Company Law Essay 2

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"Section 172 of the Companies Act 2006 is an interesting innovation in that it provides, for the first time, a legislative mandate as to for whose interests directors are to act in their management of the affairs of companies. However, there does not seem to be any framework in place to ensure that directors are held accountable for their decision-making process."

Discuss.

The **Companies Act 2006** was largely a piece of legislation which amalgamated pre-existing common law and statutes. As such, the interpretation of much of the act depends on an understanding of the original common law and equitable principles. This is particularly so for **Chapter 2 of Part 10** of the act, in which **section 172** is located[1]. It will be important to bear this in mind as we analyse the provisions in the statute for the purposes of establishing the extent to which directors are held accountable for their decision-making process. The structure of the essay is relatively simple: firstly I will explain the essence of **section 172** as whole before analysing each subsection, raising questions regarding the accountability of directors and attempting to arrive at solutions in each case. This will be followed by a short conclusion.

Section 172 of the Companies Act 2006 is entitled 'Duty to promote the success of the company'. As the name suggests, it is somewhat ambiguous. Nevertheless it is a bold attempt by the legislators to firstly ensure that directors are acting in the interests of the company and secondly to provide some detail on the factors which directors ought to take into account. Subsection 1 in particular is based on the notion of 'enlightened shareholder value', which is a middle ground between those who believe companies should be run purely for unadulterated capitalist purposes, and those who argue that companies should be directed with consideration for a variety of external issues such as the environment and the local community. The wording of subsection 1 is clearly based on existing common law. Lord Greene MR in the case of *Re Smith & Fawcett Ltd [1942] Ch 304* said that '*…directors must exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company'*. This view was bolstered in *Dorchester Finance v Stebbing [1989] BCLC 498* in which Foster J stated *'…(a) director must exercise any power vested in him as such, honestly, in good faith and in the interests of the company…"*.

[1] S.170(3): "The general duties are based on certain common law rules and equitable principles…"

Subsection 1 provides a number of requirements: the director must act in good faith, in the way *he considers* would most likely promote the success of the company for the benefit of its members as a whole. He must do this with regard to various factors (listed (a)-(f) under subsection 1) – 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. In the preceding line of the statute it is indicated that this is a non-exhaustive list. Subsections 2 and 3 state that, in certain circumstances, directors must have regard to types of success other than mere financial success if financial success is not the company's sole purpose(2), and creditors(3) (generally relevant when companies are becoming insolvent).

This may be condensed into the following areas which will now be analysed in detail: the meaning of 'the company', the meaning of 'good faith', the meaning of 'success', the relevance of paragraphs (a)-(f) of subsection 1 and the effects of subsections (2) and (3).

The meaning of 'the company' is not particularly complicated but it is nevertheless important – it is necessary to have an accurate and clear description of what the company is if directors are to be held fully accountable for the decisions regarding the company. Assistance in this matter is provided by Megarry J in the case of *Gaiman v Association for Mental Health* [1971] Ch 317 who accepted that the company included the interests of both 'present and future members of the company as a whole'. He believed this was a helpful expression of a 'human equivalent' (as necessitated by the *Salomon* principle the companies have their own legal personalities). Defining the company should not cause too much of an issue in most cases.

Slightly more complex is the issue of good faith. Directors are required to act in good faith at all times. So what does this mean? Again, case law provides the answers. It can be observed that there is both a subjective element and an objective element to the test of good faith. In *Regentcrest plc v Cohen* [2001] 2 BCLC 80, Jonathan Parker J presented this view, highlighting the important aspect as being what the director 'honestly thought was in the interests of the company'. A similar view can be found in *Extrasure Travel Insurances Ltd v Scattergood* [2002] All ER (D) 307. However, there is also an objective test which was propounded by Lord Pennycuick in *Charterbridge Corporation Ltd v Lloyd's Bank Ltd* [1970] Ch 62. This test is like a 'reasonable man' test which can be found in various areas of criminal and tort law and essentially it asks whether the 'intelligent and honest man in the position of a director of the company' would have seen the transactions as beneficial to the company.

As I have suggested above, it is neither unusual nor difficult for the law to simultaneously incorporate both subjective and objective tests for the same issue. I think a combination of both tests would provide a perfectly adequate framework for holding directors who have not acted in good faith accountable.

The 'success' of a company is a fairly vague term. However, assuming that company law is ultimately based on the principle of gaining capital it is reasonable to assume that the term 'success' should be regarded in financial terms. The wording as a whole, subsection 1 says "success of the company for the benefit of its members as a whole…" seems to bolster this view, and it would seem that subsection 2 becomes relevant where the objectives of the company are not purely financially motivated. Ultimately this is unlikely to be an obstacle when it comes to holding directors accountable for their decisions because the emphasis is so clearly on capital.

So far, the effects of the first part of **S.172(1)** have been looked at and considered with regard to their effects on directorial accountability. So far, it seems, so good with the only possible problem as I see it being the potential conflict between the subjective/objective test for good faith. However, paragraphs (a)-(f) of the subsection pose an entirely new problem.

As the title question proclaims, there has never been a legislated list of factors into which directors must take account when making decisions. This inevitably complicates the application of the latter part of subsection 1. This is further confused by the indication that the list is non-exclusive: "A director of a company must… have regard (*amongst other matters*) to-"[2]. A number of questions arise at this point: firstly, what are the other factors and who decides what they are? Secondly, what weight is to be given to each of the factors listed? Thirdly, what weight is to be given to unlisted factors in comparison to those listed? Fourthly, how much "regard" must a director pay to such factors and how is this to be evidenced?

It is difficult to see how the law can be consistent and fair when the decision of a case could come down to some mystery consideration that a director should have taken into account, according to a court (who would, presumably, have final say on what 'other matters' the director must take into account), despite it not appearing in the statute. Hopefully a common sense approach will be adopted, but even so this part of the legislation is entirely unhelpful in providing specific framework for holding directors accountable.

With regards to the weight of the factors which are listed, it is easy to assume that they should all be given equal weighting. But it would be dangerously presumptive to presuppose the court's (and parliament's) thinking on this. As the only factor which existed in legislation previously[3], could it be the case that **s.172(1)(b)** – the interests of the company's employees – is to be given more weight than the others? Furthermore, there is an apparent link between some of the factors. Paragraph (a) – the likely consequences of any decision in the long-term – effectively covers all the following paragraphs, so should directors be required to pay particular regard to this paragraph? On the other hand, paragraph (d) – the impact of the company's operations on the community and environment – seems quite specific[4], so should less regard be paid to it?

[2] Companies Act 2006 S.172(1)
[3] Companies Act 1985 S.309
[4] although there is scope for arguments that the company's impact on the community/environment will affect its reputation and business relationships as set out in paragraphs (c) and (e).

Along similar lines is the question of how much weight is to be applied to factors which are not listed? Are they to be equal? Are they less important because they are not listed and thus are "secondary" considerations? Or is each matter to be dealt with on a case-by-case basis? The answer is entirely unclear.

Finally, and most importantly: how much regard must the director give, and how are his considerations to be evidenced? Is there some clear minimum level of consideration? Going on the statute alone, it would seem that a director could get away with a very low level of consideration for these matters. But on the other hand, this is not certain and directors may be wary of inadvertently failing on one of the grounds. Setting the level too low seems almost pointless on the part of the legislators, as in reality it will have no effect whatsoever if directors are simply made to 'check boxes' as an extra administrative task. With this in mind, is it sufficient to simply note in the minutes of a meeting: "factors in Section 172 of the Companies Act 2006 were considered"? Or is further evidence of consideration required? Unfortunately this simply raises further questions such as what extra evidence is required. All of this has a significant impact on the framework for the accountability of directors.

Whilst there surely will be cases for holding directors accountable if they blatantly disregard some factors, the ambiguity of the section would make such litigation a minefield. No doubt subsequent case law will clear things up to an extent, but it seems inevitable that there will be some injustices along the way.

Subsections 2 and 3 provide for specific circumstances for which subsection 1 does not have regard. Insofar as accountability of directors is concerned, these subsections should cause much less of a problem that was seen in paragraphs (a)-(f) as they are both self-contained and apply in specific situations. Nevertheless, subsection 3 is not entirely clear as it simply states that directors should act in the interests of creditors 'in certain circumstances'. What these circumstances are is not certain, but the Australian case of *Kinsela v Russell Kinsela Pty Ltd* (1986) 10 ACLR 395 (subsequently picked up on in English law by Lord Templeman in *Winkworth v Edward Baron Development Co Ltd* [1986] 1 WLR 1512) helps by saying that in a solvent company the director should have regard to the shareholders, whilst in an insolvent company he should have regard to the creditors. However, at what point a solvent company becomes insolvent, and to whose interests the directors should have regard during such a transitional period is not clear. It could be a crucial decision for a director to make: whether to effect a decision that benefits the shareholders or one which benefits the creditors, and so this is an ambiguity which needs to be addressed as soon as possible.

In conclusion, **Section 172** provides some clear framework for accountability in that terms such as 'good faith' and 'success' may be defined from pre-existing case law. However, as we have seen, the latter part of subsection one provides an unfortunately unclear and non-exhaustive list of factors into which directors must take account. Until there is new case law on the matter it is very difficult to determine how much accountability there is for directors and their decision-making process.

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