

## Chapter 10

### Directors' Duties I: Duties of Performance

Here, basic guidance to the end-of-chapter questions will be provided.

**1. Define the following terms:**

- **general duties;**
- **enlightened shareholder value approach;**
- **pluralist approach.**

Term	Definition
general duties	The duties imposed upon directors by ss 170-87 of the CA 2006
enlightened shareholder value approach	The ultimate objective of companies (i.e. to generate long-term maximum value for shareholders) is the best way to achieve overall prosperity
pluralist approach	Company law should require companies to serve not just members, but should also serve a wider range of interests that are not subordinate to those of the members

**2. State whether each of the following statements is true or false and, if false, explain why:**

- **the CA 2006 has codified all the law relating to directors' duties;**
- **the general duties only apply to persons who are current directors;**
- **the members can ratify a director's breach of duty;**
- **a director will be in breach of the s 171 duty if they exercise their powers for any improper purpose;**
- **the s 172 duty requires the directors to balance equally the interests of the company, its members, and its stakeholders (e.g. employees);**
- **the s 174 standard of care adopts an objective and a subjective test.**

- **The CA 2006 has codified all the law relating to directors' duties:** This statement is false. The main principles relating to directors' duties have been codified, but much of the detail found in pre-CA 2006 case law has not been codified and remains relevant.
- **The general duties only apply to persons who are current directors:** This statement is false. Certain general duties can apply to persons who are not directors (e.g. former directors).
- **The members can ratify a director's breach of duty:** This statement is true, although certain types of breaches cannot be ratified (e.g. illegal acts, acts not bona fide or honest).
- **A director will be in breach of the s 171 duty if they exercise their powers for any improper purpose:** This statement is false. In a director principally exercises a power for a proper purpose, the presence of subordinate improper purposes will not result in a breach of s 171.

- **The s 172 duty requires the directors to balance equally the interests of the company, its members, and its stakeholders (e.g. employees):** This statement is false. The primary duty is to promote the success of the company for the benefit of its members as a whole. Directors may only have regard to the list of stakeholders in s 172(1) to the extent that it also promotes the success of the company for the benefit of its members as a whole.
- **The s 174 standard of care adopts an objective and a subjective test:** This statement is true.

3. 'In adopting the enlightened shareholder value approach, it is clear that the duty imposed by s 172 of the CA 2006 will do little to improve the position of a company's stakeholders. The correct approach would have been to adopt a formulation that embodied the pluralist approach.' Do you agree with this statement?

### Introduction

- Every essay should begin with a succinct introduction that demonstrates that you understand the essay question. Briefly explain what the essay is about and set out what the essay will discuss and how it will be structured.
- This question requires you to compare and contrast the enlightened shareholder value approach (which was implemented by s 172 of the CA 2006) to the pluralist approach (which was rejected by the Company Law Review Steering Group (CLRSG)).

### The CLRSG

- You might choose to begin with a brief account of the historic background to this essay question. You may choose to briefly discuss the predecessor duty to s 172 (namely the bona fide duty) and how that was perceived to be a very pro-shareholder duty that did not sufficiently take into account stakeholder interests.
- Note that the CLRSG identified two ways of reforming the duty in order to better take into account stakeholder interests, namely (i) the pluralist approach, and; (ii) the enlightened shareholder value approach.

### The pluralist approach

- The pluralist approach is discussed on p 244-45. You should begin by explaining what the pluralist approach is and the rationale behind it. A more detailed discussion can be found in the CLRSG consultation document entitled *The Strategic Framework*.
- Explain why the CLRSG rejected the pluralist approach, with the three principal reasons being:
  1. it would confer upon the directors too wide a discretion;
  2. it might not achieve its objectives, given the unpoliced nature of directors' decisions, and;
  3. it could allow directors to frustrate a takeover bid against the wishes of the shareholders.

- A more detailed account of the reasons behind the rejection of the pluralist approach can be found in the CLRSO document entitled *Developing the Framework*.

## Section 172

- The enlightened shareholder value approach is discussed at p 244. Begin by explaining what the enlightened shareholder value approach is.
- Then explain how s 172 implemented the enlightened shareholder value approach, namely having the principal duty being to promote the success of the company for the benefit of its members as a whole, but by requiring directors to 'have regard' to a range of stakeholder factors in s 172(1).
- Discuss what 'have regard' means. Discussion in Hansard indicates that it means that the directors may only have regard to these factors to the extent that they promote the success of the company for the benefit of its members as a whole. It is therefore clear that the stakeholder interests identified in s 172(1) are subordinate to the primary duty to promote the success of the company for the benefit of its members.
- You may also choose to discuss that none of the stakeholders listed in s 172(1) has standing to bring a claim against a director for breach of s 172 (apart from the members via a derivative claim).

## Conclusion

- Every essay should end with a conclusion. Briefly summarise the main points/arguments and, if possible, come to a conclusion regarding the essay topic (i.e. which of the opposing views has the stronger arguments).

**4. Belinda, Walter, Ahmed and Yvonne are the directors of Dragon Tools Ltd ('DT'). Sixty per cent of DT's shares are held by Dragon plc, with the four directors each holding 10 per cent of DT's shares.**

**For some time, a lucrative contract of sale has existed between DT and UK Electricals Ltd, under which DT provides tools to UK Electricals Ltd. Belinda and Ahmed met with an agent of UK Electricals in order to discuss renewing this supply contract. Belinda stated that the board had agreed that, based on an increase in manufacturing costs, DT would need to increase its prices by 15 per cent. Ahmed was not aware of this increase and, based on his knowledge, it had never been discussed at a board meeting. Despite this, he said nothing. The agent of UK Electricals stated that he would inform the board of the increase. A few days later, Belinda contacts the agent and states that the tools can be obtained more cheaply from Toolbox Ltd (Belinda is a director and majority shareholder of Toolbox). As a result, UK Electricals does not renew its contract with DT and instead enters into a supply contract with Toolbox.**

**At a board meeting, Walter tells the board that he has heard rumours the Dragon plc is considering selling its shares in DT to Partridge plc. The board of DT are concerned about the effect that this change in control might have, and so they**

cause DT to issue a batch of new shares that they purchase. As a result of this, Dragon plc's holding in DT is reduced to 25 per cent.

The board of Dragon plc has become aware of the above issues and seeks your advice on (i) whether any breaches of the law have taken place, and; (ii) if any breaches have taken place, how can a remedy be obtained.

## The contract between UK Electricals and Toolbox

### *Belinda's actions*

- Belinda appears to have lied about DT increasing its prices in order to encourage UK Electricals to enter into a supply agreement with Toolbox (of which she is a director and shareholder).
- Two duties are of relevance here. The first duty is found in s 172 which provides that a director must promote the success of the company for the benefit of its members as a whole.
- The duty is subjective, meaning that what matters is what Belinda thought. There can be little doubt that Belinda could not have thought that her actions would promote the success of DT. The courts have stated that where a director's actions cause the company harm (as is the case here), the court will not be easily persuaded that a director honestly believed their actions would promote the success of the company.
- If a breach of s 172 is established, the breaching act is voidable at the company's instance. Additionally, Belinda is liable to compensate the company for loss caused by the act.
- The second relevant duty is found in s 175, which provides that a director must avoid a situation in which he has an interest that conflicts with that of the company. Clearly, Belinda has such a conflict. Her interests of DT clearly conflict with her interests as a director and shareholder of Toolbox. Indeed, s 175(2) states that the s 175 duty applies in particular to the exploitation of any property, information or opportunity.
- A breach of s 175 can be avoided if it has been authorized by the directors (s 175(4)(b)). As DT is a private company, the directors do not require authorization from the articles to do this (although the articles can restrict the ability to authorize).
- We are not told whether the other directors of DT know that Belinda is a director and shareholder of UK Electricals. Even if they did, it would be highly unlikely that they would authorize the conflict in this instance given that it caused DT to lose a valuable supply contract.
- Accordingly, it appears the Belinda has breached the s 175 duty. The result would be that the contract between UK Electricals and Toolbox is voidable at DT's instance, as long as UK Electricals knew of Belinda's breach. DT can require Belinda to account for any profit made.

### *Ahmed's inaction*

- When Belinda falsely told the agent that DT had increased its prices by 15%, Ahmed said nothing, even though he appeared to know that this was not true. Like Belinda, this could involve a breach of the duty found in s 172.
- It could also involve a breach of the duty in s 173 to exercise independent judgement, as he did not question Belinda or seek clarification regarding the purported price increase. He simply accepted it and remained silent.

### **Partridge's takeover of DT**

- The board of DT are concerned that Dragon is going to sell its majority shareholding in DT to Partridge plc. To prevent this, the board of DT's issues enough shares to relegate Dragon's holding to a minority shareholding of 25%. There are several issues to discuss here.

#### *Authority to allot shares*

- The first issue to discuss is whether the board of DT has the authority to allot the shares. Where a private company has only one class of share, then the directors have authority to allot further shares of that class, unless the articles state otherwise. Accordingly, if DT has only one class of share and the shares allotted are of that class, the directors are empowered to issue the shares.
- If, however, DT has multiple classes of share or if it only has one class of share and the new shares issued are of a different class, the directors will only be empowered to allot those shares if the articles or the member authorize them.

#### *Pre-emption rights*

- Even if the directors are authorized to allot the shares, they may be limited in who they can allot them to. Shares are generally subject to pre-emption rights, meaning they must first be offered to existing shareholders in such proportion as to allow those shareholders to maintain their holdings.
- Accordingly, by allotting the shares to themselves, the directors have breached Dragon's pre-emption rights, unless those pre-emption rights do not apply or have been disapplied. For example, pre-emption rights can be disapplied by inserting a provision in the articles to that effect, but it is highly unlikely that Dragon would approve such an article amendment.
- If the shares have breached Dragon's pre-emption rights, the allotment will still be valid, but any director or officer who knowingly authorized or permitted the contravention will be liable to compensate Dragon.

#### *The proper purpose duty*

- The final issue is whether the directors' decision to issue the shares breaches any general duty. The relevant duty is that found in s 171(b), which provides that a director must only exercise powers for the purposes for which they are conferred.
- The first step is for the court to determine what power is being exercised. Here it is the power to allot shares.

- The second step is that the court will determine the purpose for which that power was delegated to the directors.
- The third step is the court will determine the substantial purpose for which the power was exercised. This is especially important where a power is exercised for multiple purposes. There could be multiple reasons to allot the shares, including:
  - (a) a desire to raise capital, or;
  - (b) a desire to relegate Dragon's shareholding to a minority shareholding to prevent the directors from losing control if Dragon does sell its shares to Partridge.
- It would appear that the principal purpose for allotting the shares is to relegate Dragon's holding and prevent the takeover of DT.
- The fourth step is to determine whether this substantial purpose was proper. If the directors of DT allotted the shares simply to preserve their own control of DT, then this will be an improper purpose (*Howard Smith Ltd v Ampol Petroleum Ltd*). However, if the directors genuinely believed that the takeover was not in the interest of DT, then the issue might be less clear-cut. All we are told is that the directors are concerned about the effects that the change of control might have.
- If the directors have breached the s 171(b) duty, they will be required to account for any gains they might have made or compensate the company for any loss sustained.