2006 allows an action to be taken against a director for any breach of duty.<sup>191</sup> The requirement to prove an exception to the rule in *Foss v Harbottle* and wrongdoer control have been removed which, in theory at least, makes it easier for shareholders to commence actions against directors.<sup>192</sup> By clarifying the standards that directors must meet and the threat of a derivative claim, the good faith duty and derivative claim could act as an incentive to consider directors to actually consider the listed interests. The expansion of the grounds available under the statutory derivative claim could make directors feel more exposed for any breach of duty<sup>193</sup> and so more likely to consider the listed interests to decrease the likelihood of a derivative claim. It has been suggested that section 172(1), coupled with the statutory derivative claim, increases the chances of non-shareholder consideration by directors.

it is at least possible though, that directors seeking to minimise ex ante the risks of derivative action, may take the view that section 172 requires them to consider the long term consequences of their decisions and the other statutory factors when reaching decisions, where they had not done so previously.<sup>194</sup>

Due to the objective test, directors can be found in breach of their good faith duty by failing to have regard to the listed interests. The way for the derivative claim to work as an enforcement mechanism for ESV would be for a derivative claim to be successful where a director failed to give good faith consideration to a listed interest in section 172(1). For this to occur three main elements would be necessary.

Firstly, the shareholder taking the derivative claim would need to have a particular interest in the infringed stakeholder group. For example a shareholder who is also an employee or a shareholder who is particularly concerned with the local community or the environment. In addition, shareholders who have a long term perspective could take a derivative claim on the basis that the directors have taken a

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<sup>190</sup> Paul Davies, *Gower and Davies Principles of Modern Company Law* (8<sup>th</sup> Edn, Sweet and Maxwell 2008), 514.

<sup>191</sup> UK Companies Act 2006 s 260(3).

<sup>192</sup> Demetra Arsalidou, 'Litigation Culture and the New Statutory Derivative Claim' (2009) 30(7) *Company Lawyer* 205, 209.

<sup>193</sup> *Ibid*, 207.

<sup>194</sup> Luca Cerioni, Joan Loughrey and Andrew Keay 'Legal Practitioners, Enlightened Shareholder Value and the Shaping of Corporate Governance' (2008) 8 *Journal of Corporate Law Studies* 79, 100.

short term approach contrary to section 172(1)(a) and could be successful despite rhetoric from directors to the contrary.<sup>195</sup> This type of shareholder behaviour is known as shareholder activism and is becoming more widespread.<sup>196</sup> It has been asserted that the legislative derivative claim makes it easier for activist shareholders to take proceedings<sup>197</sup> and that increased shareholder activism may lead to increased number of derivative actions.<sup>198</sup> Milner-Moore and Lewis hold the belief that the statutory derivative claim coupled with section 172(1) could allow activist shareholders, like environmental groups with a small shareholding, to bring tactical litigation against the directors.<sup>199</sup> Keay, is of the belief that it could be worthwhile for stakeholders to become minor shareholders so that they have the last resort of a derivative claim should they feel the directors had disregarded their interests, although states that there is a low chance of many such actions being brought.<sup>200</sup> There seems to be nothing to prevent a stakeholder taking up a small shareholding to initiate a derivative claim, for example in *Stainer v Lee*<sup>201</sup> the claimant had only a 0.08% shareholding.

Secondly, any derivative claim taken on stakeholder grounds would have to be based on a breach of good faith under section 172(1). Section 172(1) defines company success in terms of benefit to the members, so, for there to be a breach of duty it must be possible to demonstrate that the directors' failure to consider stakeholder interests had damaged the company's ability to promote the members' interests. For a breach of good faith to exist and for permission to be granted to continue a derivative claim there must have been damage caused to the company by a director and so any action based solely on damage to a stakeholder would fail. The requirement that the directors' decision causes harm to the company should not be seen as a negative from an enforcement point of view. An ability to take a derivative claim based purely on damage to stakeholder interests presents too broad a scope for director liability. Directors being sued for every decision which negatively impacts a stakeholder group would clearly not be in the interests of the company from either a shareholder or stakeholder point of view. However when the failure to consider stakeholder interests actually damages the company as an entity, or damages the company's ability to promote the members' interests, directors should be held liable for a breach of duty. There is also a requirement that the claim itself must be capable of providing some tangible benefit to the company. An action based on directors damaging the company by failing to have regard to stakeholders will not be sufficient, it must also be possible to

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<sup>195</sup> Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge, 2012), 119.

<sup>196</sup> Deirdre Ahern 'Directors' Duties: Broadening the Focus Beyond Current Context to Examine the Accountability Spectrum' (2011)33 *Dublin University law Journal* 116, 127.

<sup>197</sup> Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press, 2007), 162.

<sup>198</sup> Andrew Keay, *Directors' Duties* (Jordan, 2009), 353.

<sup>199</sup> Gary Milner-Moore and Rupert Lewis "In the line of Fire" – Directors' Duties under the Companies Act 2006' *Practical Law* available at <http://us.practicallaw.com/9-205-9008>, 4.

<sup>200</sup> Andrew Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge, 2012), 140.

<sup>201</sup> *Stainer v Lee* [2010] EWHC 1539 (Ch).

regain some wealth for the company through the derivative claim. While this makes it difficult for an action on stakeholder grounds to be granted permission it is not impossible for such scenarios to exist. A directors' action which has an adverse impact on stakeholder groups could also easily be detrimental to the company<sup>202</sup> and in severe cases directors' breach of section 172(1) on stakeholder grounds might well cause damage to the company.<sup>203</sup> Damage to the company as an entity could easily be seen as damaging its ability to promote the members' interests.

Finally, as has been argued for above, the courts would need to view the duty of good faith by an objective standard otherwise a court finding a director in breach of their good faith duty would be unlikely. Whenever it is alleged that there has been a failure to consider one of the listed interests, the directors are likely to justify their actions by reference to their good faith judgment<sup>204</sup> and claim they have acted to promote the success of the company for the benefit of the members. In order to prove that a director had indeed breached their duty under section 172(1), the shareholder would have to challenge the directors' good faith.<sup>205</sup> This is not as difficult as is perceived due the objective test which is often being applied.

While it is submitted there is a legal basis for a derivative claim based on damage to stakeholders to be successful, it is unlikely that many such claims will be successful. This is because of the continuing restrictive approach taken by the courts and the costly nature of derivative claims. For such an action to be successful it would require a wealthy shareholder, with a stakeholder interest, coupled with the courts taking a less restrictive view of the derivative claim. The courts under the derivative claim statute have continued the trend of the common law by treating derivative actions in a restrictive way with several cases not making it past the initial stage.<sup>206</sup> Despite the derivative claim legislation appearing to have widened the scope for potential actions, in reality, many of the same difficulties in taking a derivative action remain from the common law.<sup>207</sup> In many cases the courts have stated that shareholder grievances are best resolved through unfair prejudice proceedings under section 994<sup>208</sup> which is only open to shareholders. Reisberg argues that the courts will continue to be suspicious of

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<sup>202</sup> Pearlie Koh, 'The Statutory Derivative in Singapore Action: A Critical and Comparative Examination' (2001)13(1) *Bond Law Review* 64, 65.

<sup>203</sup> Andrew Keay, 'An Assessment of Private Enforcement Actions for Directors' Breaches of Duty' (2014) 33(1) *Civil Justice Quarterly* 76, 109.

<sup>204</sup> Julia Tang, 'Shareholder Remedies: Demise of the Derivative Claim' (2012) 1(2) *UCL Journal of Law and Jurisprudence* 178, 180.

<sup>205</sup> Luca Cerioni, Joan Loughrey, Andrew Keay 'Legal Practitioners, Enlightened Shareholder Value and the Shaping of Corporate Governance' (2008) 8 *Journal of Corporate Law Studies* 79, 107.

<sup>206</sup> See *Iesini v Westrip Holdings* [2009] EWHC 256 (Ch); *Stimpson v Southern Landlords Association* [2009] EWHC 2072 (Ch).

<sup>207</sup> David Kershaw, 'The Rule in Foss v Harbottle is Dead: Long Live the Rule in Foss v Harbottle' (2015) 3 *Journal of Business Law* 274, 276.

<sup>208</sup> See *Sukhpaul Singh v Satpal Singh* [2013] EWHC 2138 (Ch), [45]. *Franbar Holding Ltd v Patel* [2008] EWHC 1534. *Mission Capital Plc v Sinclair* [2008] EWHC 1339 (Ch).

derivative actions and will potentially become even more reluctant to allow actions succeed.<sup>209</sup> Another issue with derivative actions is costs and even if successful, any financial gain from the claim will be owed to the company as the derivative claim is taken on behalf of the company which acts as a disincentive for potential claimants. The two step procedure involved in the statutory derivative claim is an issue as the costs associated with even the preliminary process can be significant.<sup>210</sup> In England and Wales the general rule is that the loser pays the costs which opens the shareholder to a significant bill if unsuccessful. Since *Wallersteiner v Moir (No 2)*<sup>211</sup> the English Courts have been able to indemnify costs of a shareholder and such orders have been given in *Kiani v Cooper*<sup>212</sup> and *Stainer v Lee*.<sup>213</sup> However the order to indemnify costs will be only be awarded if the shareholder is granted permission to continue and even then there is no guarantee, in *Parry v Bartlett*<sup>214</sup> no such order was given despite the shareholder gaining permission. Perhaps one of the few ways action could be taken on stakeholder grounds and still be practically feasible, would be where a director opts for short term shareholder gain by acting to the detriment of a stakeholder group. If the decision cost the company financially in the long term, Gibbs argues that the damage caused to the company could outweigh the substantial financial costs of a claim, given the right set of circumstances. He uses the example of where disregarding employee interests would have a negative effect on the company in the long term.<sup>215</sup> Given that no stakeholder based derivative claim has been taken in any of the reported judgments the right set of circumstances seem to be difficult to find.

Given the practical difficulties in taking derivative claims other methods of enforcement under ESV should be examined. Through the UK Insolvency Act 1986 a liquidator can take an action on the company's behalf against a director who has breached their duties to the company.<sup>216</sup> This procedure led to many of the common law cases against directors for alleged breaches of the duty to act *bona fide* in the interests of the company. An action purely for the benefit of a stakeholder group would require somewhat of an altruistic liquidator<sup>217</sup> and such an action taken through good faith under section 172(1) would be likely fail without some damage to the company or to the members. However where the directors' failure to consider a stakeholder interests damaged the company or the company's ability to promote wealth for the members, the likelihood of success of such an action

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<sup>209</sup> Arad Reisberg, 'Shadows of the Past and Back to the Future: Part 11 of the UK Companies Act 2006 (in)action' (2009) 6 *European Company and Financial Law Review* 219, 225.

<sup>210</sup> Andrew Keay, 'An Assessment of Private Enforcement Actions for Directors' Breaches of Duty' (2014) 33(1) *Civil Justice Quarterly* 76, 87.

<sup>211</sup> *Wallersteiner v Moir (No 2)* [1975] 1 QB 373.

<sup>212</sup> *Kiani v Cooper* [2010] EWHC 577 (Ch).

<sup>213</sup> *Stainer v Lee* [2010] EWHC 1539 (Ch).

<sup>214</sup> *Parry v Bartlett* [2011] EWHC 3146 (Ch).

<sup>215</sup> David Gibbs, 'Has the Statutory Derivative Claim Fulfilled its Objectives? The Hypothetical Director and CSR: Part 2' (2011) 32(3) *Company Lawyer* 76, 81.

<sup>216</sup> UK Insolvency Act 1986 s 165(3) and s 167(1)(a) and schedule 4 para 4

<sup>217</sup> Thomas Courtney, *The Law of Companies* (3rd Edn, Bloomsbury, 2012), 874.

would increase and the requirement of an altruistic liquidator would no longer be necessary as the company's interests would have been infringed as well as the stakeholders.

Further, the UK Insolvency Act 1986 allows liquidators and creditors to request the court to review the conduct of a person involved in the management of a company, if that person appears to be in breach of their duties.<sup>218</sup> Where it is found that a director has been in breach, the court can order the director to contribute compensation to the company as the court thinks just.<sup>219</sup> Again there is the potential for liquidators and creditors to take action against directors for a breach of section 172(1) for failing to consider stakeholder interests if that failure damages the company. If that failure amounted to a financial loss for the company it is easily conceivable for a creditor or liquidator to take such steps. From a practical point of view a liquidator's ability to reclaim the costs of litigation conducted on the company's behalf may also make it more likely for them to take an action against a director in comparison to an activist shareholder through a derivative action. Williams, while acknowledging the potential for section 212 to enforce the ESV principles, believes that the vague nature of the duties owed through section 172(1) makes the likelihood of such actions low.<sup>220</sup> He goes on to state that any litigation under section 172 will be clouded in uncertainty because of this vagueness inherent in the standard of liability.<sup>221</sup> Williams' argument is precisely why the change of perception of good faith is necessary to enforce ESV. An objective assessment of honesty in good faith establishes a clear standard of liability and allows directors to be held in breach of their duty based on stakeholder grounds if the breach also harms the company. Should the good faith duty become a clear standard of director behaviour as is argued for in this thesis, then the possibility of actions being taken under section 212 would increase.

In addition to a liquidator taking action against directors for breach of duty, disqualification also can be a valuable tool to influence director behaviour and protect the company as an entity from abuse.<sup>222</sup> The courts have made frequent use of the disqualification legislation with 1054 disqualifications in 2013-14<sup>223</sup> and the numbers have been at a similar level over the past 4 years.<sup>224</sup> The rules on disqualification in the UK have arisen in response to the limitations of traditional mechanisms in effectively disciplining directors.<sup>225</sup> Pursuant to the Company Directors Disqualification Act 1985,

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<sup>218</sup> UK Insolvency Act 1986, s 212(1).

<sup>219</sup> Ibid s 212(3).

<sup>220</sup> Richard Williams, Enlightened Shareholder Value in UK Company Law (2009) 35 *University of New South Wales law Journal* 360, 369.

<sup>221</sup> Ibid, 367.

<sup>222</sup> David Milman, 'Disqualification of Directors: An Evaluation of Current Law, Policy and Practice in the UK' 331 *Company Law Newsletter* 1, 1.

<sup>223</sup> Statistical Tables, Section D Legal Proceedings Table D1 (Companies House, 2014) available at [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/380782/copy\\_of\\_companiesregisteractivities2013-2014.xls](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/380782/copy_of_companiesregisteractivities2013-2014.xls).

<sup>224</sup> Ibid, 1,337 disqualifications in 2009-10; 1,389 in 2010-11; 1,368 in 2011-12; 819 in 2012-13.

<sup>225</sup> Richard Williams, Enlightened Shareholder Value in UK Company Law (2009) 35 *University of New South Wales law Journal* 360, 370.

directors can be disqualified if a director of an insolvent company is deemed ‘unfit to be concerned in the management of a company’.<sup>226</sup> Disqualification can last 2-15<sup>227</sup> years and is a complete bar on being a director of a registered company in the UK.<sup>228</sup> A disqualification order can be made by a court who is winding up the company or in the case of a voluntary winding up, the court with jurisdiction to wind up the company.<sup>229</sup> Generally there is a broad scope as to what qualifies as being unfit to be a director a company.<sup>230</sup> The factors to be considered when making such orders come from schedule 1 and include a breach of ‘any fiduciary duty by the director in relation to the company’.<sup>231</sup> As one of the grounds mentioned in schedule 1 is a breach of duty, it is possible for directors to be disqualified for a breach of good faith under section 172(1) and disqualification orders have been given for acting in the detriment of employee interests.<sup>232</sup> Interestingly another element to be considered is ‘the extent of the director’s responsibility for any failure by the company to supply any goods or services which have been paid for’<sup>233</sup> which is presumably designed to allow for disqualifications against directors who have acted contrary to creditor or customer interests.

#### **6.08 Public Enforcement of Directors’ Duties**

The potential remedies discussed above are private actions based on a breach of good faith under section 172(1). Because the members’ interests are prioritised by section 172(1), in order for there to be a breach of good faith the company’s ability to promote the success of the members must be damaged. Therefore any damage to stakeholder interests, no matter how extensive, will not breach good faith under ESV if there is no damage to the members’ interests. This makes the good faith duty an unsatisfactory remedy for enforcing purely stakeholder interests. Instead, a superior method to ensure directors take into account stakeholder interests would be enforcement through a provision free of the requirement to prioritise members’ interests. One such provision is contained in the Company Directors Disqualification Act 1986 as sections 7 and 8 allow for the Secretary of State to take an action against a director if it is in the public interest to do so.<sup>234</sup> Hence the Act, establishes grounds for disqualification free of the requirement of a breach of good faith under section 172(1) and the prioritisation of members’ interests. This public interest criterion potentially grants a wide discretion to the Secretary of State<sup>235</sup> and disqualification orders could be taken under a broad range of

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<sup>226</sup> UK Company Directors Disqualification Act 1986 s 6(1).

<sup>227</sup> Ibid s 6(4).

<sup>228</sup> Ibid s 1(A)(1).

<sup>229</sup> Ibid, 1986 s 6(3).

<sup>230</sup> See Vanessa Finch, ‘Disqualifying Directors: Issues of Rights, Privileges and Employment’ (1993) 22 *Industrial Law Journal* 35, 35.

<sup>231</sup> UK Company Directors Disqualification Act 1986 s 9(1) and Schedule 1(1).

<sup>232</sup> See *Re Omaglass Ltd* (unreported, 6 April 1995).

<sup>233</sup> UK Company Directors Disqualification Act 1986 s 9(1)(A) and Schedule 1(7).

<sup>234</sup> UK Company Directors Disqualification Act 1986 s 7(1) and s 8(1).

<sup>235</sup> Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (2<sup>nd</sup> edn, Cambridge University Press, 2009), 729.

stakeholder interests.<sup>236</sup> The Secretary of State could deem that if directors acted to the detriment of stakeholders such as the community, the environment, or employees, it would be contrary to the public interest and seek for the director to be disqualified.

Perhaps the best way to establish a less shareholder orientated model of the corporate objective in the UK is for the Secretary of State to increase the frequency of disqualification orders under the public interest provisions. If the Secretary of State became willing to use the broad powers granted by the Company Directors Disqualification Act, directors may well start embracing the principles of ESV to ensure they remained free of disqualification. This would require the Secretary of State to start acting as a public enforcer of directors' duties. Private enforcement generally is seen as unlikely to provide regular and effective enforcement of directors' duties.<sup>237</sup> As discussed in Chapter four the Company Law Review Steering Group (CLRSG) viewed methods other than private enforcement as the best way to ensure consideration of the listed interests instead recommending increased reporting and transparency standards.<sup>238</sup> Given that ESV is more shareholder focused than the common law, the protection of stakeholder interests through public enforcement would provide some balance to the existing corporate governance model in the UK and would be welcomed by the pluralists who were angered by the removal of the OFR.<sup>239</sup> However it seems unlikely that the Secretary of State will start acting as a public enforcer of directors' duties. The Secretary of State has been, to date, unwilling to take many actions for disqualification with very few orders being given under the public interest provision. No such disqualifications took place in 2013-14 with only one in 2012-13.<sup>240</sup> There is also the problem of any intervention by the Secretary of State being arbitrary or politically motivated rather than acting in the interests of justice or fairness.<sup>241</sup>

The conclusion from the above discussion is that the requirement under ESV to consider stakeholder interests is likely to continue to go unenforced. Currently the UK relies heavily on private methods of enforcement for breaches of directors' duties,<sup>242</sup> however these methods are ineffective in enforcing the stakeholder element of ESV. This is due to practical difficulties with the statutory derivative claim

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<sup>236</sup> Richard Williams, *Enlightened Shareholder Value in UK Company Law* (2009) 35 *University of New South Wales Law Journal* 360, 372.

<sup>237</sup> See John Armour, Bernard Black, Brian Cheffins, Richard Nolan, 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and United States' (2009) 6 *Journal of Empirical Legal Studies* 687.

<sup>238</sup> CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI, 1999) para 5.1.44.

<sup>239</sup> Andrew Keay, 'An Assessment of Private Enforcement Actions for Directors' Breaches of Duty' (2014) 33(1) *Civil Justice Quarterly* 76, 109.

<sup>240</sup> Statistical Tables, Section D, Legal Proceedings, Table D1 (Companies House, 2014) available at [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/380782/copy\\_of\\_companiesregisteractivities2013-2014.xls](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/380782/copy_of_companiesregisteractivities2013-2014.xls). There have been similarly low numbers in previous years. 12 disqualifications by the Secretary of State under s 8 in 2010-11 and only 6 in 2011-12.

<sup>241</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 250.

<sup>242</sup> Andrew Keay, 'The Public Enforcement of Directors' Duties: A Normative Inquiry' (2014) 43 *Common Law World Review* 89, 90.

and problems with proving a breach of section 172(1) due to the prioritisation of shareholders' interests. In addition there seems to be a reluctance to adopt a public style enforcement approach to directors' duties as the Secretary of State seems reluctant to utilise the powers granted to take disqualification orders in the public interest.

In Ireland however, the public enforcement of directors' duties has become a key driver in relation to standard setting for directors.<sup>243</sup> Undoubtedly, public enforcement of directors' duties has the potential to enhance corporate governance<sup>244</sup> and has advantages over private enforcement. As Parkinson notes 'deterrence, and the creation and refinement of standards of conduct and performance, have the quality of 'public goods' which private enforcers, perusing only private gain are liable to under produce'.<sup>245</sup> Public enforcement allows for a wider representation of interests<sup>246</sup> as private enforcement mechanisms, such as derivative actions and minority oppression remedies, are available only to shareholders. Actions taken by public bodies have the potential to represent stakeholders' interests or the public interest. In addition, public enforcement is likely to have a greater deterrent effect than private enforcement<sup>247</sup> as there is likely to be much more reputational damage to a director from a public enforcement regime as compared to private litigation.<sup>248</sup> The potential for reputational damage was noted by Hardiman J in the restriction case of *Re Tralee Beef and Lamb Ltd*<sup>249</sup> where he stated a restriction order is 'gravely damaging to the reputation of a person thus afflicted'.<sup>250</sup>

The trend of Irish law moving towards public enforcement of directors' duties can be traced back to the McDowell Report<sup>251</sup> which highlighted a culture of non-compliance with company law.<sup>252</sup> The report found that existing law had no deterrent effect upon directors concluding, 'those who are tempted to make serious breaches of company law have little reason to fear detection or prosecution'.<sup>253</sup> The report led to the establishment of the Office of the Director for Corporate Enforcement (ODCE).<sup>254</sup> The role of the director is to enforce the Companies Acts, to encourage

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<sup>243</sup> Deirdre Ahern 'Directors' Duties: Broadening the Focus Beyond Current Context to Examine the Accountability Spectrum' (2011) 33 *Dublin University Law Journal* 116, 142.

<sup>244</sup> Andrew Keay, 'An Assessment of Private Enforcement Actions for Directors' Breaches of Duty' (2014) 33(1) *Civil Justice Quarterly* 76, 92.

<sup>245</sup> John Parkinson, *Corporate Power and Responsibility: The Issues in the Theory of Company Law* (Clarendon Press, 1993), 238.

<sup>246</sup> Andrew Keay, 'The Public Enforcement of Directors' Duties: A Normative Inquiry' (2014) 43 *Common Law World Review* 89, 108.

<sup>247</sup> Howell Jackson and Mark Roe, 'Public and Private Enforcement of Securities Laws: Resource Based Evidence' (2009) 93 *Journal of Financial Economics* 207, 208.

<sup>248</sup> Andrew Keay, 'The Public Enforcement of Directors' Duties: A Normative Inquiry' (2014) 43 *Common Law World Review* 89, 110.

<sup>249</sup> *Re Tralee Beef and Lamb Ltd* [2008] 2 ILRM 420.

<sup>250</sup> *Ibid*, 427.

<sup>251</sup> Report of the Working Group on Company Law Compliance (The McDowell Report), (1998).

<sup>252</sup> *Ibid* para 2.4.

<sup>253</sup> *Ibid* para 2.5.

<sup>254</sup> Company Law Enforcement Act 2001, Part 2.



compliance with the Companies Acts and to investigate offences under the Companies Acts.<sup>255</sup> Since the establishment of the ODCE corporate law enforcement in Ireland has improved significantly as the ODCE has taken an aggressive approach to ensuring compliance with the Companies Acts<sup>256</sup> and a new practice of active enforcement has evolved in Ireland.<sup>257</sup> As well as pursuing disqualification and restriction orders, the ODCE has sought to ensure a greater awareness among directors of the provisions of the Companies Acts with a view to increasing compliance.<sup>258</sup> Prior to the enactment of the Companies Act 2014 directors' fiduciary duties fell outside the scope of the ODCE as they were derived from common law rules and equitable doctrines and were not enshrined in statute.<sup>259</sup> However after the introduction of the Companies Act 2014, directors' fiduciary duties are now enacted in statute<sup>260</sup> and will be under the remit of the ODCE. As a result the ODCE can now use its powers to investigate suspected breaches<sup>261</sup> of directors' fiduciary duties and seek to ensure compliance with the duty to act in the interests of the company.

Given that the statutory directors' duties now fall within the remit of the ODCE the most effective method of public enforcement would be for the ODCE to initiate proceedings against directors for a breach of duty. This would have a significant deterrent effect on directors and, as Keay notes, the existence of a potential action being brought by a public authority could well lead to improved director behaviour.<sup>262</sup> The Companies Act 2014 states that it is a function of the ODCE 'to enforce this Act, including by the prosecution of offences by way of summary proceedings'.<sup>263</sup> However this power is likely to be reserved for the most serious of corporate offences such as fraudulent or reckless trading<sup>264</sup> rather than for breaches of fiduciary duties. The primary difficulty with the ODCE taking actions against directors for breaches of fiduciary duty would be the strain placed on its resources. Enforcing the Companies Acts is already an extremely broad remit and a rigorous enforcement of the fiduciary duties listed in section 228 of the Companies Act 2014 would require the ODCE to be given significantly increased funding.

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<sup>255</sup> Companies Act 2014 s 945.

<sup>256</sup> Irene Lynch-Fannon and Gerard Murphy, *Corporate Insolvency and Rescue* (2<sup>nd</sup> edn, Bloomsbury, 2012), 17.

<sup>257</sup> Joanne Corbett, 'Directors' Disqualification – Has Enforcement Legislation Changed Practice in Ireland?' (2009) 9 *Commercial Law Practitioner* 189, 204.

<sup>258</sup> Irene Lynch-Fannon and Gerard Murphy, *Corporate Insolvency and Rescue* (2<sup>nd</sup> edn, Bloomsbury, 2012), 18.

<sup>259</sup> Deirdre Ahern 'Directors' Duties: Broadening the Focus Beyond Current Context to Examine the Accountability Spectrum' (2011) 33 *Dublin University Law Journal* 116, 140.

<sup>260</sup> Companies Act 2014 s 228.

<sup>261</sup> Companies Act 2014 s 949(1)(b).

<sup>262</sup> Andrew Keay, 'The Public Enforcement of Directors' Duties: A Normative Inquiry' (2014) 43 *Common Law World Review* 89, 110.

<sup>263</sup> Companies Act 2014 s 949(1)(c)

<sup>264</sup> Companies Act 2014 s 610, 722.

Despite the fact that enforcement of directors' fiduciary duties now falls within the enforcement remit of the ODCE it is submitted that restriction of directors<sup>265</sup> will continue to be the means through which directors' duties are most frequently enforced by public means. As discussed in chapter five, the effect of restriction is that a restricted person cannot be appointed as a director for a five year period unless the company meets certain capitalisation requirements. Crucially, from an enforcement perspective, liquidators of insolvent companies are required to make restriction applications to the High Court against all directors involved in the insolvent company<sup>266</sup> and the burden of proof is placed on directors to show that they have acted honestly and responsibly.<sup>267</sup> This amounts to a cost effective outsourcing of enforcement and turns liquidators into quasi-public enforcers of directorial standards.<sup>268</sup> Placing the general requirement on liquidators of insolvent companies to make restriction orders has been the prime moving force in relation to directorial incompetence and misconduct in Ireland.<sup>269</sup> The ODCE also has standing to make application for restrictions.<sup>270</sup> The only defence available to a director to avoid restriction is to prove that they have acted honestly and responsibly. In *La Moselle Clothing Ltd*<sup>271</sup> Shanley J stated that in deciding whether a director should be restricted one of the main factors to be considered was 'the extent to which the director has or has not complied with any obligation imposed on him by the Companies Acts'.<sup>272</sup> The importance of compliance with the Companies Acts in assessing restriction orders was again emphasised by the Supreme Court in *Re Squash (Ireland) Ltd*.<sup>273</sup> Therefore a breach of good faith under section 228(1)(a) of the Companies Act 2014 will mean that directors will be unlikely to avail of this defence and will be restricted. The objective standard of good faith means that it is possible to prove that the director has in fact not acted in good faith in the interests of the company and so it is possible for a director to be restricted through an action by the ODCE or by a liquidator in the event of the company entering liquidation. A combination of the objective test for good faith and the public enforcement mechanisms of the ODCE and the restriction regime make it possible to implement an effective enforcement regime when directors do not act in the interests of the company. There certainly seems to be a willingness from the judiciary to embrace the public enforcement doctrine of restriction as well as a desire to hold directors

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<sup>265</sup> Established by the Company Law Enforcement Act 2001 s 150 and now in operation under s 819 of the Companies Act 2014.

<sup>266</sup> Company Law Enforcement Act 2001 s 56. The Companies Act 2014 s 819.

<sup>267</sup> Company Law Enforcement Act s 150(2). In order to avoid restriction Under The Companies Act 2014 s 819(2)(b) directors must show that they have acted honestly and responsibly and also that they have cooperated with the liquidator as far as could be reasonable expected in relation to the winding up.

<sup>268</sup> Deirdre Ahern 'Directors' Duties: Broadening the Focus Beyond Current Context to Examine the Accountability Spectrum' (2011) 33 *Dublin University Law Journal* 116, 141.

<sup>269</sup> See Deirdre Ahern, 'The Responsible Director in an Economic Downturn: Lessons from the Restriction Regime' (2009) 31 *Dublin University Law Journal* 183.

<sup>270</sup> Companies Act 2014 s 810(1)(a).

<sup>271</sup> *La Moselle Clothing Ltd and Rosegem Ltd* [1998] 2 ILRM 345.

<sup>272</sup> *Ibid*, 352.

<sup>273</sup> *Re Squash (Ireland) Ltd* [2001] 3 IR 35, 41.

accountable. In *Mitek Holdings Ltd: Grace v Kachkar*<sup>274</sup> Fennelly J, stated that the restriction regime ‘evinces public concern that directorships involve real responsibility and that persons who do not conform at least to some generally acceptable minimum standards either should not, in the public interest, be permitted or should be restricted in regard to future holding of directorships’.<sup>275</sup>

## 6.09 Conclusion

Legal strategies are only relevant to the extent that they induce compliance.<sup>276</sup> While entity maximisation offers the greatest possibility to increase benefits for all participants, enforcement of the model is also possible. Enforcement of directors’ duties under any model of the corporate objective is a difficult issue and as described in chapters two, three and four shareholder value, stakeholder theory and Enlightened Shareholder Value all have difficulties with enforcement. However, it is submitted that through the duty of good faith it is possible to hold directors to account when they fail to act in the interests of the company. Because of the objective nature of the test it is possible for a court to find a director was not acting in good faith when deciding if the director honestly believed he was acting in the best interests of the company. However despite the good faith duty and its common law equivalent the *bona fide* duty, being subject to numerous examinations by the court, the area is still severely lacking clarity as to what standard a director must adhere to in order to satisfy the duty. The courts refer to the duty as subjective in nature yet when it comes to actual application of the test, any act that is deemed unreasonable by the courts, is seen to be a view which could not be honestly held. To increase the chances of the duty having a deterrent effect on directors it honesty should be seen as an objective scale in line with the judgment set out in *Royal Brunei*.

There are a number of potential actions which can be taken to hold directors to account for a breach of good faith. However private enforcement by means of a derivative action seems unlikely to provide the desired enforcement mechanism. Issues with costs and the restrictive approach taken by the courts in relation to derivative actions appear to be a block on derivative actions acting as an enforcement mechanism. This is true of both the common law derivative action in Ireland and the statutory derivative claim in the UK. Liquidators of insolvent company can take action against directors for a breach of duty in the UK.<sup>277</sup> In Ireland public enforcement offers the best possible solution for effective enforcement of directors’ duties. It is submitted that public enforcement, through restrictions taken by liquidators or the ODCE, when directors fail to act in the best interests of the company offers the most effective means of enforcing the entity focused approach.

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<sup>274</sup> *Mitek Holdings Ltd: Grace v Kachkar* [2010] 3 IR 374.

<sup>275</sup> *Ibid*, 397.

<sup>276</sup> Henry Hansmann, Reinier Kraakman, Paul Davies, Gerard Hertig, Hideki Kanda, Edward Rock, Klaus Hopt Luca Enriques, John Armour, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009), 45.

<sup>277</sup> UK Insolvency Act 1986, s 212(1).

## Chapter 7 Conclusion

### 7.01 – Research Question and Answer

The research question of this thesis was to determine which model of the corporate objective would be most likely to confer the greatest benefit to all constituents in a company. There is good reason for attempting to find a satisfactory normative model which can be practically implemented given the growing influence companies exercise over the economy, company stakeholders and society in general. The law should require more from companies than simply increasing profits for their shareholders and companies should maximise wealth for all participants in the company. Numerous attempts have been made at answering the question: in whose interests should a company be run? Shareholder value, stakeholder theory, codetermination, Enlightened Shareholder Value (ESV) and entity maximisation and sustainability have all been discussed as possible solutions for Ireland. The answer proposed is that directors should operate the company with the aim of maximising the entity's wealth and ensuring its sustainability. Instead of focusing on providing benefit to specific sets of interests such as shareholders or stakeholders, directors should seek to promote the success of the company as a separate legal entity. It is submitted that it is possible, with a reinterpretation from the Irish courts of what it means to act in the interests of the company, to implement an entity focused approach to the corporate objective in Ireland. It is also submitted there is a sufficient legal basis for Ireland the courts to make such a reinterpretation based on the doctrine of separate legal personality and cases from the UK prior to the enactment of the UK Companies Act 2006.

### 7.02 Reasons for Advocating the Entity Focused Approach

The first reason for advocating the entity focused approach to the corporate objective is that it reflects the legal reality that the company is a distinct entity separate from all its various constituents and interest groups. A company is, as Farar describes it, 'A legal concept which, through the conferment of separate legal personality, provides legal recognition of bodies of persons as distinctive holders of rights under a collective name, having distinct legal consequences. This is not simply a matter of form and fiction'.<sup>1</sup> The company entity is an organisation that is separate from all those who are associated with it including the shareholders.<sup>2</sup> Therefore equating the company's interests with the shareholders and applying shareholder value does not represent the legal reality of what a company is. The corporate form developed because of its unique ability to promote and protect all kinds of investors, not just shareholders, and this was only possible because the entity was legally separate from its

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<sup>1</sup> John Farrar, 'Frankenstein Incorporated or Fools Parliament? Revisiting the Concept of the Corporation in Corporate Governance' (1998) 10 *Bond Law Review* 142, 142.

<sup>2</sup> Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Elgar 2011), 178.

investors.<sup>3</sup> Because of this unique ability to promote many different types of interests, treating the company as a separate entity offers the best method to maximise benefits for all constituents.

The second reason is that other models are ill-equipped to meet the normative goal of providing maximum wealth to all participants in the company. Stakeholder theory was rejected on grounds that it is impractical and unenforceable from a legal perspective. Actually operating the company for the benefit of all participants removes any clear objective and leaves directors completely unaccountable, the consequences of which is likely to damage the company in its attempts to be economically successful.<sup>4</sup> If the company is not successful it is much less likely to provide benefits to its constituents. Codetermination was rejected as implementing a two-tiered board model in a common law jurisdiction is extremely unlikely to happen in the near future and it is also unlikely to achieve the goals of increased benefits for all participants as the model's primary focus is on the interests of employees and shareholders. ESV was rejected on the basis that the very system of requiring directors to 'have regard to' stakeholder interests is unsatisfactory because of its unenforceable nature.<sup>5</sup> Significant issues with enforcement have been experienced with a duty to have regard to the interests of employees both in the UK<sup>6</sup> and Ireland<sup>7</sup> and the experience with ESV has been no different.<sup>8</sup> Efforts at enforcing the stakeholder element of ESV through corporate disclosure have proven futile and, as outlined in chapter six, there seems to be no legal method available to effectively enforce the listed interests contained in section 172(1) of the Companies Act 2006. Because the duty to have regard to the listed interests under ESV is completely unenforceable what remains is a clear legislative duty to promote the success of the company for the benefit of the shareholders. A legislative scheme which prioritises shareholder interests but which requires directors to take into account stakeholders is simply a model of shareholder value and unlikely to benefit any other interest group other than shareholders.

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<sup>3</sup> Margaret Blair, 'The Neglected Benefits of the Corporate Form; Entity Status and the Separation of Asset Ownership from Control' in A Grandori (ed) *Corporate Governance and Firm Organization: Microfoundations and Structural Forms* (Oxford University Press 2004).

<sup>4</sup> Michael Jensen, 'Value Maximisation, Stakeholder Theory and the Corporate Objective Function' (2001) 7(3) *European Financial Management* 297, 301.

<sup>5</sup> Nicholas Grier, 'Enlightened Shareholder Value: Did Directors Deliver' (2014) 2 *Juridical Review* (2012) 95, 95.

<sup>6</sup> UK Companies Act 1985 s 309; See Lee Roach, 'The Traditional Justification for Exclusive Shareholders Governance Protection: Expanding the Pluralist Approach' (2001) 22 *The Company Lawyer* 9, 15; Len Sealy, 'Directors' Wider Responsibilities – Problems Conceptual Practical and Procedural' (1987) 13 *Monash University Law Review* 164, 177; Andrew Keay, 'Section 172(1) of the Companies Act 2006: An Interpretation and an Assessment' (2007) *Company lawyer* 106, 109.

<sup>7</sup> Companies Act 2014 s 224(1) re-enacting s 52(1) of the Companies Act 1990; See Thomas Courtney, *The Law of Companies* (3rd edn, Bloomsbury 2012), 874; Deirdre Ahern, *Directors' Duties: Law and Practice* (Roundhall 2009), 178.

<sup>8</sup> See Shuangge Wen, 'Exploring the Rationale of Enlightened Shareholder Value (ESV) in the Realm of UK Company Law – The Path Dependence Perspective' (2011) 14 *International Trade and Business Law Review* 153, 159; John Birds, 'The Companies Act 2006: Revolution or Evolution?' (2007) 49 *Managerial Law* 13; Andrew Keay, 'Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's Enlightened Shareholder Value Approach' (2007) 20 *Sydney Law Review* 577.

The final alternative is shareholder value. Chapter two demonstrated the divergence between shareholder value theory and the common law judgments from England, Wales and Scotland. The chapter argued that the common law did not advocate a shareholder value approach but instead required directors to take decisions on the basis of what was in the best interests of the company as an entity<sup>9</sup> and that directors should consider the interests of stakeholders, as well as shareholders, in deciding what was in the interests of the company.<sup>10</sup> However this approach was not taken by the Irish courts who interpreted the duty to act in the interests of the company as a duty to act for the benefit of the shareholders,<sup>11</sup> thus advocating a shareholder value approach. Many arguments were discussed in favour of shareholder value such as agency theory and property rights, however no argument reflected the reality that the company is a distinct legal entity<sup>12</sup> which is incapable of being owned<sup>13</sup> and that directors' fiduciary duties are owed to this separate entity.<sup>14</sup> The only persuasive argument in favour of the shareholder value approach is that the model best allows companies to provide benefits to all participants due to its ability to be practically implemented. While this may be true when stakeholder theory is the only alternative, shareholder value is not the best way to benefit all constituents. Instead, viewing the company as an entity distinct from its shareholders and stakeholders is the best way to confer such benefits.

The entity approach provides the company itself with the best chance of being successful as the company's interests take priority over all interest groups. The focus of directors under the model is to maximise the company's wealth and ensure its sustainability. This aim allows for stakeholder interests to be taken into account and even prioritised over shareholder interests, if it is of benefit to the company to do so, an outcome which is not possible under shareholder value. With the priority of directors being on maximising the company's wealth, the company is more likely to be economically successful and all participants can benefit from knock-on effects of profitable companies.<sup>15</sup> By generating wealth, companies not only benefit shareholders but also meet a number of other social

<sup>9</sup> *Re BSB Holdings Ltd* [1996] 1 BCLC 155; *Dawson International Plc v Coats Platon plc* [1989] BCLC 233; *Re Welfab Engineers* [1990] BCLC 833.

<sup>10</sup> *Lonhro v Shell Petroleum* [1980] 1 WLR 637; *Fulham Football Club v Cabra Estates* [1994] 1 BCLC 363; *Evans v Brunner Mond & Co Ltd* [1921] 1 Ch. 359.

<sup>11</sup> *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC, 22; *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported) HC, 77; *Re Frederick Inns Ltd.* [1994] 1 ILRM 387, 396.

<sup>12</sup> *Salomon v A Salomon & Co Ltd* [1897] AC 22; *A L Underwood Ltd v Bank of Liverpool* [1924] 1 KB 775; *Macura v Northern Insurance Co Ltd* [1925] AC 619; *Roberts v Coventry Corporation* [1947] 1 All ER 308; *Wallersteiner v Moir (No 2)* [1975] QB 373; *Lee v Lee's Farming Ltd* [1961] AC 12; *Re Frederick Inns* [1991] ILRM 582; *Johnson v Gore Wood & Co (A Firm)* [2002] 2 AC 1; *Attorney General v Jameson* [1904] 2 IR 644. *Allied Irish Coal Supplies Ltd. v Powell Duffryn International Fuels Ltd* [1998] 2 IR 519.

<sup>13</sup> John Parkinson, 'Model of the Company and the Employment Relationship' (2003) 41 *British Journal of Industrial Relations* 481, 483.

<sup>14</sup> *Percivil v Wright* [1902] 2 Ch 421. *Dawson International plc v Coats Platon plc* [1989] BCLC 233; *Crindle Investments et al v Wymes et al* [1998] 2 ILRM 275; *Re A Company (No. 004415)* [1997] BCLC 479 Ch D; *Peskin v Anderson* [2001] 1 BCLC 372; *Smith v Cork and Bandon Railway Co* (1870) 5 IR EQ 63; *Bloxham (in Liquidation) v The Irish Stock Exchange Ltd* [2014] IEHC 93.

<sup>15</sup> Keith Davis, 'The Case For and Against Business Assumption of Social Responsibilities' in Archie Carroll, *Managing Corporate Social Responsibility* (Little 1977), 40.

objectives<sup>16</sup> such as providing employment, paying corporation tax and providing products and services for the public. The entity focused approach is in contrast to shareholder value which requires directors to maximise wealth for the shareholders which can be damaging to the company in the long term. This is because interests of the company as an entity may not always coincide with those of the current shareholders.<sup>17</sup> For example, severe cost cutting may increase profit in the short term but is likely to be harmful to the company's business in the long term.<sup>18</sup> As a result, by damaging the company as an entity, shareholder value can be harmful to both shareholders and stakeholders in the long term.<sup>19</sup> Therefore, it is submitted that entity maximisation is more likely to achieve the goal of maximum possible benefits for all constituents than any other model of the corporate objective.

The final reason in favour of the entity maximisation and sustainability model is that it is reasonably enforceable. While the entity focused approach outlined in this thesis has the ultimate goal of providing benefit for all company constituents, the model does not have the difficulties with practical application which prevents the implementation of stakeholder theory. Entity maximisation provides directors with one clear goal, maximising the value of the company as an entity while ensuring its sustainability. It also provides a clear criterion how to decide between competing interests, directors should act in favour of the interests which is most likely to provide most benefit to the company as an entity. In addition, legal enforcement of the entity focused approach can be ensured through the duty to act in good faith. The Companies Act 2014 requires directors to 'act in good faith in what the director considers to be the interests of the company'.<sup>20</sup> As outlined in chapter six, this standard of good faith is assessed primarily on objective grounds. This objective test means that it is possible to hold director to account when they fail to act in the interests of the company. This can be done either through a derivative action, an action taken by a liquidator or by restriction orders. These enforcement methods may have a deterrent effect on director behaviour and ensure directors do comply with their duty to act in the interests of the company and so act as the enforcement mechanism for an entity focused approach. However this deterrent effect could be magnified further if the true objective standard of good faith became clear. In this regard, this thesis has argued that honesty should be judged by an objective standard in line with the judgment in *Royal Brunei Airlines v Tan*.<sup>21</sup> This would make the objective standard of good faith clear while still not interfering with the application of the business judgment rule.

### 7.03 The Future

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<sup>16</sup> James Wallace, 'Value Maximisation and Stakeholder Theory: Compatible or Not' (2003) 15(3) *Journal of Applied Corporate Finance* 120, 121.

<sup>17</sup> Alistair Alcock, 'An Accidental Change to Directors' Duties' (2009) 30 *Company Lawyer* 362, 364.

<sup>18</sup> Eric Orts, 'The Complexity and Legitimacy of Corporate Law' (1993) 50 *Washington and Lee Law Review* 1565, 1591.

<sup>19</sup> Larry Mitchell, *Corporate Irresponsibility: America's Newest Export* (Yale University Press 2001), 11.

<sup>20</sup> Companies Act 2014 s 228(1)(a).

<sup>21</sup> *Royal Brunei Airlines Sdn Bhd v Tan Kok Ming* [1995] 2 AC 378.

How the courts will choose to interpret the Companies Act 2014 will decide the Irish approach to the corporate objective. This thesis has argued for a reinterpretation of what it means to act in the interests of the company in Irish law and that there is a sufficient legal basis for such a reinterpretation based on the doctrine of separate legal personality and cases from the UK prior to the enactment of the UK Companies Act 2006. While implementing an entity focused approach in the UK would require significant legislative reform, the entity approach can be applied in Ireland if the courts interpreted the duty to act in the interests of the company as a duty to act in the interests of the company as an entity rather than a duty to promote the shareholders' interests. Such a determination can only be made by the development of new case law and there is reason to believe that the courts may take a different view of the duty should a case was brought under the Companies Act 2014. The cases which equate a duty to act in the interests of company with a duty to act in the interests of the shareholders are more than twenty years old.<sup>22</sup> Ireland, in more recent years, has seen a greater focus on directors' duties serving a public interest function.<sup>23</sup> This is evidenced by the establishment of the Office for the Director of Corporate Enforcement and introduction of the restriction regime, the main aim of which is to protect the public.<sup>24</sup> The Company Law Review Group (CLRG) made it clear that they were unwilling to recommend following ESV which prioritises shareholder interests instead preferring a more general statement of directors' duties which would give the judiciary 'interpretational latitude'.<sup>25</sup> The Companies Act 2014 has also introduced the new fiduciary duty to act honestly and responsibly<sup>26</sup> which suggests that directors' duties encompass more than simply a duty to maximise wealth for shareholders. However despite these developments which indicate that the interpretation of the duty to act in the interests of the company may be altered in the future, currently Ireland would still seem to advocate a shareholder value approach and it is only by the development of new case law under the Companies Act 2014 that this can change.

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<sup>22</sup> *G & S Doherty Ltd v Doherty* (19 June 1969, unreported) HC, 22; *Irish Press Plc v Ingersoll Irish Publications Ltd* (15 December 1993, unreported) HC, 77; *Re Frederick Inns Ltd.* [1994] 1 ILRM 387, 396.

<sup>23</sup> Deirdre Ahern, 'Directors' Duties: Broadening the Focus Beyond Current Context to Examine the Accountability Spectrum' (2011) 33 *Dublin University Law Journal* 116, 140.

<sup>24</sup> See *La Moselle Clothing Ltd and Rosegem Ltd* [1998] 2 ILRM 345; *Duignan v Carway* [2002] IEHC 1; *Re Colm O'Neil Engineering Services Ltd* [2004] IEHC 83.

<sup>25</sup> Company Law Review Group, First Report, (Department of Jobs, Enterprise and Innovation, Dublin, December 2011) available at <http://www.clrg.org/1streport/first.asp> para 11.3.6.

<sup>26</sup> Companies Act 2014 s 228(1)(b).



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