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RECENT DEVELOPMENTS IN DIRECTORS' DUTIES

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ABSTRACT

Company directors play a key role in any company and thus in the contribution which business makes to the economy and to society. Reform of company law is being actively debated. This places under the spotlight such questions as: should directors' duties be made clearer? Should directors only owe duties to their shareholders? Are directors adequately monitored, for example in corporate activities, pay and political donations? The object of the lecture is to review areas of current debate and identify areas where changes are occurring or may occur.

KEYWORDS

The Law; Companies; Directors; The Courts

INTRODUCTION

With the fall of communism in the late 1980s, it has come to be recognised that the success and stability of society in many parts of the world depends, not on the state, but on private enterprise. Private enterprise has brought many benefits to the economies of many countries. The state has withdrawn from a number of areas, for example in the United Kingdom in relation to gas, electricity and water; areas which were generally considered to be areas for state ownership. In this country we have had deregulation, now replaced by a government initiative for better regulation.

But private enterprise is primarily motivated by economic success, and there will always remain areas in which the state wishes to assert control for, perhaps, the benefit of society or in the interests of national security. In addition, there will always remain a function for the state in providing institutional controls for the regulation of companies, or perhaps, in the alternative, ensuring that they are satisfactorily regulated by self-regulation. This function of the state is increasingly necessary, as private enterprise is allowed into new areas and becomes more powerful. However, at the same

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time there is a huge incentive for governments to be friendly to business, having regard to the wealth that they create and the holes in public spending that they are able to fill.

The growth of private enterprise has happened all over the world. With the growth of private enterprise, so too there has been international interest in the way in which directors are made accountable under the general law. In the developed nations, in particular, there is a concern that companies should neither be corrupt themselves nor corrupt others, particularly those in government, and this has led to the initiatives being taken by the World Bank, the OECD and the European Union to reduce corruption.

There is a raft of regulatory issues created by the increase in multi-national companies, that is companies which operate in several jurisdictions and whose operations, either by reason of their size and market share or by reason of, say, their effect on the environment, are likely to have a profound effect on the inhabitants of the countries in which they operate. In some respects there has been a considerable shift of power from government to business, in a way that is reminiscent, in this country, of the East India Company or the Hudson's Bay Company. In some countries, including our own, companies are allowed to make political donations. One might well ask whether multinational companies are really eco-friendly, as they often suggest, or whether that is just good public relations. Multi-national companies raise serious issues. The law on directors' duties is one way of regulating them, but the specific problems of multi-national companies are outside the area that I wish to cover this evening.

This evening I want to focus on domestic law. The demands on the law are changing just as business itself is changing. In the last century investment was concentrated in the railways and waterways. Now investment has moved to financial services and internet companies. The law has to keep up with technological and other change, and things are moving very fast indeed. Where does our law stand? Britain is still one of the major trading nations in the world. In 1996, for instance, Britain had the largest inwards and outwards direct foreign investment after the United States of America. Has our companies legislation kept pace with this? Many would say not; laws from the E.C., which we have had to implement on minimum capital, dividends, statutory accounts and the like, have overwhelmed us. Other common law countries, such as Canada, New Zealand and Australia, have brought their companies legislation up to date, but we have fallen behind. That is why, in 1998, the Department of Trade and Industry (DTI) launched a major independent inquiry into our company law, known as the Company Law Review.

In this lecture I shall focus on recent developments. However, in order for you to see their importance and role in the unfolding debate on directors, I intend to map out some major milestones in the history of regulating directors, which it may be helpful for you to have in mind. My choice of milestones is eclectic, and is geared to the developments which I propose to consider.

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Historical Context

The first milestone concerns limited liability. At the end of the last century the key issue was the separate personality of the company. In 1897 that was finally established in *Salomon v Salomon* ([1897] AC 22). In that case Mr Salomon had sold his solvent business as a boot manufacturer to a company and took a debenture for the outstanding purchase price. Mr Salomon and his family subscribed for the shares in the company. The company went into liquidation, and the liquidator sought to make Mr Salomon liable for the company's debts. As is well known, the House of Lords decided that he was not liable, even though the company was owned by himself and his family, and that it was not merely an agent or alias for Mr Salomon, and, accordingly, he incurred no liability for its debts. The company was a separate legal person.

The doctrine of limited liability has had the effect that the law has never really developed any consistent or coherent theory of duties of directors to creditors. The approach has been a somewhat compartmentalised one. There are a number of sets of circumstances in the Insolvency Act 1986 which lead to pre-insolvency transactions being invalidated. There are also some very limited cases when the courts will look behind the company and fix liability for its debts on its controllers. This is known as 'piercing the veil' of incorporation. This doctrine has been supplemented by a statutory provision on wrongful trading in Section 214 of the Insolvency Act 1986, whereby, in a liquidation, the court may declare that the directors should be personally liable for the company's debts where the director knew, or ought have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation, unless the director took every step reasonably open to him to minimise the loss to creditors. It is difficult, in fact, for liquidators to establish liability under this provision, and it is little used.

There is a provision in the Companies Act that a public company must have a minimum share capital, but this is a very modest amount, and does not apply to the vast number of companies which are private companies. The courts have never developed any theory of liability on the part of shareholders or directors on the basis that the company has been undercapitalised, as the courts have done in the U.S.A. We have not developed any limitation on limited liability where businesses are organised into a group of companies. In this way it is possible to insulate one area of business which fails from the rest of the group. The furthest the courts have gone is to recognise that, once the company is insolvent, the shareholders no longer have the right to waive compliance by directors with their duties (*West Mercia Safetywear v Dodd* [1988] BCLC 250) or to distribute the assets of the company to themselves by way of dividend or in a way which would, as a result of the company's insolvency, amount to an unlawful distribution of the company's assets (see *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626).

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The decision in *Salomon* was an enormous boost to the corporate vehicle; but the corporate vehicle was already in active use, and companies were obtaining investors who were content to put up money without being involved in the management of the company. This led to another significant development, which was the subject of Berle and Means' celebrated work, *The Modern Corporation and Private Property*, published in the U.S.A. in the 1930s. Berle and Means, a lawyer and an economist, studied companies in the U.S.A., including the Standard Oil Company owned by the Rockefeller family, and they concluded that corporations had ceased to be merely legal devices by which individuals and their families carried on their private businesses with the benefit of limited liability. In many companies a further development had occurred, namely, the managers and the owners of the company had ceased to be the same persons or to be members of the same family. In many companies ownership and control had become separated or detached. This applied in the U.K. as much as it did in the U.S.A.

That is not to say that in all companies there is a detachment of ownership from control. As at May 1998, there were about 1.2m companies on the active register in Great Britain. Of those, only 11,700 were public companies, of which less than 2,500 were listed on the Stock Exchange or the Alternative Investment Market. Many of the 1.2m private companies will be subsidiaries of other companies; it is not known how many private companies fall within this description; but the fact remains that the vast majority of companies in this country are private companies — hence the Company Law Review's call to 'think small first', and to build up the Companies Act round the model of the private company rather than vice-versa.

The nature of the company makes a considerable difference in practice, and hence in law. In the smaller owner-managed companies a greater degree of informality has to be and a lighter level of regulation permitted. The courts recognise this. For instance, in the recent case of *Atlas Wright (Europe) v Wright* ([1999] BCC 163) the Court of Appeal held that shareholders could informally (that is without a meeting) agree to a director's service contract exceeding five years if they knew about the term and approved the contract. The Court of Appeal held that this was a valid approval, even though Section 319 of the Companies Act 1985 requires shareholder approval and lays down formalities for disclosure of the service contract, both before and at the meeting. As I have said, the Company Law Review's message, when it comes to writing the law for companies, is 'think small first'; but, in the area of directors' duties, the law has to set standards. It is, therefore, not possible, in this context, to think small first, or to start with the model of the small company. One has to start with a company where there is a division between ownership and control, and the special considerations flowing from owner management do not exist.

Returning to Berle and Means, it is interesting to note the direction in

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which Berle and Means pursued their observation and the predictions that they made about the future. They considered that there were analogies to be drawn with the law of trusts, where the courts of equity had stepped in to fill the breach and worked out a detailed law for protecting beneficiaries from their trustees. This was the law built up by the courts of Chancery over many centuries. Essentially, the view of Berle and Means was that directors were to be made accountable through duties imposed by the general law. For example, the courts would impose limitations on the powers of trustees, even if they were absolute on their face. In particular, the courts had required even seemingly absolute powers to be exercised for a proper purpose, that is, for the purpose for which they were impliedly granted. Likewise, directors would have to exercise their powers in an even-handed way between the different classes of shareholders. I shall endeavour to explain, in due course, what the duties of directors under the general law in main part comprise. The important point that I am making at this stage is that it is the courts which developed them. We tend to think of company law as a code or statutory subject, but, at the very heart of it, in the most difficult and sensitive area, the law has been developed by the courts. I will give you an example of a recent development to show how the courts have had to expand or, strictly, expound the law to keep it up to date.

Berle and Means made another prediction. They observed correctly that shareholders took little interest in the running of the company; provided that the company paid dividends and made profits, shareholders did little to exercise their rights. Berle and Means took this to be an invitation to the state to exercise control over directors. They compared the economic power of companies to the threat to the nation state posed by the concentration of religious power in the mediaeval church. They suggested that shareholders had, by their inertia, surrendered their powers over management to the community, and that, accordingly, it was for the community to legislate in such a way that the company was operated, not just in the interests of its shareholders, but also in the interests of the community at large. Berle and Means regarded it as almost essential, if the corporate system was to survive, that the control of large companies should develop into a purely neutral technocracy, balancing a variety of claims by various interest groups in the community. Thus, a major debate began, which has gone on throughout the twentieth century, as to whether directors owe duties, not just to their companies, but also to other interest groups. They might be employees, customers, suppliers, the local community or the community at large. That is often called the 'stakeholder', or constituency, question, and I shall come back to this issue in due course.

The work of Berle and Means was exceptionally far-sighted. They put their finger on an important characteristic of the Anglo-American business environment, namely the separation of ownership from control. Because of this particular characteristic, our Companies Act regulates directors in a

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much more detailed way than the laws of other member states of the E.U. It also means that it is probably crying for the moon to look for a simplified Companies Act, except in relation to owner-managed companies.

There are a few more milestones in the twentieth century history of directors' duties that I should like to pick out. The first is the development, from the 1960s onwards, of self-regulation, first when the City Panel on Take-overs and Mergers was established. There are many other forms of self-regulation, including the rules of the Stock Exchange which applied to listed companies. In their wake came the Cadbury Committee's enquiry into corporate governance, which made a number of important recommendations about directors, in particular that they should not hold the office of chief executive at the same time. The Cadbury Committee was succeeded by two further committees, the Greenbury Committee and the Hampel Committee, but now the recommendations of all three committees have been drawn together in a single Combined Code on corporate governance. This is now in the listing rules of the Stock Exchange. The Code deals with the responsibilities of the board, for example with respect to accounting matters, the composition of the board (that it should, for instance, include independent non-executive directors), the length of directors' service contracts and the making of an annual report to shareholders on the board's policy towards remuneration of directors. At the present time the Stock Exchange has no means of punishing directors who contravene the Combined Code, but, under the new Financial Services and Market Bill, they will be given power to impose fines on directors who contravene the Code. The Cadbury Code led to discussion on corporate governance in many other countries, and most recently, in May 1999, the OECD issued guidelines on corporate governance which are intended, primarily, for use in developing countries.

In the 1980s Parliament took a great interest in directors. There was a series of financial scandals, involving companies and individuals such as First Re-Investment Trust Limited and Sir Denys Lowson and Peachey Property Corporation Limited and Sir Eric Miller. Swingeing restrictions were placed on specified transactions in which directors had an interest. The restrictions introduced in 1980 included: a restriction on the length for directors' service contracts without prior shareholder approval to five years; a requirement for shareholder approval where the company was entering into a transaction for the acquisition or disposal of property with a director or an associate of his; and restrictions supplementing the prohibitions on loans to directors. These supplementary provisions restricted the company from avoiding the prohibitions on loans by, for example, causing the company to pay for goods or services to the director on terms that the director paid the company back in due course. These transactions did not involve the company advancing money to a director against a promise to repay, and so they were not, in law, regarded as loans, though they had the same economic effect. Following the

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consolidation of the Companies Acts in 1985, all these restrictions, together with a number of earlier restrictions, such as that on making loans to directors and paying them compensation for loss of office in excess of contractual amounts, now appear in Part X of the Companies Act 1985. Part X of the Act, then, is the part which deals with regulating transactions in which directors have a conflict of interest.

The next major milestone in the history of directors' duties to be borne in kind is the creation, in 1985, of new powers (now to be found in the Company Directors Disqualification Act 1986) in the courts to disqualify directors for periods of 2-15 years if they had, by their conduct, shown themselves unfit to act as directors of public companies. The original hope was that the court would, when exercising these powers, elucidate the duties of directors. This has not, in point of fact, happened, because the courts have treated unfitness as a question of fact, rather than as a mixed question of fact and law. After an uncertain start, the number of disqualification proceedings has increased in recent years — from less than 600 new cases issued in 1992-3 to over 1400 in 1997-8. However, it can still take a long time after the company has gone into liquidation for the proceedings to come to trial. The Insolvency Service has stated that it has under consideration measures to enable these cases to proceed without involving the courts, but these cannot be introduced without primary legislation, which is to be introduced when Parliamentary time permits. There is considerable ignorance among directors about this Act. In a survey in 1993, 59% of the directors surveyed did not know about the Act. It is somewhat surprising that, when a further survey was done by the Insolvency Service in 1998, the number of directors who said that they had not heard of the Act had gone up to 66% of those surveyed! (Report by the Comptroller and Auditor-General and the Insolvency Service: *Company Director Disqualification — a Follow up Report*, HC 424, paras 2, 47-9, Session 1998-9)

Lastly, but not least, as I have mentioned, the DTI has set up an independent inquiry into core company law. There is an independent steering group to oversee this review (*Company Law Reform — Modern Company Law for a Competitive Economy*, DTI, March 1998). In February 1999 the steering group issued a framework document (*Company Law Reform — Modern Company Law for a Competitive Economy, the Strategic Framework*. A consultation document from the Company Law Review Steering Group, February 1999) seeking views on a number of issues, including the stakeholder issue or constituency question that I have already mentioned.

In addition, the Law Commissions have been working on the law regulating directors' conflicts of interest — that is as we have seen in Part X of the Companies Act 1985 — and the question whether there should be a statutory statement of duties. In September 1998, the Law Commissions issued a consultation paper (*Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties*. A joint consultation paper,

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Law Commission Consultation Paper No 153, Scottish Law Commission Discussion Paper No 105, 1998). The consultation period ended in November 1998, and a final draft of their final report has now been delivered to the DTI. It will be published in September 1999.

With that introduction, I shall now look at some of the more recent developments.

The Role of the Courts

I propose to examine the role of the courts in developing the directors' duty of care skill and diligence. As I have explained, the courts have played a central role in developing directors' duties. In this particular area the law, until recently, required little of directors. Law students often remember the *Marquis of Bute's case* (*Re Cardiff Savings Bank* [1892] 2 Ch 100) in 1892, which was an action against the Marquis of Bute, who was appointed Bank President at the age of six months, and attended only one meeting of the board in 39 years. Nonetheless he escaped liability. All that a director was expected to show was the skill that might be expected of someone with *his* knowledge and experience, not that of a reasonably competent person in his position (*Re City Equitable Fire Insurance Co* [1925] Ch 407, 428-9). In addition, a director was not expected to give continuous attention to the affairs of the company (*Re City Equitable Fire Insurance Co*, above). This may loosely be called a subjective test. The fact that the law demanded so little of directors caused concern. It was out of step with the standard of care expected of employees and other people who owed a duty of care. Parliament tried to alter the law in 1978, but the bill failed because a general election was called.

There was another important development. I have referred already to the statutory provision which was introduced in 1985 and gives the court power to hold a director liable for a company's debts if the director had traded wrongfully. This made the director liable, not simply if he failed to live up to the standard to be expected of a director with his knowledge and experience, but also if he failed to do what a person would have done with the general knowledge and skill reasonably to be expected of a person carrying out the same functions as are carried out by the director in relation to the company. This added a new test, which may loosely be called an objective test. In reliance on the test in Section 214(4), Hoffmann J. held, in 1993, that the standard of care for a director was now both objective and subjective. A director was expected to conduct himself with both the general knowledge skill and experience to be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and the general skill and knowledge that that director has (*Re D'Jan of London Ltd* [1993] BCC 646).

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The arguments for increasing the standard of care to be expected of directors is a strong one, and the standard needed to evolve to deal with heightened expectations about corporate governance; but it could have had the effect of discouraging suitable candidates putting themselves forward for appointment as non-executive directors, which would have been unfortunate. There was, of course, no research done before the courts expounded the new standard. There was also a risk that it would be seen as stifling entrepreneurial attitudes and lead to defensive, rather than innovative, management. However, these things do not seem to have happened. Directors seem to have taken the increased standard in their stride. Directors and officers insurance is now increasingly available, which may have helped put the minds of prospective directors at rest. The standard, as stated by Hoffmann J., is now generally considered to reflect the existing state of the law. It has been applied since, notably in *Bairstow v Queens Moat Houses plc*, which was decided by Nelson J. on 23 July 1999, after a hearing which had lasted nearly a year.

A new problem in the field of negligence has now emerged. As companies have become larger, so the function of the board in many companies has changed. In 1925 the courts had said that, in relation to matters that could properly be delegated to an official of the company, a director was justified in trusting that official to perform his duties honestly in the absence of grounds for suspicion. That formulation did not suggest that the director had any responsibility for the system if he left it to an official to carry out a number of activities or transactions on behalf of the company; but today, in many large companies, the board cannot, in reality, do anything but review policy matters. They must leave a large number of operational matters to officials of the company. That is the state of affairs which the law must now address. The law must decide what responsibilities, if any, the directors have to monitor the officials to whom tasks were delegated. In 1963 the Supreme Court of Delaware, one of the leading jurisdictions in the U.S.A. for corporations law, had to consider this problem in *Graham v Allis-Chambers* (188 A 2nd 125, Del. 1963), in which the directors of a large electrical manufacturing company had failed to spot that certain employees at the middle level of management had engaged in illegal price-fixing activities. The court held that the board did not have to install a system to check that the officials were acting within the law until a triggering event occurred. Until then the board could rely on its officials whom it trusted. However, the absence of responsibility for systems could not be taken to be an absolute rule. In accounting matters, the company has to have systems which minimise the risk of fraud.

The next celebrated case in which the question of the director's duty of care and reliance on others arose was *Smith v Van Gorkom* (488 A 2d 858, Del. 1985) in 1985. In that case the same court, the Delaware Supreme Court, held that directors were in breach of the duty of care where they had accepted what a fellow director had told them about the merits of a merger,

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without taking sufficient care to investigate the position. The directors had, in approving the merger, been content to shoot from the hip.

Likewise, the Australian courts have had to grapple with the monitoring duties of directors. The question came up in a case called *Daniels v Anderson* (16 ACLR 607, 1995). The facts of this case have a ring of familiarity about them. An employee of the company, which was an importer of goods, engaged in foreign exchange transactions. These transactions were solely conducted by him. These transactions had, at first, the appearance of bringing surprisingly large amounts of profits, and there are references to not wanting to break the golden egg by upsetting the employee responsible. Ultimately these dealings caused the company substantial losses. There was no system in place to control the dealings. As a result of losses on these transactions, the company became insolvent. The company sued its auditors for damages for breach of duty in failing to advise it about the deficiencies in its internal control. The auditors claimed contribution from the company's directors, on the grounds that they had been negligent. The trial judge held that the executive director was in breach of his duty of care to the company, and liable to make contribution to the damages payable by the auditors. There were warning signals about the adequacy of the company's internal system for monitoring foreign exchange dealings which he had not investigated. However, the trial judge held that the non-executive directors were not liable. On appeal, the New South Wales Court of Appeal held that, where a person takes office as a director, he has a duty to ensure that he understands the nature of his duties. The duty will vary according to the nature of the company and the experience and skill of the particular director. The court affirmed the trial judge's holding that the non-executive directors were not in breach of their duty of care. The court set aside the order for contribution made against the executive director, but upheld the trial judge's finding that he had been in breach of his duty of care to the company. The court stressed that directors could not blindly rely on the judgements of others, and that they needed to take proper steps to satisfy themselves that the company was properly run and to monitor the management. In this case the executive director was negligent (among other things) in failing to set up a proper system for monitoring foreign exchange dealings.

It was, of course, not long before a similar problem faced the English courts. The courts here have now considered the question of the responsibility of directors for the acts of employees of the company, in the context of various applications to disqualify main board directors of Barings plc. In one of the early applications, Sir Richard Scott V-C confirmed that the overall responsibility of a director was non-delegable. The degree of responsibility that a director had for the actions of a person to whom he had delegated activities on behalf of the company must depend on the facts; for example, it might be that personal liability would attach because the system was inadequate. This decision was applied in a subsequent case heard by

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Jonathan Parker J., in which three main board directors of Barings plc were disqualified ([1999] BCLC 433). He also applied a previous decision of the Court of Appeal, that a director must have sufficient knowledge and experience to discharge his responsibilities.

What these cases show is that the courts are willing to develop the law to meet new problems in the field of directors' duties, and that they have done so in the area of responsibility for systems failures. In 1925 it was sufficient to say that a director was not liable for breach of the duty of care if he delegated some activities to a trusted official; but by the end of the century the courts have had to put a gloss on that to meet the situation now, where a board does little else than review broad issues of policy. It cannot, itself, oversee what the employees are doing, but, depending on the circumstances, it will probably need to set up a system to see that someone else is checking that there are appropriate limits on their authority, and that those limits are being observed.

Shareholder Remedies

In the *Barings* cases the issue of the director's responsibility arose in the context of disqualification proceedings. The next question is whether the company could obtain damages for the breach of duty. The chances are that the company, itself, will not bring proceedings, at least if the director remains on the board. In certain circumstances minority shareholders can bring proceedings in the name of the company under the rule in *Foss v Harbottle.* The courts have traditionally, and rightly, placed strict conditions on the circumstances in which minority shareholders can bring such proceedings; but one of those restrictions currently prevents minority shareholders from bringing proceedings — derivative actions as they are known — where the directors are alleged to have acted negligently, unless it can also be shown that the failure to bring the proceedings amounts to a fraud by the majority on the minority. In 1997 the Law Commission, in consultation with the Scottish Law Commission, published a report on *Shareholder Remedies* (Law Com. No 246, 1997). A major part of this report was concerned with the derivative action which, at present, is partly governed by some extensive case law, applying and developing the rule in *Foss v Harbottle* and partly by a rule of court. The Law Commission recommended and drafted a new rule of court, which would be a comprehensive statement of the circumstances in which the derivative action could be brought. It was hoped that this rule could form part of the new Civil Procedure Rules introduced on 26 April 1999, in consequence of Lord Woolf's reports on *Access to Justice*. The rule recommended and drafted by the Law Commission would, for instance, enable a derivative action to be brought where the case against the directors was simply that they had been negligent, without there being any fraud on the minority. However, the permission of the court would be required, and

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the court would be required to take a number of matters into account, including, of course, whether the claim was in the interests of the company and the views of other shareholders. On this part of the report (The Law Commission's report on shareholder remedies also made recommendations about proceedings for relief from unfair prejudice under Section 459 of the Companies Act 1985 and a proposed new regulation to be inserted into Table A conferring exit rights. The House of Lords, in *O'Neill v Phillips* thought that some of the recommendations on Section 459 already represented the law.) the Lord Chancellor's Department has indicated that the Law Commission's new rule can be included in the new rules of court with minor amendments when this area is reached (*Access to Justice: Specialist Jurisdictions: Proposed Next Procedures.* A consultation paper, 1997). At present the existing rule has simply been carried forward in the schedule to the new rules. As I have said, the existing rule is not comprehensive, and, in addition, it leaves intact the old case law, including the restriction which would prevent most derivative actions based on breach, by directors, of their duty of care.

The Work of the Law Commission on a Statement of Duties

I would now like to turn to developments in the area of a statutory statement of directors' duties under the general law. As I have said, this was part of the work carried out by the Law Commission and the Scottish Law Commission in their recent project on company directors. A major part of this project was devoted to the question of whether there should be a statutory statement of directors' duties. The Law Commissions issued their consultation paper in September 1998. They sought views on whether directors' duties could be codified in whole, or part, or made the subject of a statutory statement which was in addition to the existing law. They also considered non-statutory statement of directors' duties, that is an authoritative statement of the duties published, after consultation by the DTI, which could be put on to the forms which directors have to sign when they are appointed. To illustrate the options being put, the Law Commissions included in their consultation paper a draft statement of a directors' duties. There were 8 main duties:

1. *Loyalty*

A director must act in good faith in what he considers to be the interests of the company.

2. *Obedience*

A director must act in accordance with the company's constitution (such as the articles of association), and must exercise his powers only for the purposes allowed by law.

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3. *No secret profits*

A director must not use the company's property, information or opportunities for his own or anyone else's benefit, unless he is allowed to by the company's constitution or the use has been disclosed to the company in general meeting and the company has consented to it.

4. *Independence*

A director must not agree to restrict his power to exercise an independent judgment. But if he considers, in good faith, that it is in the interests of the company for a transaction to be entered into and carried into effect, he may restrict his power to exercise an independent judgement by agreeing to act in a particular way to achieve this.

5. *Conflict of interest*

If there is a conflict between an interest or duty of a director and an interest of the company in any transaction, he must account to the company for any benefit he receives from the transaction. This applies whether or not the company sets aside the transaction. But he does not have to account for the benefit if he is allowed to have the interest or duty by the company's constitution, or the interest or duty has been disclosed to and approved by the company in general meeting.

6. *Care, skill and diligence*

A director owes the company a duty to exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having both:

(a) the knowledge and experience that may reasonably be expected of a person in the same position as the director; and
(b) the knowledge and experiences which the director has.

7. *Interests of employees, etc.*

A director must have regard to the interests of the company's employees in general and its members.

8. *Fairness*

A director must act fairly as between different members.

The consultation paper set out the case for codification; that, in short, it might make the law more accessible, more comprehensible, and, to an extent, more certain. It also pointed out the disadvantages of codification. Directors' duties under the general law have, as we have seen, to be developed by the courts when need requires it; see, for example, the cases that I mentioned concerning the responsibility of a director to see that proper systems are installed to monitor the activities of management. Statutory

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codification runs the risk of making the law inflexible. It also makes courts focus on the letter of the statute rather than on the principle, policy and rationale behind the rules being codified. I can give an example of this from Part X of the Companies Act 1985, which the Law Commissions also reviewed in the course of the project.

Section 320 of the Companies Act 1985 requires a company to obtain prior shareholder approval if it buys an asset exceeding £100,000 or 10% in value of the company's assets from a director or a connected person of his, and the Act sets out a statutory code of liabilities imposed if this approval is not obtained. The director and the connected person are liable to indemnify the company for "any loss resulting from the transaction". Meanwhile, the company can rescind the transaction unless, for example, third party rights have intervened or the company has been indemnified for its loss. Likewise, the liability to indemnify the company against loss applies whether or not the company has rescinded the transaction.

In *Re Duckwari plc (No 2)* (2 BCLC 315, 1998), the company entered into a transaction with a connected person simply to buy a property of the requisite value. Shareholder approval was not obtained. The price was a proper one, but the property went down in value because of a fall in the market. The trial judge held that the policy behind the section was to protect the company against transactions at inflated values, and that, accordingly, the indemnity should not include market loss.

Under the general law, where the defendant negligently gives advice as a result of which a party buys a property and that property falls in value because of a fall in the market, the defendant is not necessarily liable for the loss attributable to the fall in market value. Moreover, the courts have said that the principles of causation and remoteness which apply at common law also apply to cases in equity where a party is said to have been in breach of trust, other than cases where a beneficiary is entitled to have the trust fund reconstituted. There the normal rules of remoteness and causation do not apply.

In the *Duckwari* case, the Court of Appeal held that the liability imposed on a director or connected person because of a breach of Section 320 is akin to the liability of a trustee who purchases unauthorised investments. Liability should, therefore, extend to the full amount of the loss. The court was, however, reinforced in this conclusion by the wording of the section. Under the section the indemnity extends to any loss resulting from the transaction, and, where the company is indemnified, it ceases to be entitled to set aside the transaction. Accordingly, said the court, the indemnity must, *as a matter of construction*, cover all damage which is suffered, because otherwise the company would not be in the same position as it would have been if the transaction had been rescinded. The court did not have to consider, and did not consider, whether the rationale of the rule that applied to traditional trusts should also apply to directors and their companies.

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I am not, of course, criticising the legal reasoning here. The point I am making is that the court did not decide that the associate should be liable to indemnify the company for market loss because it considered that the policy of the rule should require this. Rather, that was its conclusion because of the *wording* used by Parliament. If the law on this point had not been codified, the courts could have considered what was the *appropriate* measure of damage, given that the normal principles of law that a claimant should only recover loss which the defendant has caused, and given that the rule relied on by analogy was a specialist rule which applied to traditional trusts.

Views on the merits of codification therefore differ. The Law Commissions' views will be known when the report is published in September 1999. Until then its report is subject to Parliamentary privilege.

The Work of the Company Law Review Steering Group

In its project on company directors, Law Commissions have been concerned with a complex presentational issue whether there should be a statutory statement of directors' duties. They were not concerned with the content of those duties. That issue was left to the Company Law Review, though, speaking personally, it is to be hoped that the Steering Group will not be concerned with any re-engineering of those duties unless it is justified.

One of the major issues so far considered by the Steering Group is the stakeholder issue or constituency, to which I referred earlier. The seventh duty in the Law Commissions' statement of duties comes from Section 309 of the Companies Act 1985 (it is the only duty in the statement which does not simply come from the general law). The Act does not give any right of action to the employees, and it is not clear whether the section gives directors an autonomous power to act in the interests of employees, or whether they can only do so where it is in the interests of the company so to do. This is, therefore, a section which, on any analysis, needs clarification. The question is how to clarify it, and this is bound up with the question whether it is the duty of directors merely to enhance shareholder value or whether the company has some wider social purpose as well. Should Section 309 apply not just to employees, but to other interest groups as well, such as customers, suppliers, the community, and so on? At present the section requires directors to take into account the interests of employees. Should the duty to other interest groups be permissive or mandatory? There are very real legal difficulties in providing that directors should have duties to more than one interest group, since it will be difficult to balance the interests of the different interest groups. Moreover, it is possible that the interest groups will have to have some direct remedy if their interests are not duly taken into account. Then there is the question whether, given the role that companies play in the

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community, directors should, in any event, have a discretion to give money for charitable or philanthropic purposes, irrespective of the interests of the company.

These are immensely difficult questions. The answers lie, not just in law, but in economics and political science. The Steering Group have sought views on all these issues, and we must wait to see what they ultimately recommend.

Law Commissions and Part X

I would now like to say a word about the balance of the Law Commissions' project on company directors. This was a review of the provisions of Part X of the Companies Act 1985, which deal with transactions where directors have a conflict of interest. The provisions of this part of the Act are tortuous. To enable the Commissions to rationalise them, the Commissions took a very unusual step of obtaining a report on the economic considerations behind this part of the Act. This report was in the consultation paper. Just as the work of Berle and Means in the 1930s had been the combined work of a lawyer and an economist, so both lawyers and economists had input into the Law Commissions' work. The report was done by Dr Simon Deakin and Professor Alan Hughes of the ESRC Centre for Business Research in the University of Cambridge, and I am particularly grateful for all the help that they gave. The primary purpose of the economic research was to see how the provisions could be rationalised, to see how effective the law was, judged purely in terms of rule efficiency, and to predict possible effects of reform. In the course of doing that, the report identified areas for empirical research, and, since the consultation paper was published, some fascinating empirical research has been carried out among, principally, directors, to try to predict the effect of the Law Commissions' recommendations. This is also a relatively new departure for the Law Commissions. (The Law Commission carried out some empirical research as part of its project on *Shareholder Remedies* and on some other projects.) It has the great advantage of making their recommendations research-based, and I hope that this is an experiment that will, in appropriate circumstances, be repeated by law reformers in future. The empirical research was completed, and will be published as part of the Law Commissions' final report.

There are two short points that I would make from this work to give you a flavour of its significance. As I have mentioned, Part X contains a section which limits the period of directors' service contracts to five years, unless there is prior shareholder approval; but shareholders have no right to be consulted about any other term of the service contract, such as the amount of the directors' remuneration, or any provision called a golden parachute,

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whereby he receives a handsome sum in certain events if he leaves the company. Large companies do not like to go to shareholders for prior approval for anything. It is embarrassing and causes delay. Accordingly, companies have found a way of getting round this section altogether, by agreeing that directors should have long notice periods or that they should have contracts which are renewed automatically, in an extreme case every day, for the maximum period. In that way the director knows that he always has a right to damages for five years if his contract is summarily determined, unless that is he has been in breach of contract. So the economic research shows that this section has little economic purpose. It cannot help control directors' remuneration. It is anomalous to ask shareholders to approve the term as to length alone, when there could be other provisions which are contrary to shareholders' interests and in which directors have a conflict of interest.

Part X employs a number of mechanisms for monitoring transactions in which directors have a conflict of interest. Sometimes prior shareholder approval is required. Sometimes it is enough to provide details in the next accounts. The economic research also provided an analysis of the rules in terms of the approval mechanism according to their economic rationales. This may provide a template for future legislation in this field. In this connection, I now turn to two topics that have come up recently where legislation is likely to be needed to provide the means of monitoring directors conflict of interests.

Neill Committee — Political Donations

Part X has resonances in the context of political donations by companies. At present the directors can decide whether the company should make a political donation. All the law provides is that the amount of the donation must be disclosed in the annual accounts. However, in October 1998 the Committee on Standards in Public Life, under the chairmanship of Lord Neill, recommended that a company wishing to make a political donation should have the authority of shareholders. The DTI have now consulted on this issue, and in the consultative document a Bill was promised before the summer recess.

DTI and Directors' Remuneration

The Law Commissions' work expressly excluded questions of the amount of directors' pay, which is the other area which has been in the news recently. The Government has now accepted that, in the words of the Secretary of State for Trade and Industry (Speech to National Association of Pension

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Funds, 19 July 1999, *The Economist*, July 24-30 1999, p 25), "in a global economy, world class performance must be rewarded with world class pay". The DTI is to issue a consultative document this week, but it seems likely that it will be content to propose new powers for shareholders, such as the power, at the annual general meeting, to consider the directors' report on board policy on directors' remuneration. This is an area where there is certainly a conflict of interest, and it appears that the template that emerges from the Law Commissions' work in this field could have some relevance.

In any event, the Law Commissions' project covered one aspect of directors' pay, namely the appropriate approval mechanisms for payments for loss of office. This is an area which causes considerable controversy, since directors often receive large payoffs, even when they failed to perform satisfactorily as directors. The Companies Acts on one interpretation (often, one suspects, adopted) do not require shareholder approval of compensation paid to executive directors. There is a strong case that it should do so if it exceeds what the directors is contractually due, for example because his duty to mitigate has not been fully taken into account.

Professional Directors/Responsible Risk Takers

Before I conclude, I will draw your attention to other recent developments. The Institute of Directors has introduced the examined qualification of Chartered Director, which should help raise the standard of competence exercised by directors. In a separate development, the Secretary of State for Trade and Industry has said that he proposes to consult on changes in the law to benefit directors who become insolvent, but were 'responsible risk-takers'. He also proposes to introduce measures to aid the rescues of insolvent companies. Again, we have to wait to see what is actually proposed, but it is to be hoped that this desire to be friendly to business will not lead to any lowering of the standards which we have come to expect of directors.

Conclusion

I have come to the end of the points that I wanted to cover. I cannot hope to cover this field comprehensively, or do more than paint a large canvas roughly with a very broad brush. I have felt that the canvas has been moving as I did so; but it is important, in an age of change, to see the change as part of a continuum; to build on the principles that have been built up over the years and start from there. As I have explained, and as many, including Berle and Means have noted, the origins of directors' duties lie in law established many centuries ago in the old Inns of Court. I hope that I

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have shown you that this is a vital area of the law. It is 'vital' in the sense that companies and directors play an important role in society, and that the law that sets their duties must be kept relevant and up to date. The law in this area is also full of vitality in the sense that it is fast moving and undergoing significant change. We can expect further developments early in the next century.

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