ENLIGHTENED SHAREHOLDER VALUE IN UK COMPANY LAW

RICHARD WILLIAMS*

I INTRODUCTION: ENLIGHTENED SHAREHOLDER VALUE AND SECTION 172 OF *COMPANIES ACT 2006*

The economic difficulties that have beset Western economies since the financial crisis of 2008–09 have prompted policy-makers in many countries to place an increasing emphasis on the need to foster a long term perspective in business decisions.[1] This narrative has sparked renewed interest in the 'enlightened shareholder value' provisions in section 172 of the United Kingdom ('UK') *Companies Act 2006* (UK) ('*Companies Act*'), which requires directors to have regard to a range of interests in discharging their duty to promote the success of their company.[2]

Section 172 of the *Companies Act* enshrines the principle of enlightened shareholder value ('ESV') into UK company law by appending to the directors' duty to 'promote the success of the company for the benefit of its members as a whole' a list of matters to which directors are required to 'have regard' in discharging the duty. The ESV principles in section 172 are stated with a high degree of generality and, as such, read very much like a list of exhortations to 'good' conduct by directors rather than specific instructions to undertake, or refrain from undertaking, any particular actions. Nonetheless, section 171(1)(a)–

* Lecturer in Law, Homerton College, University of Cambridge. I am grateful for the comments of the *UNSW Law Journal's* anonymous referees in compiling this paper. Responsibility for any errors in the paper remains, however, entirely my own.

1 In the UK, for example, the current Prime Minister and Leader of the Opposition have promoted, respectively 'moral capitalism' and 'responsible capitalism'. See, eg, 'Cameron's "Moral Capitalism" Vision', *The Guardian* (online), 19 January 2012 <http://www.guardian.co.uk/uk/feedarticle/10048672>; 'Ed Miliband's Speech on Responsible Capitalism', *UK Labour Party*, 19 January 2012 <http://www.labour.org.uk/ed-miliband-on-responsible-capitalism,2012-01-19>.

2 See, eg, Jingchen Zhao, 'Promoting More Socially Responsible Corporations through UK Company Law after the 2008 Financial Crisis: The Turning of the Crisis Compass' (2011) 22 *International Company and Commercial Law Review* 275, 283; Virginia Harper Ho, '"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide' (2010) 36 *Journal of Corporation Law* 61. See also Andrew Keay, 'Risk, Shareholder Pressure and Short-Termism in Financial Institutions: Does Enlightened Shareholder Value Offer a Panacea?' (2011) 5 *Law and Financial Markets Review* 435, though Keay argues that enlightened shareholder value is unlikely to prove useful in combating short-termism by boards of financial companies.

(f) of the Act requires directors to have regard to following principles in discharging their core duty:

- the likely consequences of any decision in the long term;
- the interests of the company's employees;
- the need to foster the company's business relationships with suppliers, customers and others;
- the impact of the company's operations on the community and the environment;
- the desirability of the company maintaining a reputation for high standards of business conduct; and
- the need to act fairly as between members of the company.[3]

The inclusion of ESV principles in the *Companies Act* was recommended by the Company Law Review Committee which undertook a wide-ranging review of UK company law during the late 1990s and early 2000s. The Review Committee considered at some length whether the duty of loyalty for directors of UK companies should retain the shareholder focus of the common law,[4] or should be reoriented along 'pluralist' lines, with directors obliged to give equal weight to the interests of constituencies such as company employees and creditors, alongside the interests of shareholders.[5] The Committee declared itself to be in sympathy with the view that business affairs should be conducted with an eye to the long term and in a manner that enhanced the welfare of different groups in society, but felt that it was important the law placed a clear obligation on directors that ensured focused and competitive management and which did not turn them 'from business decision makers into moral, political or economic arbiters'.[6] As such, mandatory pluralism was rejected in favour of ESV,[7] which was offered as a means of retaining the benefits of focused management fostered by the shareholder-orientation of the common law duty, but which captured some of the inclusive aspects of pluralist approaches to corporate governance.[8]

The inclusion of ESV principles in the UK *Companies Act* gives the duty of loyalty in UK law a different look to the common law duty to act 'bona fide in the best interests of the company'[9] and to the equivalent statutory provisions in Australia and New Zealand.[10] But it is not clear to what extent the statutory statement of ESV principles has altered the substance of the duty in UK company

3 *Companies Act* s 172(1)(a)–(f).

4 See, eg, *Re Smith and Fawcett Ltd* [1942] Ch 304; *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 ('*Greenhalgh*').

5 On stakeholder company law, see generally John Edward Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Clarendon Press, 1993). For a summary of the shareholder and stakeholder approaches, see Andrew Keay, 'Moving Towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value and More: Much Ado About Little?' (2011) 22 *European Business Law Review* 1, 3–7.

6 Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework* (London, 2000) [2.21].

7 Ibid ch 2.

8 Ibid [3.22].

9 *Re Smith and Fawcett Ltd* [1942] Ch 304.

10 See, eg, *Corporations Act 2001* (Cth) s 181 ('*Corporations Act*') and *Companies Act 1993* (NZ) s 131.

law. The core duty in section 172 remains to promote the interests of the members generally and directors are required only to 'have regard' to ESV principles in discharging this duty. Further, the duty in section 172 is owed to the company[11] and outsiders have no ability, at least where a company is solvent, to enforce ESV principles.

Nonetheless, the adoption of ESV principles along UK lines has been advocated in other jurisdictions as a desirable means of combating failures in corporate governance identified in the wake of the global financial crisis. Harper Ho, for example, has advocated the adoption of an ESV model in US jurisdictions on the basis that, whilst ESV does not oblige directors to act on the basis of stakeholder interests, it nonetheless 'endorses a multi-stakeholder decision-making rule and makes management at least indirectly accountable to stakeholders'[12] which has the effect of 'nudging companies in the direction of greater social responsibility'.[13] Shan Ho has also advocated the adoption of ESV in the Hong Kong Companies code, though in this case on the basis that ESV reflects 'modern commercial practices', rather than as a specific response to the events of 2008–09.[14]

It is argued here that ESV does not represent any substantive change in the approach of UK company law to stakeholders, and as such that the model of the UK *Companies Act* it is of doubtful usefulness to other jurisdictions in seeking to enhance social responsibility in their company law. This argument is advanced in three parts. First, it is noted that despite the expanded list of ESV principles included in section 172, the provision does little more than state explicitly that which has long been implicit in the common law, namely that 'having regard' to the interests of other constituencies is an integral part of managing companies for the benefit of members generally. It is noted that the statutory statement of ESV principles has the potential to act as a catalyst for development in stakeholder protection beyond the common law. However, the second part of this article contends that this is unlikely in the face of procedural limitations within section 172. Insolvency law provisions, particularly actions by creditors for misfeasance under section 212 of the UK *Insolvency Act* provide a mechanism for circumventing these limitations in insolvent companies, but it is noted that the vague nature of ESV principles and uncertainty surrounding the ability to recover substantial sums for breach of ESV principles make it unlikely that the statutory statement will represent any substantive advance on the common law position. Third, it is argued that more significant developments in the protection of stakeholder interests have taken place though the application of the standard of 'unfitness to be concerned in the management of companies' in the UK's *Company Directors Disqualification Act 1986* (UK) ('*Disqualification Act*'). The

11 *Companies Act* c 46, s 170(1).

12 Harper Ho, above n 2, 79. See also Zhao, above n 2.

13 John M. Conley, 'An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct' (2005) 38 *Cornell International Law Journal* 493, 500, cited in Harper Ho, above n 2.

14 John Kong Shan Ho, '"Director's Duty to Promote the Success of the Company": Should Hong Kong Implement a Similar Provision?' (2010) 10 *Journal of Corporate Law Studies* 17, 32.

UK's disqualification rules allow state agencies to act directly as regulator of a director's conduct, which is assessed against the broad and flexible standard of unfit conduct. This article shows that this standard is routinely used to protect the interests of various stakeholder groups and highlights the many procedural advantages that the disqualification rules have over ESV as a means to enhance the importance of stakeholder interests in the regulation of a director's conduct. Analysis of disqualification therefore further illustrates why ESV is not a particularly radical innovation in UK company law, but shows too that neither is it the most effective mechanism for enhancing stakeholder protection that UK law provides.

II THE COMMON LAW AND ESV

The established view of UK company law, like that of the US, Australia, New Zealand and Canada, is that it gravitates towards an economic and proprietary analysis of the company and therefore promotes the goal of profit maximisation in the interests of shareholders.[15] That directors must act in the best interests of the company was set down in *Re Smith and Fawcett Ltd*, where Lord Greene MR declared that the common law required directors to act 'bona fide in what they consider to be the best interests of the company' and not what the court may consider to be so.[16] In *Greenhalgh*,[17] it was held that this obliged directors to act in a manner that advanced the interests of the 'corporators as a general body' and not for the company as a distinct legal entity. In the UK the duty is now enshrined in the first limb of section 172(1) of the *Companies Act* which states that directors 'promote the success of the company for the benefit of its members as a whole', and in Australia in section 181 of the *Corporations Act 2001* (Cth).

The claim that the duty of loyalty requires directors to pursue 'profit maximisation' arises from the association of the 'interests of the company' with the 'interests of the members', as a general body. In identifying one group, that is shareholders, as the sole beneficiaries of directors' efforts, the law appears to impose a narrower duty on directors than could arise, for example, from a duty for directors to exercise their powers in the interest of the company *as a separate legal entity*.[18] A duty to members seems squarely focused on increasing the financial value of the company whereas a duty to the company as a separate commercial entity could imply much more of a balancing of the interests of the different stakeholders that make up the separate entity, such as shareholders, employees, creditors etc.[19] However, as commentators have noted,[20] the

15 See, eg, Parkinson, above n 5, 76–82.

16 *Re Smith and Fawcett Ltd* [1942] Ch 304, 306. In Australia, see also *Mills v Mills* (1938) 60 CLR 150.

17 [1951] Ch 286, 291. See also *Fulham Football Club Ltd v Cabra Estates Plc* [1992] BCC 863, 876 (Neill LJ). In Australia, the same rule was adopted in *Ngurli Ltd v McCann* (1953) 90 CLR 425.

18 See Parkinson, above n 5, 76–9.

19 As is the case in many continental European jurisdictions, see Simon Deakin, 'The Coming Transformation of Shareholder Value' (2005) 13 *Corporate Governance: An Institutional Review* 11, 12.

association of the various common law (and now statutory) duties to promote the interests of the company for the benefit of members with 'profit maximisation' owes much more to the normative case for profit maximisation advanced by advocates of private and contractual conceptions of the company than it does to positive analysis of the case law itself.[21]

So far as UK and Australian law is concerned, case law in fact provides little guidance on the content of the duty to promote the interests of the company for the collective benefit of members and has,[22] in both jurisdictions, shown a distinct tendency to limit more detailed exposition of the duty to statements as to what it *is not*, rather than what it *is*. It has been clear from an early stage that the duty cannot, for example, simply be equated with 'what the members want'. In *Greenhalgh*, Evershed MR stated that the interests of 'members generally' should be determined by reference to the views of a hypothetical member of the company, not the actual members,[23] and in *Gaiman v National Association for Mental Health*[24] (in the UK) and *Provident International Corp v International Leasing Corp Ltd*[25] (in Australia) it was suggested that in discharging this duty, directors could consider the interests of current and *future* members in deciding how to promote the best interests of the company.

The fact that the interests of the members cannot simply be equated with their actual wishes and desires presents clear difficulties for the notion that the law mandates strict 'profit maximisation'. But it also raises a broader question about the consequences of identifying the members as the object of directors' efforts. It has been contended, for example, that the identification of the interests of the company with the 'interests of the members' is at least necessary in order to give meaning to the duty to promote the success of the company.[26] Without such clarification it is claimed that the duty would be almost meaningless because of the abstract nature of corporate personality.[27] However, in truth, attempting to fill

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20 See, eg, Harper Ho, above n 2, 74; Jill E Fisch, 'Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy' (2006) 31 *Journal of Corporation Law* 637, 650. See also Deakin,above n 19, 11–12. Deakin concludes that the maximisation 'shareholder value' as the primary corporate objective owes its existence to 'norms and practices surrounding the rise of the hostile takeover movement' in the 1970s and 1980s, rather than to 'core company law': at 16.

21 See generally Parkinson, above n 5, 75; Harper Ho, above n 2.

22 See, eg, comments of Nourse LJ in *Brady v Brady* (1987) 3 BCC 535 ('*Brady*'), who described the notion of 'the interests of the company' as 'one which is often used but rarely defined': at 522. On the equivocal treatment of 'the interests of the company' in case law, see further 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, 341–6.

23 [1951] Ch 286. In the UK this approach has been extended to the directors' duty to creditors in companies nearing insolvency, see, eg, *GHLM Trading Ltd v Maroo* [2012] EWHC 61 (Ch), where, discussing the principle in *West Mercia Safetywear v Dodd* [1998] BCLC 250, Newey J commented that where creditors interests became relevant the duty in *Companies Act* s 172 becomes one 'to have regard to the interests of the creditors *as a class*' and not individual creditors: at [168].

24 [1971] Ch 317, 330. See also *Brady* (1987) 3 BCC 535 (Nourse LJ).

25 [1969] 1 NSWLR 424, 440.

26 Paul L Davies, *Gower and Davies: The Principles of Modern Company Law* (Sweet and Maxwell, 8th ed, 2008), 16–24.

27 Ibid.

this void by identifying the interests of the members *generally* as the object of corporate power is a strategy that can only have very limited success. For once the actual wishes of the members are divorced from the legal notion of 'the interests of the members', as they are by both UK and Australian law, then a rule requiring the promotion of the interests of the members becomes little less of an abstraction than a rule requiring directors to further the interests of the company as an artificial entity. In practice both approaches require directors to act according to an artificial construct that will be derived from the director's balancing of whichever social, political and economic factors that they consider relevant to determine either (i) what are the interests of the members *as a general body*, or (ii) the interests of the company *as a commercial entity*. To be sure, identifying the interests of the members as the relevant test will likely lead to directors attaching particular weight to factors they consider to be important to the members. However, the abstract nature of the 'interests of the members' makes it almost inevitable that the interests of other groups will be considered by directors in as much they are felt to bear on determining a course of action that is in the interests of the members. Indeed, this has been clear since the nineteenth century, when it was famously stated in *Hutton v West Cork Railway Company*, that the directors were free to confer benefits on groups other than shareholders, provided that the relevant 'cakes and ale' were genuinely considered to advance the interests of company (and its members).[28]

The limited normative implications of the legal duty to promote the interests of members[29] are further evidenced by its subjective nature.[30] For whatever the process of reasoning by which directors determine 'the interests of the members generally', in practice the duty has never required directors to manage the affairs of a company for the benefit of its members, in the sense that any conduct that failed to promote the interests of members would necessarily be liable to sanction. Rather, the subjective nature of the duty means that the law has only ever required that directors exercise their management powers in a manner that *they considered* will promote the interests of the company for the benefit of its members, for it is only conduct that is not believed, in good faith, to promote the interests of members that will be sanctioned.[31] This reinforces the scope for directors to take account of the interests of non-shareholder groups.

Stripped of overlying normative arguments that link the shareholder-orientation of UK and Australian law to the notion of profit maximisation, it is therefore unsurprising that it has been observed that the ESV principles in section 172 of the UK *Companies Act* have in fact made little change to the expectations of directors in UK company law.[32] In part, this is due to procedural limitations

28 (1883) LR 23 Ch D 654, 673.

29 Deakin, above n 19, 11–13; Keay, above n 22, 341–346.

30 *Re Smith and Fawcett Ltd* [1942] Ch 304. The subjective nature of the duty to promote the success of the company is retained by *Companies Act* c 46, s 172(1), *Corporations Act* s 181(1)(a) and *Companies Act 1993* (NZ) s 131(1).

31 See, eg, *Re Smith v Fawcett Ltd* [1942] Ch 304.

32 Shan Ho, above n 14, 23; Harper Ho, above n 2, 79.

with the scheme of the *Companies Act* itself. The duty in section 172 remains owed to and, in the main, only enforceable by the company[33] and directors are required only to 'have regard' to ESV principles. However, it is also clear that the traditional common law duty of loyalty was sufficiently broad to accommodate the matters now identified in section 172 as ESV principles.

The reason, of course, for this is that the common law recognised and accommodated the fact that reasonable people may legitimately disagree as to which course of action promotes the interests of the company 'for the benefit of members as a whole'. There is rarely a single path to corporate prosperity and in practice directing the affairs of a company inevitably involves balancing the interests of many different groups before settling on the preferred course of action. In this sense, the ESV principles in section 172 of the *Companies Act* do little more than give expression to matters of practical business sense that clarify rather than revolutionise the existing law, as, indeed, the UK government was at pains to emphasise during the passage of the ESV provision through the UK Parliament.[34] It would be the poor director indeed who, for example, exercised his powers without any regard to the long term impact of his decisions,[35] or who for whom 'the need to foster the company's business relationships with suppliers, customers and others'[36] was a matter of indifference. To be sure, it might be possible to claim, if one focuses solely on the promotion of the interests of members, as Parkinson did, that the legal model 'excluded all non-ownership interests' from directors' minds, but looking at the law in its full context it is hard to contend that directors are not free under the traditional duty of loyalty (for example, as is broadly incorporated into the Australian and New Zealand corporations/company laws) to consider a whole range of interests in their management decisions.

This view is supported by a 2007 study of Australian directors' attitudes to stakeholders.[37] The survey, which was comprised of the responses of 367 directors of Australian companies found that whilst a plurality (44 per cent) tended to rank shareholder interests first in their 'order of priority' in corporate decision making,[38] over 90 per cent of directors of Australian companies responding to the survey felt that the existing law on directors duties in Australia (which essentially reflects the common law position in the UK before the *Companies Act*) was broad enough to allow them to consider the interests of both stakeholders and shareholders and, further, that 55 per cent of directors believed that the current provisions of the *Corporations Act required* them to take account

33 *Companies Act* c 46, s 170(1). See further below.

34 United Kingdom, *Parliamentary Debates*, House of Lords, 9 May 2006, vol 681, col 840; United Kingdom, *Parliamentary Debates*, House of Lords, 6 Feb 2006, vol 678, col GC255.

35 *Companies Act* c 46, s 172(1)(a).

36 *Companies Act* c 46, s 172(1)(c).

37 See Malcolm Anderson et al, 'Evaluating the Shareholder Primacy Theory: Evidence from a Survey of Australian Directors' (Research Report, Centre for Corporate Law and Securities Regulation, University of Melbourne, 2007) <http://cclsr.law.unimelb.edu.au/files/Evaluating_the_shareholder_primacy_theory_-__evidence_from_a_survey_of_Australian_directors__20_11_07_1.pdf>.

38 Ibid 6 (table 1).

of the interests of stakeholders.[39] Although the sample size for the survey is small, it strongly suggests that the flexibility to take account of a range of interests that is built into the traditional duty to promote the success of the company is well understood by practitioners in the field.

Therefore, if the duty to promote the interest of members is understood in its proper context then it can be seen that UK's ESV provisions do little more than make explicit that which had always been implicit in the common law, namely that promoting the interests of the company requires directors to consider a wide range of interests. To be sure, section 172 of the UK *Companies Act* appears to place directors under some form obligation to consider ESV principles, and this is an innovation.[40] However, ESV principles are vague and any obligation on directors, such as it currently is, is only to 'have regard' to them. This, combined with other procedural limitations within the section, severely restricts the likelihood that the *obligation* imposed on directors to consider ESV principles will prove to be a catalyst for changes in stakeholder protection beyond the position under the common law, and therefore, that it would cause the duty in the UK to diverge in substance from the position in common law jurisdictions such as Australia and New Zealand.

III PRIVATE ENFORCEMENT AND INSOLVENCY RULES

It is widely recognised that procedural limitations in section 172 make litigation under the provision complex and potentially very costly and that they are, as such, likely to restrict the impact of the statutory statement of ESV principles.[41] First, the language with which the *Companies Act* seeks to incorporate ESV principles into a director's decision-making process is extremely vague. The statute requires only that directors 'have regard' to ESV principles and gives no further indication of the level of engagement with ESV principles necessary to comply with the provision.[42] As such, sufficient regard to ESV principles under the statute could encompass anything on a scale from 'having a think about it' to giving the matter detailed consideration. Litigation under section 172 will accordingly be clouded in uncertainty due to the vague nature of the standard for liability, except, perhaps, in cases where clear evidence of a failure to have *any* regard to the relevant principles is available.[43] Even

39 Ibid 10 (table 5).

40 See Davies, above n 26, 16–28. Davies notes that failure to 'have regard' to ESV principles would constitute a breach of duty and render such a decision challengeable.

41 See, eg, Keay, above n 5, 24–36. The impact of procedural limitations on likely levels of litigation under the provision must be considered against the backdrop of already very low levels of private enforcement of corporate law rules against directors. See, eg, John Armour et al, 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and United States' (2009) 6 *Journal of Empirical Legal Studies* 687.

42 Keay, above n 5, 29.

43 See, eg, *Re M & W Roith Ltd* [1967] 1 WLR 432 for an example of the evidential burden under the old common law.

where such evidence is available, however, the general, even nebulous, nature of the ESV principles themselves further hinders the prospects of successful litigation. The Act provides no guidance of the level of foresight and inquiry necessary to have sufficient regard, for example, to 'the likely consequences of any decision in the long term'[44] and in practice such uncertainty would surely deter all but the most bold of litigants. Furthermore, harm from contravention of such broad principles would likely be difficult to qualify in damages, making recovery highly uncertain even in the event of a successful application.[45]

Aside from the disincentives to litigation under section 172 that arise from the uncertainty of ESV principles, their likely impact is further restricted by the fact that ESV duties are owed to and only enforceable by, the company,[46] which in the ordinary course of events means the directors.[47] Of course, this is not specific to section 172 as directors, through their general management powers, are responsible for the enforcement of all legal claims held by the company. Directors' role in the process of instigating litigation on behalf of a company, however, gives rise to a clear conflict of interest where litigation against fellow directors is concerned. This conflict creates an inevitable drag on the regulatory impact of all directors' duties, but is likely to be particularly acute when it comes to the ESV provisions. Directors are likely to have little interest in giving teeth to otherwise vague ESV principles through litigation against fellow directors. The same is likely to be true for shareholders, who, where they are able to,[48] are most unlikely to instigate litigation alleging breach of ESV principles that do not safeguard their interests.[49] Conflicts between directors' and shareholders' interests and ESV principles therefore probably all but rule out enforcement of ESV principles through traditional directors' duties litigation.

In insolvency, however, third parties can acquire rights to request damages for the company in respect of breaches of duty by directors and this provides an alternative mechanism through which ESV duties may be enforced. Section 212 of the UK *Insolvency Act 1986* (UK) ('*Insolvency Act*') provides that any liquidator *or creditor* of an insolvent company may make an application to the court requesting it to review the conduct of any director, or other person involved in the management of the company, if it appears that that person has been guilty of any misfeasance or breach of duty in his management of the company's affairs.[50] Where the court finds that a director or other person has indeed been guilty of misfeasance or breach of duty it may order that person to 'contribute

44 *Companies Act* c 46, s 172(1)(a).

45 See generally Keay, above n 5, 33.

46 *Companies Act* c 46, 170. See generally ibid.

47 Under general management powers. In the UK context, see *Companies (Model Articles) Regulations 2008* (UK) SI 2008/3229.

48 Shareholders may initiate proceedings under s 172 by means of derivative action, now governed in the UK by *Companies Act* c 46, s 260.

49 See further Keay, above n 5, 33, 35–6.

50 This includes any officer of the company, a liquidator or administrative receiver of the company's property or any other person who has been concerned, or has taken part, in the promotion, formation or management of the company: *Insolvency Act* c 45, s 212(1)(a)–(c).

such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty as the court thinks just'.[51]

Neither liquidators nor creditors suffer from the conflicts of interest that inhibit enforcement of ESV by directors and shareholders and creditors actually have a positive interest in ensuring that ESV principles are respected. However, despite the potential for third party litigation under section 212 of the UK *Insolvency Act*, the likelihood of actions for breach of ESV principles in insolvency is low. For one thing, litigation would be just as risky and potentially expensive for third party creditors and the liquidator as it would for the company or shareholders due to the vague nature of ESV principles and the weak duty only to 'have regard' to them.[52] Creditors in particular may suffer as litigants from being corporate outsiders and not having access to company documents necessary to make out a claim for breach of ESV principles.[53] Unless it was clear that significant sums could be recovered from directors for breach of ESV principles, creditors would consequently be unlikely to take on the financial risk of litigation.[54] Indeed, the fact that recovery under section 212 is made for the company and not simply litigating creditors poses a significant free-rider problem that may well discourage creditors from instigating litigation.[55]

Liquidators are entitled to reclaim the costs of litigation conducted on the company's behalf as sums legitimately incurred in the performance of their duties,[56] but are similarly unlikely to embark on potentially expensive proceedings without the prospect of substantial damages being recovered from a director for the company. Indeed, if a liquidator were to launch such proceedings without the prospect of recovery he could himself be found liable for the costs of the litigation.[57] Given that the quantum of damages that could be awarded for breach of ESV principles is highly uncertain, it would seem that the likelihood of their enforcement by liquidators is little higher than the likelihood of enforcement by directors and shareholders.

However, UK policy makers could, if they so chose, overcome the difficulties of private enforcement of ESV by utilising directors' disqualification legislation. UK company law has long sought to raise standards of conduct amongst directors through the use of directors' disqualification rules, particularly the disqualification for unfitness to be concerned in the management of

51 *Insolvency Act* c 45, s 212(3)(b).

52 Keay, above n 5, 33.

53 Though as Vanessa Finch notes, creditors who wish to bring a claim under s 212 of the *Insolvency Act* will be aided by disclosure rules in insolvency proceedings: see Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge, 2nd ed, 2009), 705–06.

54 See generally Finch, ibid 707–09. Finch notes that secured creditors would have no need for recovery under s 212 and so the provision is likely to be of primary relevance to unsecured creditors. Unsecured creditors, tend however, to be the least well-off creditors, and so the least able to bring proceedings under s 212.

55 Finch, ibid 708.

56 See generally Finch ibid 553–5, 708.

57 See, eg, *Walker v Walker* [2006] 1 WLR 2194.

companies.[58] In large part disqualification rules have arisen in response to the limitations of traditional mechanisms in effectively disciplining directors. Disqualification actions are brought in the public interest[59] by state agencies[60] and as such provide an obvious means by which changed attitudes towards 'good' conduct in corporate management may be quickly realised. However, protecting the interests of stakeholders is already an integral part of the regulation of directors' conduct through disqualification actions. And disqualification arguably represents a much more important advance in ensuring that directors do not act abusively towards stakeholders than that which is likely to arise from ESV. So whilst a number of private law mechanisms exist in principle through which ESV principles may be enforced, none are likely to prove effective.

IV DISQUALIFICATION OF DIRECTORS AND ESV

Disqualification rules provides the UK State with a means by which it may seek to foster desirable, rather than simply 'lawful', conduct in the management of companies. The current UK disqualification provisions were enacted following the report of the Cork Committee[61] on insolvency law reform. Cork advocated a significant expansion of public interest proceedings in corporate insolvency law in order to develop an effective regime for tackling so-called 'abuses of limited liability' which were perceived as inflicting significant harm on the public.[62] A key part of this agenda was the expansion of powers to seek the disqualification of directors on the ground of 'unfitness to be concerned in the management of companies'. The unfitness provisions are now found in sections 6 and 8 of the *Disqualification Act*. The leading provision is section 6, which allows for the disqualification of directors of insolvent companies on the ground of unfitness and typically over 1000 directors are disqualified under the provision each year.[63] Applications for disqualification under sections 6 or 8 of the Act are brought by the State, in the person of the Secretary of State, or in the case of section 6, the official receiver of an insolvent company acting on his behalf,[64] wherever he feels that an individual is unfit and that it is 'expedient in the public interest' to bring disqualification proceedings.[65] As such, UK law provides a broad

58 See *Disqualification Act* c 46, ss 6(1) and 8(1).

59 *Disqualification Act* c 46, ss 6(1) and 8(1).

60 Applications for a disqualification on the ground that a director is 'unfit to be concerned in the management of a company' may be made by the Secretary of State, or in the case of an insolvent company, by the official receiver acting on his behalf: see *Disqualification Act* c 46, ss 7(1) and 8(1).

61 United Kingdom, *Insolvency Law and Practice: Report of the Review Committee,* Cmnd 8558 (1982) ('Cork Report').

62 Ibid 1741.

63 In 2010–11, for example, 1389 directors of insolvent companies were disqualified on the ground of unfitness (under s 6 of the Act), whereas only 12 directors of solvent companies were disqualified under s 8: see *Statistical Tables on Companies Registration Activities 2010/11* (Companies House, 2011), table D1 <http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2010_2011.pdf>.

64 *Disqualification Act* c 46, s 7(1).

65 *Disqualification Act* c 46, s 7(1) and s 8(1).

administrative jurisdiction for the State to take an active part in shaping the conduct of directors through disqualification proceedings and in this respect the UK's disqualification provisions are significantly broader than the disqualification provisions of Australia's *Corporations Act*. Australian disqualification provisions do not contain any equivalent to the unfitness provision, with disqualification in the *Corporations Act* instead relying more heavily on breaches of duty by directors or specific offences under the corporations law.[66]

The primary concern of the UK's Cork Committee in recommending an expansion of disqualification for unfitness powers was to provide the State with a mechanism by which it may remove the privilege of limited liability from entrepreneurs who were guilty of engaging in 'sharp' business practices.[67] However, the standard of liability in sections 6 and 8 – that is, unfitness to be concerned in the management of companies – is not defined by the Act and so provides a broad and flexible standard by which the conduct of directors may be regulated. A list of conduct that is described as 'relevant' to determining unfit conduct is included in schedule 1 of the *Disqualification Act,* but the list is non-exhaustive and non-binding.[68] It is firmly established that a court may disqualify an individual on the basis of any conduct that it considers meets the standard of unfitness[69] and indeed many of the most common matters of unfit conduct cited in disqualification cases are matters that are not listed in schedule 1.[70] Nonetheless, the schedule of relevant matters makes it abundantly clear that disqualification for unfitness is concerned with a broad notion of undesirable conduct in the management of companies and not simply conduct that is in breach of specific company law rules or prejudicial to shareholder interests. Indeed, certain matters highlighted as 'relevant' to unfit conduct in schedule 1 of the *Disqualification Act* mirror ESV principles. Protecting the welfare of creditors and customers, for example, is central to many of the 'relevant matters' cited in the *Disqualification Act*,[71] and in this sense shares much in common with ESV principles highlighting the need to foster relationships with customers, suppliers and others.[72] More generally, the breadth of unfit conduct in disqualification proceedings is highlighted by phrases such as 'breach of

66 See, eg, *Corporations Act* s 206C (disqualification for breach of a civil penalty provision); s 206E (disqualification for contraventions of the *Corporations Act*); and s 206F (ASIC's power of disqualification following an adverse report by a liquidator).

67 See Cork Report, above n 61, [1739], [1744] and [1834].

68 *Disqualification Act* c 46, s 9(1). The matters in the list are described only as 'relevant' in determining unfit conduct.

69 See, eg, *Re GSAR Realisations Ltd* [1993] BCLC 409, 421 (Ferris J) and *Re Bath Glass* (1990) 4 BCC 130, 132–133 (Gibson J).

70 For example, failure to pay Crown debts (taxes) whilst treating the Crown creditor less favourably than other creditors or trading whilst insolvent to the detriment of creditors: see generally Adrian Walters and Malcolm Davis-White, *Directors Disqualification and Insolvency Restrictions* (Sweet and Maxwell, 3rd ed, 2010) ch 5.

71 See, eg, *Disqualification Act* sch 1 para 7: 'The extent of a director's responsibility for any failure by the company to supply goods or services which have been paid for (in whole or in part)'.

72 *Companies Act* c 46, s 172(1)(c).

commercial morality',[73] or a 'breach of commercial probity'[74] which have variously been used in attempts to identify the essence of unfit acts.[75] As such, a wide, almost limitless, variety of conduct has been cited in disqualification cases to sustain a finding of unfitness. In addition to the core allegations of Crown debt misconduct[76] and trading whilst insolvent to the detriment of creditors, it has been accepted that directors may be sanctioned for taking 'excessive remuneration' from companies,[77] misusing interest gained from money held by the company on behalf of clients,[78] as well as conduct detrimental to the welfare of employees.[79]

The fact that the disqualification legislation has been used to protect the interests of creditors and other constituencies shows that UK company law has, for many years, included a mechanism for enhancing the protection of 'stakeholder' interests. Crucially however, the standard of liability that has been used to do this, that is unfit conduct, is not tied to an overriding duty to promote the interests of the members of the company. As such disqualification for unfitness is arguably a conceptually more radical provision for advancing third party interests than the ESV parts of section 172, which are of course, subordinate to the overriding interests of shareholders. The public interest[80] nature of disqualification proceedings is a crucial in this respect, as it allows the disqualification standard to be used to sanction a broad range of conduct that affects shareholder and stakeholders alike without apparent contradiction. Those who view the company as a social enterprise and follow Dahl's claim that 'every large corporation…[is] an entity whose existence and decisions can be justified only insofar as they serve public or social purposes',[81] for example, would no doubt assert that corporate power should only be exercised for social good and any exercise of power that cannot be justified against this goal would be contrary to the public interest and so 'unfit' and there is nothing in the *Disqualification Act* to prevent such an interpretation. Of course, those who view the company as private and contractual in nature[82] would interpret the 'public interest' in

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73 *Re Dawson Print Group* (1987) 3 BCC 322, 324–325 (Hoffmann J):

> There must, I think, be something about the case, some conduct which if not dishonest is at any rate in breach of standards of commercial morality, or some really gross incompetence which persuades the court that it would be a danger to the public if he were to be allowed to continue to be involved in the management of companies, before a disqualification order is made.

74 *Re Lo-Line Electric Motors Ltd* [1988] Ch 477, 486 (Browne-Wilkinson V-C).

75 However, attempts at paraphrasing the standard have been discouraged: see, eg, *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch 164, 176.

76 Ibid 183; *Disqualification Act 1986* c 46, s 6.

77 See, eg, *Re Keypak Homecare Ltd* [1990] BCC 117 (though the allegation was not made out on the facts).

78 *Re CSTC Ltd* [1995] 1 BCLC 545.

79 *Re Omaglass Ltd* (Unreported, 6 April 1995) (failure to maintain a bonus fund for salesmen to meet commission payments), see Amada Hoey, 'Disqualifying Delinquent Directors' (1997) 18 *Company Lawyer* 130, and, Walters and Davis-White, above n 70.

80 Cork Report, above n 61, ch 49; *Disqualification Act* c 46, s 7(1).

81 Robert A Dahl, 'A Prelude to Corporate Reform' (1972) 1 *Business and Society Review* 17, quoted in Parkinson, above n 5, 23.

82 See, eg, Frank H Easterbrook and Daniel R Fischel *The Economic Structure of Corporate Law* (Harvard University Press, 1991).

regulatory proceedings much more narrowly, essentially as allowing the State to only enforce private rights in circumstances of market failure and this too could be readily applied to the Act. However, it is the fact that the concept of unfit conduct is not compelled by the Act in either direction (save the non-exhaustive guidance in schedule 1 to the Act) that gives disqualification its inherent flexibility.[83] Agencies charged with enforcing the legislation are consequently free to fashion their own concept of unfit conduct contrary to the public interest by taking into account a wide range of political, economic and social factors. Disqualification rules consequently provide a ready mechanism through which changing expectations of conduct in the management of UK companies have been, and may continue to be, quickly realised.

This is not to say, however, that the disqualification for unfitness provisions have somehow transformed UK company law from a 'shareholder-orientated' to a 'stakeholder-orientated' system; but it is to show that effective protection of the interests of various stakeholder groups has, through disqualification, long been integrated into the UK approach to regulating the conduct of directors. Where this placed UK law on the shareholder-stakeholder scale though rather depends on understanding the conceptual basis upon which protection of third party interests has been undertaken in disqualification cases. In this vein it is clear that the concept of unfit conduct in disqualification proceedings has been interpreted by UK courts as seeking to combat agency problems[84] that arise in third-party contracts with companies, in the sense that unfit conduct is essentially taken to equate to opportunistic conduct by directors that would be eschewed by efficient contracts. As such, financial loss plays a key role in identifying unfit conduct, though not all conduct resulting in loss is, of course, deemed unfit. In *Re Sevenoaks Stationers (Retail) Ltd*,[85] for example, Dillon LJ in the Court of Appeal stated that

> [i]t is beyond dispute that the purpose of section 6 is to protect the public, and in particular potential creditors of companies, *from losing money through companies becoming insolvent* when the directors of those companies are people unfit to be concerned in the management of a company.[86]

Similarly the UK's National Audit Office prefaced its study of the efficiency of disqualification by stating that '[t]he disqualification arrangements are intended to promote confidence and risk-taking in the market, by assuring those

83 One commentator has noted that the uncertainty surrounding the concept of unfit conduct has led to different approaches to the level of blameworthiness necessary to justify disqualification being adopted by judges: see Vanessa Finch, 'Disqualifying Directors: Issues of Rights, Privileges and Employment' (1993) 22 *Industrial Law Journal* 35; see also Finch, *Corporate Insolvency Law*, above n 53, 729–32.

84 Agency problems arise in contractual relationships where the welfare of one party (the principal) is dependent upon the actions of another (the agent) and where the agent has incentive to act in a manner detrimental to the principal. On agency problems between companies and their creditors, often described as financial agency problems, see Reinier H Kraakman et al (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press, 2nd ed, 2009) ch 2.

85 [1991] Ch 164.

86 Ibid 176 (emphasis added).

who do business with limited liability companies that directors who are unfit will be disqualified'.[87]

In terms of the case law, it is clear too that financial misconduct lies at the heart of unfit conduct. This is obvious in high-profile examples of unfit conduct, such insolvent trading, and failure to pay Crown debts or the 'misuse of a company bank account' (by, for example, issuing cheques that cannot be honoured)[88]. Financial misconduct is also, however, at the heart of sanctioning directors who fail to supply goods 'paid for' to customers,[89] who misuse customer deposits,[90] fail to maintain a bonus fund to meet commission payments to employees[91] and even in cases where directors are sanctioned for taking excessive remuneration from their companies. In the latter case it has been held that directors' remuneration will only be excessive and unfit where it cannot be justified by the financial circumstances of the company concerned.[92]

The financial agency cost approach to unfit conduct is essentially market-based in the sense that it seeks to eschew conduct that would not arise in efficient contracts between companies and those with whom they deal. This approach leaves little room for notions of 'social responsibility' in unfit conduct, at least in the sense of looking beyond financial considerations and associated concepts of market failure. The courts' approach to unfit conduct in disqualification can therefore be seen as very much in keeping with a market-orientated, private view of the company in the sense that 'public interest' regulation is deemed legitimate only where there has been a failure of 'private law' and 'market' mechanisms.[93] The fact though that this does not preclude the law from protecting the interests of stakeholder groups further highlights the success of disqualification in incorporating substantive protection of stakeholder interests into UK company law without disturbing the interests of the members, albeit through predominately insolvency related regulation. To be sure, paternalistic or pluralist regulation (in the sense used by the UK Company Law Steering Group[94]) may be eschewed, but it is clear that this does not mean that the rights of non-shareholder groups are excluded.

The question remains though as to whether the new statutory statement of ESV principles might itself alter the courts' approach to disqualification,

87 National Audit Office, Report by the Comptroller and Auditor General, *The Insolvency Service Executive Agency: Company Director Disqualification – A Follow Up Report* (HMSO, London 1999) 1.

88 See, eg, *Re Admiral Energy Group Ltd* (Unreported, 19 August 1996), cited in Walters and Davis-White, above n 70, 5–45.

89 See *Disqualification Act* sch 1 para 7; *Re Western Welsh International System Buildings Ltd* (1988) 4 BCC 449.

90 See, eg, *Re CSTC Ltd* [1995] 1 BCLC 545.

91 *Re Omaglass Ltd* (Unreported, 6 April 1995).

92 See, eg, *Re Keypak Homecare Ltd* [1990] BCC 117, 120. On the financial basis of 'excessive remuneration' in disqualification cases, see Richard Williams, 'Disqualifying Directors: A Remedy Worse than the Disease?' (2007) 7 *Journal of Corporate Law Studies* 213, 222.

93 On justifications for public interest regulation in predominantly market-orientated systems of economic organisation see Anthony Ogus, *Regulation: Legal Form and Economic Theory* (Clarendon Press, 1994), ch 3.

94 See, eg, Company Law Review Steering Group, above n 6.

providing grounds for the introduction of such paternalistic regulation of directors' conduct. The inherent flexibility of the unfit conduct standard, for certain provides at least the possibility for ESV to provoke a different approach to regulation. To date, however, there is no evidence that the new principles have had any impact on the disqualification cases, and moreover, no evidence that state agencies charged with initiating disqualification proceedings have sought to use disqualification powers to enforce ESV principles. ESV principles have not featured in any reported disqualification cases since 2009, and data on the matters of unfit conduct alleged against directors across all disqualification for unfitness cases similarly show no indication of ESV having an impact on the operation of the legislation.[95] In truth, of course, this is not surprising. ESV principles reflect common sense business practices that were in any case accommodated by the existing disqualification law, so it could hardly be expected that the new section 172 would have a dramatic impact. What may be more significant in the current context, however, is the fact there is little evidence of the State seeking to utilise ESV in disqualification procedures to drive more intrusive stakeholder protections, which we might expect if it were to seek to use policy tools to force a new settlement on directors in order to combat 'short-termism' in business behaviour in the wake of concerns arising out of the global financial crisis..

As we have seen, private mechanisms through which ESV may be enforced – that is, litigation by companies, shareholders, liquidators and creditors – are inhibited by the risk and cost of litigation and the uncertain nature of recovery for breach of ESV provisions. Disqualification actions, by contrast are publicly funded proceedings initiated by State agencies that have no objective other than to act in public interest. The fact that ESV appears to have had little or no impact in disqualification cases is therefore significant, suggesting either a lack of willingness on the part of the State to seek more intrusive regulation of directors' conduct through the use of ESV principles or a reluctance on the part of the courts to depart from established principles. In respect of the activities of state agencies, it would, however, not be surprising if they had in fact shied away from the opportunity to utilise ESV principles through the disqualification legislation. The government of the day made it clear at the time that the ESV provisions were enacted that they were 'subordinate to the overriding duty [of directors] to promote the success of the company',[96] and emphasised that the question of whether sufficient regard had been had to the factors was 'a matter for the director's good faith judgment'.[97] This does not indicate a desire on the part of the government that ESV should impose new paternalistic obligations on boards, and hardly suggests that an activist approach to the legislation that sought to

95 See, Insolvency Service, *Annual Report and Accounts 2010–2011* (London, 2011) table 16 <http://www.official-documents.gov.uk/document/hc1012/hc13/1388/1388.pdf>.

96 United Kingdom, *Parliamentary Debates,* House of Commons, 11 July 2006, Standing Committee D, Company Law Reform Bill, Fifteenth Sitting, col 591. See also Davies, above n 26.

97 United Kingdom, *Parliamentary Debates,* House of Commons, 11 July 2006, Standing Committee D, Company Law Reform Bill, Fifteenth Sitting, col 591.

advance such an agenda would be taken by state agencies. Of course, as the political environment has changed, such sentiments would be no bar to the state using its powers to seek a more robust role for ESV principles in UK company law. The fact that they have not however, suggests that recent rhetoric has yet to lead to firm measures to seek to change the culture of UK boards beyond the protections that are already afforded in the disqualification legislation.

V CONCLUSION

It is very unlikely that the ESV principles in section 172 of the UK *Companies Act* will bring about substantive change in the management of UK companies and, as such, that it is has advantages to commend it to other common law jurisdictions interested in integrating the protection of stakeholder interests into general norms of behaviour for directors. It is far from clear that ESV represents any significant change in UK company law, for whilst the common law required directors to act in the best interests of their companies for the benefit of members, the rule allowed directors a good degree of discretion to take account of outside interests, provided that this was done with the intention of promoting the welfare of members. The reality of business administration rarely allows a single interest to drive corporate decision-making and to the extent that profit maximisation has been pursued by UK boards it will have been so in dialogue with other interests. The common law recognised and accommodated this reality. To be sure ESV is certainly an innovation in so much as it imposes some form of obligation to consider other interests, but the vague nature of ESV principles and difficulties enforcing them through directors' duties, derivative, and insolvency law actions under section 212 of the UK *Insolvency Act* mean that the ESV duty is likely to be a poor agent for change. More significantly though, the experience of directors' disqualification in UK law suggests that regardless of ESV, UK company law has long endorsed a 'multi-stakeholder'[98] approach to the regulation of directors' conduct through the application of the unfit conduct standard. Moreover, disqualification for unfitness, as a form of public interest regulation that is not tied to an overriding concept of shareholder primacy, represents a much more radical legal innovation than ESV. The fact that notions of social responsibility have failed to gain ground in disqualification suggests little appetite on behalf of the courts or state agencies for a fundamental change in the expectation of directors, but nonetheless the experience of disqualification shows that effective protection of stakeholder interests can exist within a legal structure that endorses a broadly private, shareholder focused conception of the company without reference to the traditional duty of loyalty. Rather than focusing ESV, therefore, it is submitted that UK disqualification rules provide a more useful blueprint for reformers in other jurisdictions who wish to seek

98 Harper Ho, above n 2.

greater protection for third party interests within a shareholder-orientated corporate governance framework.