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Subject Area - Law

Berle and Dodd Companies Act 2006 Directors Duties

“What would Professors Berle and Dodd make of the new Companies Act 2006 provisions on directors duties?”

In the following essay any reference to “the Act” or to any sections of an Act shall be interpreted as the Companies Act 2006 and sections of the Companies Act 2006, unless otherwise specified.

Introduction

Academic debate concerning the scope, form and content of directors' duties is perhaps one of the oldest issues in company law and corporate governance. Prior to 1 October 2007 the duties of directors in England and Wales were derived from the common law, equitable principles and statutory provisions, particularly the Companies Act 1985.

The Companies Act 2006 (the Act) received Royal Assent on 8 November 2006. It includes a new statutory statement of the general duties of directors codifying the common law principles and substitute the additional rules on directors' duties relating to fair dealing found in Part X of the Companies Act 1985. The Act also introduces a new right for shareholders to initiate proceedings against the directors in the company's name in specific circumstances (the “derivative action”). The derivative action provisions and most of the directors' duties provisions are already in force. The new codified directors' duties come into effect in two stages: on 1 October 2007 and 1 October 2008.

The provisions contained within the Act are pretty much a rewrite of company law with approximately two-thirds of the Companies Act 1985 repealed. Government accepts that directors' duties are fundamental to company law, so the Act attempts to provide greater clarity as to what is expected of directors. Historically, the argument relating to company directors' duties centred on the question of who the directors are accountable to in the first place. It was particularly evident in Berle and Dodd's debate which started back in 1936 with Berle advocating the so-called “shareholder primacy” concept whilst Dodd supported the “stakeholder primacy” theory. The aim of this research paper is therefore to critically assess the Act in the light of Berle and Dodd's debate and see how Berle and Dodd would potentially react to the new provisions on the directors' duties.

1. Summary of Companies Act 2006 provisions on directors' duties

1.1 Duties which came into effect on 1 October 2007

Duty to act within powers (section 171)

This duty codifies the previous position under the common law whereby a director must exercise his duties and powers in accordance with the terms on which they were granted (i.e. according to the company's constitution) and only employ his/her powers for the purposes for which they were granted.

Duty to promote the success of the company (section 172)

One of the main differences between the old common law regime and the new regime is in the formulation of the directors'

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loyalty duty to their company. Previously the fiduciary duties of directors under common law required directors to act in good faith and in the interests of their company. The new provisions require a 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 director must also have regard when doing so to a non-exhaustive list of six features as laid out in section 172(1) of the Act:

“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”.

There is still some uncertainty around the scope of the new duty. This includes the meaning of the term “success of the company”, which is entirely new. During Parliamentary debates the Government said that “success means what the members collectively want the company to achieve” and that for a commercial company “success will usually mean long-term increase in value”. It is also uncertain whether the term “members as a whole” means just the present members of the company or whether, as under the old common law, the duty is owed to present and future members.

Duty to exercise independent judgment(section 173)

A director must exercise independent judgment. This duty can not be breached by a director acting according to an agreement to which the company is a party which restricts his discretion, nor is it infringed by his acting as per authorisations in the company’s constitution.

There are, however, some differences between the old and the new duties. The fact that the duty is not breached when a director acts as authorised by the company’s constitution, coupled with the broad definition of “constitution” (e.g. to include shareholder resolutions), means that the exercise of the directors’ independent judgment may now be subject to more interference from shareholders than was previously the case.

Duty to exercise reasonable care, skill and diligence(section 174)

A director must exercise reasonable care, skill and diligence. This is defined as being the “care, skill and diligence that would be exercised by a reasonably diligent person with:

the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
the general knowledge, skill and experience that the director has”.

This duty mirrors the test set out in the Insolvency Act 1986 and reflects very closely the position developed under the common law prior to the Act.

1.2Duties yet to come into effect

According to the Government’s Companies Act 2006 Implementation Schedule, sections 175-177 are due to come into force on 1 October 2008.

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Duty to avoid conflicts of interest (section 175)

Section 175 states that: "A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company". Potential examples are, for example, directorship of more than one company where the interests of the companies conflict or possibly may conflict or being (or being connected with) a major shareholder of the company.

Situational conflicts can be authorised either by the (non-conflicted) directors or by shareholders (section 180(4) and the general common law power of shareholders to authorise conflicts).

Duty not to accept benefits from third parties (section 176)

Section 176 provides that a director "must not accept a benefit from a third party conferred by reason of him being a director or his doing (or not doing) anything as a director".

This duty stems from the fiduciary duty upon a director not to make a secret profit. It largely encapsulates the previous law, and is not considered to impose a new restriction upon directors. There is no scope for authorisation by independent directors, so a director would need to seek shareholder authorisation.

Duty to declare interest in proposed transaction or arrangement (sections 177 and 182)

If a director has an interest in a "proposed or an existing transaction or arrangement with the company" (a "transactional conflict"), he must declare it under sections 177 or 182.

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2. Berle and Dodd's Debate

A well-known debate by A. A. Berle and E. M. Dodd on corporate accountability took place in the United States during the 1930s. The positions that were set out in that dialogue remain classic and continue to dominate current discussions on the question: to whom are corporations accountable? Berle argued that:

"all powers granted to a corporation or to the management of a corporation are necessarily and at all times exercisable only for the benefit of all the shareholders as their interest appears".

That was a logical view because the shareholders are the legal owners of the company having invested in the share capital and it is sensible to suggest that they are the "ultimate beneficiaries of whatever success it [the company] enjoys since they are entitled to what is left over after other claims the company is obliged to meet have been satisfied".

In contrast, Dodd saw corporations as economic institutions that have a social role to play as well as making profits for shareholders, and that companies had responsibilities to the company's stakeholders, such as shareholders, employees, customers and to the general public; he emphasised that:

"it is undesirable ... to give increased emphasis at the present time to the view that business corporations exist for the sole purpose of making profits for their stakeholders. ... [P]ublic opinion, ... is today making substantial strides in the direction of the view of the business corporation as an economic institution which has a social service as well as a profit-making function, that this view has already had some effect upon legal theory, and that it is likely to have a greatly

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increased effect upon the latter in the future”

Since the Berle and Dodd dialogue took place, the argument on corporate governance related to, on the one hand, the so-called “shareholder primacy theory” (established from Berle’s debate) and, on the other, the “stakeholder theory” (established from Dodd’s argument).

It is clear from Dodd’s statement above that directors should look beyond profit maximisation and the position of the stakeholders (i.e. employees, creditors, suppliers, communities and the environment, claimed to have relevance to the managerial concern) should be echoed in the legal obligations imposed on management. Literally, that means considering the company as a social mechanism with an independent existence, rather than as the property owned by shareholders.

In his analysis, Dodd referred to the “legal model” of the company that was at that moment a prevalent model of the company with “nature of business as a purely private enterprise” with shareholders being key figures. Dodd’s idea was that that could be changed and should be changed so that the company could take into account a variety of stakeholders’ interests, balancing these with the interests of shareholders.

The differences between Berle’s and Dodd’s theories can be best illustrated by what happens in the event of a conflict between competing interests under the respective theories. Berle thought that the shareholders’ interests should be given preference, and his principal objection to the stakeholder model, put forward by Dodd, was that the latter was unenforceable. Indeed, if one considers it, it can be alleged that interests external to the operation of the company have no valid legal standing and, therefore, cannot establish legal claim.

The dialogue between Berle and Dodd was largely settled after 1932, but did not stop completely. Eventually, Berle accepted that, as a descriptive matter, events in US corporate law had settled the debate in Dodd’s favour, although mostly because Dodd’s analysis on the nature of the model of the company was far more developed.

Attenborough in his article clarifies that the belief that the purpose of the modern company is to maximise shareholder value, along with typical capital market and ownership features, characterises the Anglo-American shareholder primacy paradigm. This is often contrasted with the continental European perception of the company, which revolves over a stakeholder theory: in Germany, for example, directors owe a duty to have regard to some notion of the company or the public interest as having interests separate from those of the association of shareholders as such.

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3.Assessment of the Companies Act 2006 in light of Berle and Dodd’s debate

Attenborough claimed in his article that many practitioners traditionally view UK Company law as firmly sticking to the shareholder primacy theory. It is important to notice that there is no direct duty to the shareholders imposed on the directors by the UK Company law. However, the latter does ensure that the interests of shareholders as the most important stakeholders in the company are adhered to by the directors in exercise of their duties.

In order to understand the ideas behind the directors’ duties laid out in sections 171 -177, it is important to investigate

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various reports produced by the Company Law Review Steering Group (the CLRSG) in order to aid the Government in the preparation of the Company Law Reform Bill 2005. It was perceived by many that the CLRSG's review could be an excellent opportunity for policy-makers to deal, among other things, with the flaws and drawbacks in the complicated relationship between directors and stakeholders.

3.1 Section 170 of the Act

It is helpful to start with analysis of section 170(1) of the Act that states that "[T]he general duties specified in sections 171 to 177 are owed by a director of a company to the company".

The Court of Appeal affirmed this principle in *Peskin v Anderson* and held that the general fiduciary duties of directors are owed only to the company as a whole. However, the term "company as a whole" seems to be vague. The expression has on a number of occasions been interpreted as the general body of shareholders, present and future (*Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd*). Cases such as *Alexander v Automatic Telephone Co* show that English courts have been rejecting the idea that the company owes duties to anyone else besides the general body of shareholders, including its employees, creditors, consumers and the community.

In view of section 170(4) of the Act that stipulates that "directors' general duties should be interpreted and applied in the same way as common law rules or equitable principles", it is therefore safe to assume that the government's intention is to limit managerial liability to shareholders. Indeed, Goddard in the White Paper in the run up to launching the Company Law Reform Bill 2005 lamented that:

"This is not to suggest that directors' duties are owed to individual shareholders, but rather that the economic model of principal-agent is reflected in company law through the equating of the company's interests with that of the shareholders".

For a start that is a clear indication of the courts' and government's intentions and something that is in line with Berle's shareholder primacy theory.

3.2 Section 172 of the Act

Section 172 of the Act is perhaps the most troublesome and could be at the same time the most interesting section to be assessed by Berle and Dodd.

It emphasises in particular the duty of a 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". Paragraph 325 of the Explanatory Notes to the Companies Act 2006 clearly stipulates that "[T]his duty [section 172] codifies the current law and enshrines in statute what is commonly referred to as the principle of "enlightened shareholder value".

The CLRSG clearly saw that directors-stakeholders' issue should be formulated as a vital one in its deliberations. When identifying two possible approaches to addressing the issue, the CLRSG used the definitions of "enlightened shareholder value" and "pluralist" model rather than the expressions "shareholder primacy" or "stakeholder theory".

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The main difference between these two models can be illustrated by what happens when there is a conflict of interests between the shareholders and the other stakeholders. The enlightened shareholder value model provides that directors should promote the success of the company for the benefit of its shareholders as a whole, but that they should also recognise, as the circumstances require, “the company’s need to foster relationships with other stakeholders, its need to maintain its business reputation and its need to consider the impact of its operations on the community and the environment”. In comparison, the pluralist model requires the directors to balance these potentially conflicting interests, without giving automatic priority to the shareholders.

It is very important to realise that the enlightened shareholder value model does not fall conveniently under Berle’s principle and at the same time have some characteristics of Dodd’s theory – all in all it appears to be a hybrid of both theories.

The CLRSG’s initial concern was that the preferential scheme of the law (the shareholder primacy principle) fails adequately to recognise that businesses are wealthier where participants operate cordially as teams, and that directors should appreciate the wider interests of the society in their decisions. It has been a frequent criticism of directors that they focus strongly on the short-term benefits for companies as this pleases shareholders.

While the question of shareholder primacy seems to take a central place in the ambit of section 172 of the Act, it can be inferred from the presence of six external factors (listed in paragraph 1.1(b) above) to which directors should have due regard that the CLRSG saw the need to examine more closely elements that based Dodd’s work.

(a) The CLRSG’s view of stakeholder (or pluralist) model

It is easy to see the appeal of Dodd’s theory. Establishing relationships of trust between the company and its employees is crucial as in the highly competitive world the abilities and skills of the workforce are an important factor governing the company’s potential to compete. It can also be assumed that employees may be reluctant to get firm-specific skills or invest their time and effort in the company if they do not find the company’s management credible or if they feel that priority will automatically be given to the shareholders; employees that have trust in their employers will be more willing to acquire firm-specific skills and this in turn can have a positive effect on profits.

Wider responsibilities such as those to the society and the environment are also fundamental to corporate success. It can be claimed that responsible behaviour of this kind can lead to increases in profits by reducing costs, because certain environmental projects such as waste recycling and energy conservation can have optimistic effects on profit margins. Acting as a responsible community organisation can also reduce costs by creating its own advertising and good publicity.

Whilst accepting the stakeholder theory arguments above as commendable, the CLRSG contemplated these and subsequently rejected the pluralist theory. The CLRSG was confident that the pluralist approach was neither workable nor desirable in the United Kingdom. Although the CLRSG did express some support for the objectives behind the pluralist approach (and indeed they are present in the enlightened shareholder value model), its main concern was that there is no feasible way of enforcing such a duty.

This would include practical problems of overseeing and controlling the directorial discretion to override the interests of

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shareholders in favour of other stakeholders, and the fact that a pluralist approach would potentially permit directors to frustrate a takeover bid. Indeed, the duty on the directors to balance the views of numerous groups within the corporate structure may represent a potential problem, in particular identifying whether it is objective or subjective duty. The existence of former would demand some interferences from the court in case of dispute. This would give a wide discretion to the court, and it is not clear whether the courts are willing to exercise such discretion. In the case of later, a subjective duty would in practice amount to little more than discretion, and this discretion would be hard to police.

In addition, it was alleged that pluralist theory would require substantial reform of the law on directors' duties. Roach in his article noticed that a significant redefinition of directors' duties will be required. Instead of defining the company simply as the body of shareholders, a new definition would have to be introduced that would take into account all the other relevant groups. For example, the introduction of a pluralist approach may impose more obligations on the company, or require the company to follow up its promises to its employees, even though such promises are unenforceable at law. Furthermore, the enhancement of the position of non-shareholder stakeholders may demand additional representation or protection from the corporate governance mechanisms, which will inevitably result in significantly all-embracing reforms.

(b) Enlightened shareholder value model

Given the arguments against the pluralist approach, the CLRSG drafted its statement of directors' duties with an enlightened shareholder value model in mind. However, the fact that a director should also take into account a non-exhaustive range of factors and that includes having regard to the interests of employees and creditors shows that UK law moves a bit away from the concept of pure shareholder value theory as advocated by Berle.

The approach taken by the CLRSG does go so far as to include the community and the environment in its list of relevant factors that the directors may need to consider. This might be a fundamental inclusion, that is especially evident when comparing section 172 of the Act with its predecessor - section 309 of the Companies Act 1985, which is limited to employees only and states:

“(1) The matters to which the director of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.”

Nonetheless, it was submitted by Attenborough that section 172 provides a statutory formulation of the duties of directors and simply imposes a general obligation to consider other interests. The main beneficiaries remain the company's shareholders. He further goes on by saying that this effectively means that in case of a conflict between, say, the protection of the employees or the environment, the financial interests of members are afforded obvious priority (for instance, in the cases of imminent redundancies as a result of falling share prices). It is possible to assume that duties to other stakeholders besides the shareholders are still at best minimal.

So, the spirit of section 172 of the Act balances in the middle between Berle and Dodd's arguments, and while still being based upon Berle's model, it is slowly progressing towards Dodd's. While the enlightened shareholder value sounds as if it is taking a different approach and directors have a different role to play when compared with the past, there does not appear to be a great movement away from the shareholder value principle. This was also admitted by the

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CLRSG in one of the reports that “the enlightened shareholder value approach is not dependent on any change in the ultimate objective of companies, shareholder wealth maximisation ...”. However, on the other hand, by including the wider stakeholders duties as part of the directors’ duties, the enlightened shareholder value theory creates an indirect enforcement mechanism that wipes out some of Berle’s criticism of the pluralist model of the company and brings the law much closer to Dodd’s idea of a wider social context for the company. By so doing it also places responsibility for the enforcement of these wider social interests with the directors as was expected by Dodd.

3.3 Section 174 of the Act

The duty under section 174 of the Act codifies the director’s duty to exercise reasonable care, skill and diligence, but once the director has done so the decision as to what leads to the success of the company is one in his good faith and judgment. This corresponds to the present law and ensures that business decisions are for the directors and cannot be left to the courts’ discretion, as long as the directors are acting in good faith.

Certainly, UK courts have shown an increasing reluctance to re-examine the intricacies of commercial decisions made by directors, and given that the duty to act in good faith involves a subjective test, that means that the decisions of directors will probably be able to be challenged in few cases. Consequently, it is unclear at present how directors will be found liable for failing to have regard to these factors, or for not paying sufficient attention to them. This is because directors appear to have complete discretion in so far as they only need to “have regard to” non-shareholder constituencies. Thus directors will be held to have acted lawfully provided that they are acting in a way that they judge would most likely promote the success of the company for the benefit of the shareholders. The director will probably easily discharge his duty provided he/she can demonstrate that he/she did actually think about these statutory features, even considering them less essential than other factors. Eventually, liability will only be proved if the company can show it suffered a loss as a result of the directors’ breach of duty, which, may be a difficult thing to prove.

Again, it is evident that the spirit of the Act did not provide enough cushion to form good basis for bringing in Dodd’s theory. Indeed, there is no pressure as such in the Act to force directors to consider interests of wider groups. Probably, the potential of section 174 of the Act would inspire Berle by keeping shareholders’ interests intact. Indeed, this is further reinforced by the fact that it is only the shareholders who can officially initiate the proceedings against the directors for the alleged breach of, say, section 174 of the Act as demonstrated below.

3.4 Section 260 of the Act – proceedings by shareholders

The directors’ duties under the Act are expressly stated to be owed to the company. Despite the possibility of the indirect enforcement mechanism by the wider constituencies mentioned above, practically the only stakeholders in the company who are able to take action under the Act appear to be the shareholders. Under section 260(1)(a) of the Act the shareholders can, for the first time, bring derivative proceedings against directors under the UK statute subject to court approval.

All of this means that directors are highly likely to make sure that, in order to protect themselves, they get the best deal for shareholders, even if it means disregarding the interests of others (and potentially breaching section 172(1) of the Act in a technical sense). Otherwise, the shareholders will be able to pursue them for breach. For this reason, because of the

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lack of direct enforceability of such a duty other than by members of the company, it is fair to say that the stakeholder debate is viewed as part of the directors' decision-making and stakeholders are not given a voice in corporate affairs. This approach again supports Berle's theory and provides a clear indication that courts and the Government aim for all-round protection of shareholders in the first place, a view that goes against the spirit of Dodd's model.

Conclusion

When considering the Companies Act 2006 in the light of Berle and Dodd's debate, it is interesting to note the parallels between the work of the CLRSG and the works of Berle and Dodd in the 1930s. The "enlightened shareholder value" and "pluralist" approaches put forward by the CLRSG are, in essence, the same views as those put forward by Berle and Dodd over 70 years ago.

The duty to promote the success of the company (in section 172 of the Act) and the underlying enlightened shareholders value model takes its basis from Berle's shareholder primacy. The Act makes clear that directors have to act in the interests of shareholders, however, taking due account of the interests of employees, suppliers, consumers and the environment. In this way, the Act still recognises that wider constituencies and their relationships with the shareholders can have a positive impact on the company's profits. This inclusion is undeniably fundamental and reflects the view of Dodd that the company should take into account a community of interests and that the directors should balance these interests and not automatically prioritise the interests of shareholders.

However, section 172, when read in the entire context of the Act, nonetheless, shows the tendency towards the shareholder primacy standard. In particular, no method of enforcement of directors' general duties by non-shareholder constituencies is provided, and without that the real effect of the new legislation is largely ineffective. This supports Berle's principle objection of unenforceability in relation to Dodd's model and is still a significant area of difficulty.

On paper, the Harvard debate was won by Dodd. Historically, however, it is Berle's view that has dominated. The Companies Act 2006 is a further example supporting the latter. The Companies Act 2006 is a brave step towards doing what Dodd and numerous other academics have been incapable to do for the last century, namely to create a mechanism to include wider stakeholder groups within directors' duties. While the steps taken have not been radical departures from Berle's principle, they are nonetheless significant.

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