

Practice questions for Chapter 22 – Directors' duties

Essay question

'The codification of directors' duties was an unnecessary step. The enacted duties do not differ substantially enough from their equitable and common law counterparts to warrant placing them in statute, and the courts will still need to refer to pre-2006 case law when determining whether or not a breach of duty has occurred.'

Discuss.

Introductory issues

- You should begin by noting that, prior to the Companies Act 2006, the duties of directors could be found in a mass of case law (much of it antiquated) and statute. As a result, the law was unclear and inaccessible and many directors had little knowledge of the duties they were subject to.
- You may also wish to point out that calls for the codification of directors' duties came as far back as the work of the Davey Committee 1895, but it was only with the work of the Law Commission in the late 1990s and the work of the Company Law Review Steering Group that the possible implementation of codification became a reality.

Codification

- Students should point out that codification was not meant to radically reform the content of directors' duties – the Companies Act 2006, s 170 makes it clear that the statutory duties are based on principles deriving from the law of negligence and other duties analogous to those of a trustee. Further, s 170 makes it clear that, when interpreting the general duties, the courts should take into account pre-2006 case law. Accordingly, the later part of the quote in the question is indeed true. However, the fact that the law is based on the pre-2006 law does not mean that codification was an unnecessary step for two reasons.
- First, placing the duties in statute has a number of notable advantages. Second, the duties under the CA 2006 are different in several respects to their pre-2006 common law counterparts.

Advantages

- Codification can result in a number of advantages. First, if codification is successfully achieved, it can make the law more accessible. Anyone could look to the statutory statement of directors' duties and reasonably comprehend the duties owed. As the Law Commission stated:

A layman should not have to look to his lawyer whenever he needs to know the basic principles. What a director needs is to know what to do before he acts, not afterwards, since he may be sued or subject to disqualification proceedings if he fails to comply with his obligations.¹

- Second, successful codification could result in the law becoming more predictable and will remove the judge's discretion to develop the law in subjective and unpredictable ways.

¹ Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* (Law Com CP No 153, 1998)

- Third, the duties could be expressed in broad and general language which could be applied to a wide range of situations. This would allow the law to adapt to emerging practices.

Disadvantages

- The Law Commission has identified several arguments against codification. First, codification is not a straightforward process – it is notoriously difficult and there is no guarantee that codification will succeed. In some cases (e.g. where the law is settled), codification can be achieved with little difficulty. However, there is little doubt that the success of codification is subject-specific. In some areas, it can be successful, whereas in other areas, it is highly problematic. For example, for a long time, the Law Commission tried to produce a contract code, but despite lengthy and protracted consultation, a consensus could not be achieved and the project was abandoned and branded as too ambitious.
- Second, codification may provide a clearer and more accessible statement of duties, but it will not provide a comprehensive statement of the duties of directors. The codified duties will need to be interpreted by the judges in marginal cases where the law is not clear. In such cases, recourse to the statute will not be enough and the relevant case law will need to be known. Accordingly, it could be argued that accessibility will only be marginally improved, and the idea that a layman can acquire a definitive idea of the duties of directors is naïve.
- A corollary of this is that the codified law may not result in a notable increase in predictability. The codified duties will not cover every case and Parliament cannot be expected to foresee every situation that might arise. The judges will still need to fill in any gaps that arise.
- Third, codification might well lead to a loss in flexibility. Most areas of company law are dynamic and the law needs to be able to respond to new situations. If the codification of directors' duties is too comprehensive and detailed, there would be a real danger of cases arising that fall outside the scope of the duties, but which should be regulated. The ability of the judges to adapt the law to new situations and practices will be halted and the law could become rigid.
- This loss of flexibility is mitigated if the codification is in broad and general language. However, as noted, the danger of this approach is that the law could become unclear.
- A fourth problem with codification is that it is not easy to amend codified law. To amend the statutory statement of duties, an Act of Parliament would need to be passed. Amending legislation can be a long and complex process, so codified law may be slow to adapt to changing circumstances.

The general duties

- In order to answer the question, students should point out those areas where the law has remained the same and those areas where the codified duties differ. As a general rule, the duties found in the 2006 Act are the same as those pre-2006, albeit with some slight alterations (e.g. the duty to act within powers and act for a proper purpose are merged under s 171). This is backed up further by:
 1. Section 170(1) which provides that the general duties are owed to the company – this preserves the position at common law.
 2. Section 170(4) which provides that the courts, when interpreting the general duties, shall have regard to 'the corresponding common law rules and equitable principles.'
 3. Section 178(1) which provides that the consequences of breaching a general duty are the same as under the corresponding common law duty.
- However, the 2006 Act has reformed the duties in some notable ways, with the obvious example being the duty contained in s 172, namely to promote the success of the company for the benefit of

its members. You should discuss how the s 172 duty differs to the previous 'bona fide in the interests of the company' duty. This will involve a discussion of the two approaches proposed by the Company Law Review Steering Group, namely the 'pluralist approach' and the 'enlightened shareholder' approach. Students should state why the latter approach was favoured.

- It has been argued by many that the common law duty was shareholder-focussed, whereas the duty contained in s 172 is more stakeholder-friendly. This is backed up by the list of relevant factors contained in 172(1) which includes the interests of employees, the community and the environment, as well as the likely consequences of any decision in the long-term. However, in keeping with the enlightened shareholder approach, directors must have regard to these factors, but they cannot be used to override the primary duty to promote the success of the company for the benefit of its members.

Conclusion

- Conclude based on the arguments made. There is little doubt that the general duties are extremely similar to the pre-2006 common law. Many would also agree that placing the statement of directors' duties in statute does make the duties clearer and more accessible.
- However, the 2006 Act has also changed the content of directors' duties in some notable ways. It is probably too early to tell to what extent these changes will alter the duties of directors, but the s 172 duty has the potential to change the traditional shareholder-centric behaviour of directors.

Problem question

Ethos plc is a major, international graphic design company. Ross, a major shareholder, is concerned that several of Ethos' directors may have breached their statutory duties and seeks your advice:

- The board of Ethos discover that Asset Strip Ltd is considering a takeover bid of Ethos. Asset Strip plans to break up the various parts of Ethos and sell them off individually and to remove the company's directors. Ethos is making a considerable profit and the directors genuinely believe that it would not be in the interests of the company or its shareholders for Ethos to be taken over by Asset Strip. Accordingly, the directors cause the company to issue new shares, which are issued to Sylvia - an existing shareholder who is known to oppose the takeover.
- Anna, a director of Ethos who has worked for the company for over 20 years, decides to retire. In recognition of Anna's service, the directors of Ethos agree that the company will pay Anna £1,000.
- Ethos' Articles of Association state that 'Ethos plc may engage in any activity directly related, or incidental to, the carrying on of a graphic design business.' The directors of Ethos cause the company to lend £5,000 to Ceri, who will then pay off the loan over a two-year period. Ceri is a major client of Ethos, but aside from this, she has no other links with the company or its directors. A number of Ethos' shareholders hear of the loan and argue that Ceri must give the money back immediately.
- Around twenty of Ethos' employees are engaged in web design. However, the web design division of Ethos has not been profitable for some time and the directors have considered closing the division down. Accordingly, the directors decide to close down the web design division and the make the twenty employees that worked there redundant.
- One of Ethos's directors, Mike, is in extreme financial difficulty and is close to having to declare himself bankrupt (which would make him ineligible to act as a director of Ethos). Accordingly, to prevent this, the other directors of Ethos cause the company to lend Mike £15,000. The transaction is disclosed at a meeting of the directors and the directors unanimously agree to authorize the loan. Mike was present at this meeting, but did not vote on whether the loan should be made.

- Problem questions relating to directors' duties can be quite difficult, as you will need to identify which duty may have been breached. In particular, the various duties relating to conflicts of interest or transactions involving the company can be confusing and difficult to distinguish. Make sure that you are fully aware of the relevant duty(ies) before discussing it. It may even be the case that a single act is capable of breaching several duties.
- Although questions tend to focus on the general duties, do not neglect the rules relating to those transactions that require shareholder approval. Although it could be questioned whether they are duties at all or simply procedural rules that must be followed, it is common for problem questions involving directors' duties to also include a transaction that requires shareholder approval. Regarding such transactions, compliance with the general duties is not enough.

The board of Ethos discover that Asset Strip Ltd is considering a takeover bid of Ethos. Asset Strip plans to break up the various parts of Ethos and sell them off individually and to remove the company's directors. Ethos is making a considerable profit and the directors genuinely believe that it would not be in the interests of the company or its shareholders for Ethos to be taken over by Asset Strip. Accordingly, the directors cause the company to issue new shares, which are issued to Sylvia - an existing shareholder who is known to oppose the takeover.

- The relevant duty to discuss here is the duty found in the CA 2006, s 171(b) which states that a director must only exercise powers for the purposes for which they are conferred. This duty is based on the common law 'proper purpose' doctrine and many of the cases decided under the common law remain relevant. The majority of the cases involving the proper exercise of directors' powers, like our problem, concern the power of the directors to issue shares.
- The problem that arises is that the directors may issue shares for several reasons. Some of these reasons may be proper, whereas others may be improper. Issuing shares in order to prevent Asset Strip from taking over Ethos could be regarded as a proper purpose, as the directors genuinely believe that the takeover would not be in the interests of the company or its shareholders. However, a side effect of preventing the takeover is that the directors retain control of the company, and the courts have repeatedly indicated that it is an improper purpose of power for directors to issue shares in order to keep themselves in office.²
- Where multiple purposes exist, some of which are proper and some of which are improper, the courts will seek to determine the dominant or substantial purpose.³ If the dominant purpose is proper, the exercise of power will be valid, notwithstanding that subservient improper purposes existed. Conversely, where the dominant purpose is improper, the duty will be breached, even though secondary proper purposes exist.
- The issue to determine here is what is the dominant purpose behind Ethos issuing the shares. If the dominant purpose is for the directors to keep themselves in office, then the exercise of their power will be improper and the duty will be breached. However, based on what we are told, it would appear that the dominant motivation behind the issuing of shares is to prevent the takeover.
- There is no legal principle that states that the directors cannot act in order to prevent a takeover from succeeding. However, in most cases, directors acting in such a way will have difficulty establishing that they are not acting in such a way in order to maintain themselves in office.
- Despite this, several judges have stated that directors who exercise their powers in order to prevent a takeover may not necessarily breach the duty contained in s 171(b). In *Cayne v Global Natural Resources plc*,⁴ Megarry VC discussed whether or not directors could act to prevent a takeover where

² See e.g. *Punt v Symons* [1903] 2 Ch 506 (Ch).

³ *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 (PC).

⁴ (CA 25th August 1982).

the bidder was an asset stripper (as in our case) or someone who would run the company incompetently. He stated:

I cannot see why that should not be a perfectly proper exercise of fiduciary power by the directors. The object is not to retain control as such, but to prevent [the company] from being reduced to impotence and beggary, and the only means available for the directors for achieving this purpose is to retain control. This is quite different from directors seeking to retain control because they think they are better directors than their rivals would be.

- If Megarry VC's view is regarded as correct, then it could be argued that the directors of Ethos have not breached the proper purpose. However, the law in this area is unclear and Megarry VC's view has not been accepted by some members of the judiciary (see e.g. Hoffmann J (as he then was) in *Re a Company (No 005136 of 1986)*).⁵

Anna, a director of Ethos who has worked for the company for over 20 years, decides to retire. In recognition of Anna's service, the directors of Ethos unanimously agree that the company will pay Anna £1,000.

- Students may feel that this involves a discussion of the duty to avoid a conflict of interest, or the duty to declare an interest in a proposed transaction, but in fact, the issue of payments made to departing directors has become such a controversial and commonplace one that specific provisions exist regarding when the company can make such a payment.
- The provisions relate to payments for 'loss of office' which includes payments made as consideration for, or in connection with, a director's retirement. Section 217(1) provides that a company cannot make a payment for loss of office to a director unless it has first been approved by a resolution of the members of the company. Obtaining board approval for the payment is not enough.
- Accordingly, the directors of Ethos have made an improper payment to Anna. The consequences of breaching s 217(1) are twofold. First, Anna will hold the £1,000 payment on trust for Ethos. Second, all the directors of Ethos (as they all agreed to the payment) will be jointly and severally liable to indemnify Ethos for any loss sustained by the company resulting from the payment.⁶

Ethos' Articles of Association state that 'Ethos plc may engage in any activity directly related, or incidental to, the carrying on of a graphic design business.' The directors of Ethos cause the company to lend £5,000 to Ceri, who will then pay off the loan over a two-year period. Ceri is a major client of Ethos, but aside from this, she has no other links with the company or its directors. A number of Ethos' shareholders hear of the loan and argue that Ceri must give the money back immediately.

- At first glance, it would appear that this situation involves a discussion of the duty to avoid a conflict of interest, or the duty to declare an interest in a proposed transaction. However, this is not the case as the question makes clear that Ceri has no links with the company or its directors. Accordingly, no conflict exists.
- You may think that the question concerns the rules relating to loans, quasi-loans and other credit transactions. However, those rules only apply to situations where the company makes a loan or quasi-loan to a director, or enters into a credit transaction with a director. As Ceri is not a director, these rules do not apply.
- The relevant duty is the duty found in the CA 2006, s 171(a) which provides that the directors are under a duty to act in accordance with the company's constitution. The Articles of Association form

⁵ [1987] BCLC 82.

⁶ CA 2006, s 222(1).

the most important part of the company's constitution, so the directors are under a duty to act in accordance with it.

- It is highly unlikely that providing a loan to a client will be regarded as 'directly related, or incidental to, the carrying on of a graphic design business.' Accordingly, it is likely that, in providing the loan to Ceri, the directors have acted *ultra vires* and have breached the duty found in s 171(a).
- However, applying the CA 2006, s 39, the loan agreement itself will remain valid and cannot be set aside on the ground that it is *ultra vires*. Accordingly, where the directors engage in an act that is outside the scope of their powers under the company's constitution, they will be in breach of duty, but the transaction will still bind the company. Therefore, Ceri will not need to pay the money back immediately, and the terms of the loan agreement will remain enforceable.

Around twenty of Ethos' employees are engaged in web design. However, the web design division of Ethos has not been profitable for some time and the directors have considered closing the division down. Accordingly, the directors decide to close down the web design division and the make the twenty employees that worked there redundant.

- The relevant duty here is found in the CA 2006, s 172 which requires each director to 'act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.' The duty is subjective, meaning that what matters is that the directors actually and honestly believed.
- The exact meaning of 'company for the benefit of its members as a whole' is unclear and will remain so until a body of case law develops, although this formulation does appear to give primacy to the interests of the corporate entity. The issue that arises in our problem is that s 172(1) contains a list of relevant factors that the directors must take into account, with one such factor being the interests of the company's employees. Clearly, closing the web division down is not in the interests of the twenty employees who were made redundant.
- However, it is highly unlikely that closing down the web division and making the employees redundant will breach the duty contained in s 172. First, although the directors must take into account the relevant factors, the interests of these factors are still subservient to the overriding duty to promote the success of the company for the benefit of its members (this is known as the 'enlightened shareholder' approach). Closing down an unprofitable part of the business will free up capital which can be used to invest in profitable areas of the business, or to distribute to the shareholders in the form of dividends. Both actions would certainly appear to be actions designed to promote the success of the company for the benefit of its members, and so not breach of duty is likely to have occurred.

One of Ethos's directors, Mike, is in extreme financial difficulty and is close to having to declare himself bankrupt (which would make him ineligible to act as a director of Ethos). Accordingly, to prevent this, the other directors of Ethos cause the company to lend Mike £15,000. The transaction is disclosed (as is Mike's interest in the transaction) at a meeting of the directors and the directors unanimously agree to authorize the loan. Mike was present at this meeting, but did not vote on whether the loan should be made.

- Initially, this appears to be a case involving the duty to declare an interest in a proposed transaction or arrangement, but recourse to this duty alone will not provide an accurate answer. Certainly it is the case that it involves a transaction between a company and its director, and Mike does indeed have an interest in the transaction.
- Section 177(1) provides that the duty to declare an interest in a proposed transaction or arrangement is not breached where the director discloses his interest to the company before the transaction is entered into. Under the 2006 Act, disclosure to the directors will suffice (although the

company's articles can require more exacting disclosure requirements). Accordingly, the board of Ethos has not breached this duty.

- However, more exacting rules apply in relation to loans, quasi-loans and credit transactions. Where a company enters into such a transaction with one of its directors, mere disclosure is not enough. The CA 2006, s 197(1) provides that the company can only enter into such a transaction with a director if it first obtains approval from the general meeting via the passing of an ordinary resolution. The directors of Ethos have not obtained the approval of the general meeting.
- Not all loans are subject to this requirement (e.g. loans or quasi-loans that do not exceed £10,000), but a loan of £15,000 will be. Accordingly, the directors have breached s 197(1). Two consequences follow. First, the transaction is voidable at the Ethos' instance. Second, irrespective of whether Ethos avoids the transaction, any director is liable to account to Ethos for any gains made, and is also liable to indemnify Ethos for any losses sustained, as a result of the loan.