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REFORMING DIRECTORS' DUTIES

Sarah Worthington*

Introduction

Taken together, the English and Scottish Law Commissions,[1] the DTI[2] and the Company Law Review Steering Group ('CLRSG')[3] have produced hundreds of pages on the subject of directors' duties during the last three years. All of this work is just a small part of the DTI's current review of the whole system of core company law, a review billed as the most comprehensive ever undertaken in the UK. This note cannot do justice to the detailed work of all these bodies, but aims simply to summarise the principal directions of the work so far produced – and only so far as it relates to directors' duties – and to highlight some aspects which give cause for concern. In doing that, it is consciously biased towards consideration of the perceived problems, rather than praise for noteworthy advances. The reason is simple. This mammoth review process is not yet completed. The CLRSG is due to produce its final report in Spring 2001. Before that date, it seems important to cast a critical eye over the work completed so far. That said, it would be surprising if the CLRSG did not already intend to address some of the issues raised here. Its work to date has always been presented as part of a consultation process aimed at discovering the optimum solution.

The need for a comprehensive reform of UK company law is not doubted. The UK rules have long ceased to provide an enviable model for other countries to adopt. The current companies legislation is widely regarded as being too complex and detailed, and as containing rules which are now either obsolete or unwarranted.[4] The DTI's stated aim is to produce a simple, rational framework which is modern and competitive, and which facilitates enterprise and promotes transparency and fair dealing.[5] It is against this that its efforts need to be judged.

Summary of critical conclusions

The CLRSG recognises that the issue of directors' duties lies at the heart of corporate governance.[6] It says its proposals 'go a long way towards sketching out a radically improved framework of company law for the new Century.'[7] True, its proposals involve major changes to the legal presentation of directors' duties (a statutory enactment of both the existing common law duties and their remedies is recommended), but they recommend little conscious change to the substance.

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[1] Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* (1998, Law Com No 153, Scot Law Com No 105) ('LCCP'); Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* (1999, Law Com No 261, Scot Law Com No 173) ('LCR').
[2] DTI, *Modern Company Law for a Competitive Economy* (1998) ('MCL').
[3] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework* (1999, URN 99/654) ('SF'); Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework* (2000, URN 00/656) ('DF'); Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure* (2000, URN 00/1335) ('CS').
[4] MCL pp 6-7.
[5] MCL Foreword and para 3.8.
[6] DF para 3.2.
[7] DF para 1.8.

Perhaps the most controversial and hard fought debate relates to the 'scope' issue: for what purposes and in whose interests should companies be run? The CLRSG concluded that the overall objective of wealth generation and competitiveness for the benefit of all could best be achieved through adopting an 'inclusive' or 'enlightened shareholder value' approach, rather than a 'pluralist' or 'stakeholder' approach.[8] The former approach puts shareholders at centre stage: companies are to be run primarily for the benefit of shareholders, although directors are required to take relevant decisions in an 'inclusive' fashion, so as to recognise best practices in relation to a broad range of interested groups (be they employees or customers, or the wider community which might be affected by social or environmental concerns). The 'pluralist' view, on the other hand, would give shareholders no inevitable primacy, but would require the directors to balance the interests of all the relevant stakeholder groups in determining whether a course of action was in the 'interests of the company'. This issue is taken up later.

In the end, this inclusive, enlightened shareholder value regime appears to be distinctly pluralist in objective, even if avowedly traditionalist in substance. This view is reinforced by the arguments advanced for adoption of a related strategy, the imposition of an enhanced reporting regime for listed and large private[9] companies.[10] This new report (part of the Annual Report), called the Operating and Financial Report (OFR), is designed to be a full account by the directors of the performance and direction of the company's business, including a review of achievements, trends and strategic direction. In addition, however, the OFR is to include a report on the company's wider relationships, risks and opportunities, and social and environmental impacts, where these are relevant to an understanding of the business.[11] This proposal for a broad-ranging mandatory OFR seems to mark a formal recognition of the increasing interest of a wide range of stakeholders in the greater public disclosure of corporate functions and activities.[12]

Otherwise little is to change. There is no recommendation for institutional changes in board structure (often seen as a necessary component of a pluralist governance regime).[13] There is no discussion of the divided loyalty problems experienced by both nominee directors and directors of companies forming part of a group. There is scant discussion of the relationship between directors and third parties,[14] directors' training, qualifications, and terms and conditions,[15] the role of non-executive directors,[16] and the overall functioning of the corporate governance system.[17] All the consultation papers are alert to self-regulatory regimes and codes of best practice which are in place for listed companies, but these options have not impacted on proposals for core company law reform.[18] Finally, so far as directors' duties are concerned, there has been little obvious concern with the specific issues faced by directors of small companies, despite the DTI's assertion that it will 'think small first'. Initial suggestions for a different governance structure for owner-managed companies[19] have been shelved as inimical to transitions to larger company structures.[20] In short, the proposals

[8] Much has been written on this debate. See, for example, J. Parkinson, *Corporate Power and Responsibility* (1993, Oxford); P. Ireland, 'Corporate Governance, Stakeholding and the Company: Towards a Less Degenerate Capitalism' (1996) 23 *Journal of Law and Society* 287; J. Kay, and A. Silberston, 'Corporate Governance' (1995) *National Institute Economic Review* 84; F. Easterbrook and D. Fischel, *Economic Structure of Corporate Law* (1991, Harvard), ch 1.
[9] An annual turnover in excess of £500 million is suggested: CS para 3.2.
[10] DF paras 5.79ff; CS ch 3.
[11] SF paras 2.16-2.18; CS paras 3.1-3.4, 3.32-3.42.
[12] E.g., DF para 2.21.
[13] DF paras 3.138-3.141, although also see para 2.24 on enabling structures.
[14] DF paras 3.92 – 3.104; CS para 4.22ff.
[15] DF paras 3.105 – 3.111; CS para 4.42-4-43.
[16] DF paras 3.132 – 3.153; CS paras 4.44-4.47.
[17] DF paras 3.126 – 3.128 and 3.154 – 3.168.
[18] LCR para 1.11; DF paras 3.112-3.121.
[19] DF paras 7.95 – 7.107.
[20] CS paras 2.35-2.36.

generally reflect existing rules; they do not purport to design afresh for modern conditions. Perhaps this tried and tested regime does provide the best possible framework, but little evidence is offered to support that conclusion.

Chronology of reform – the importance of the scope issue

At a very fundamental level it might be suggested that this conservative result was inevitable because the plan of attack in the law reform process was compromised from the start. A sensible discussion of corporate governance cannot take place without adopting a position on the role of companies: what interests should companies, and company law, serve? Only then is it possible to assess which duties ought to be imposed on directors and, after that, how and by whom those duties can best be enforced. By accident rather than by design, the current process has addressed these issues in precisely the reverse order, commencing with an examination of certain limited enforcement issues[21] and leaving assessment of the function of modern corporations (the 'scope' issue) to the concluding stages. Even in the final stages, the reform perspective has been subtly distorted: the CLRSG has not considered itself able to deal with insolvency-related issues for fear of transgressing into territory reserved to the contemporaneous review of insolvency matters. Maybe no great harm has been done, but it is hard to imagine that certain issues and possibilities have not been missed.

On the specific issue of directors' duties, for example, the CLRSG adopts much of the work of the Law Commissions. This is to be expected, yet the Law Commissions' task was to deal simply with the presentation of the general law, not its reform.[22] Their remit did not permit them to consider what interests companies ought to serve, the relevance of corporate size, or the possibilities of alternative board structures; moreover, their final report did not deal with the role and function of different types of directors (executive, non-executive, nominee, shadow or alternate).[23] Later, when the CLRSG came to determine the critical 'scope' issue (i.e., in whose interests should companies be operated and controlled?), it simply backed its conclusions into the Law Commissions' findings. It used its answer to the scope question simply to interpret and reframe the traditional duty imposed on directors to act bona fide and in the interests of the company.

Had the work started with the scope question, then maybe the proposals would have been more ambitious. Starting with issues of scope, it might have been possible to step back from company law as traditionally formulated, and to consider, in the context of a discussion of the purpose and functions of companies, what protections the law ought to provide, and to whom, and how those protections might best be formulated and enforced. For example, there are already many constraints on what a company can do. These include general constraints (e.g. employment law), company-specific constraints (e.g. capital maintenance rules), and constraints directed at specific companies (e.g. specific objects clauses). Who are all these rules designed to protect? Is it the company's shareholders, or some broader community of interests? Should primary liability for failures rest with the company or the company's directors? If the latter, is enforcement best mediated by penalties and criminal law sanctions, or by civil law actions for damages? Can these answers be rationally tailored to meet the reform objective that directors' duties be stated comprehensively and in an accessible form? Much the same questions can be asked in relation to the disclosure obligations imposed on companies and their directors, and indeed also in relation to the specific common law and equitable duties imposed on directors. Instead, many of the current proposals seem manacled to their historical roots; the focus appears to be bottom up, rather than top down, with the result that proposals may be unduly conservative.

[21] Law Commission, *Shareholder Remedies* (1997, Law Com No 246).
[22] LCR para 1.3.
[23] LCR para 1.32.

Guiding principles of reform

Despite these problems with chronology, most observers probably still expected the reform proposals to be quite radical. The entire reform process has been governed by carefully articulated principles designed to achieve imaginative ends. This consciously self-reflective process began with the early Law Commissions' work on shareholder remedies.[24] There the Law Commissions set out a long list of 'guiding principles', twelve in all, against which reform measures could be evaluated. These principles included the idea that the law should be a facilitator, working efficiently and cost-effectively, without imposing excessive regulation, and generally without interfering with contractual arrangements or proper commercial judgements. The law should be accessible, comprehensible, clear and consistent with common sense, and, wherever possible, it should also be precise and certain. Sanctions should be appropriate. Within companies, shareholders and directors should have separate but interdependent roles, with directors permitted to take into account the interests of persons other than shareholders 'to the extent the law allows this' (an issue discussed later). Disclosure requirements should be ample but efficient, so that cost does not outweigh utility.

All twelve principles reappear in the Law Commissions' report on directors' duties.[25] However, the Law Commissions also produced a refined list of four 'headline' principles that could properly guide the consideration of individual issues. These are accessibility, certainty, graduated regulation of conflicts of interests, and efficient disclosure.[26] The Law Commissions suggested that identification of these principles (even without weighting them, and even acknowledging that not all were relevant to all issues) would nevertheless permit conceptual questions to be identified, and would provide a benchmark for testing the different views expressed by respondents.[27]

Against this background, the CLRSG produced its own somewhat different list of four guiding principles.[28] First, it advocated a presumption against interventionist legislation, and in favour of facilitating markets, especially by the provision for transparency of information. Secondly, it favoured minimum complexity and maximum accessibility, with its related principle of 'think small first'. Thirdly, it was against creating criminal offences. Finally, it asserted that the enforcement jurisdiction should be allocated to the most suitable regulatory body.

Had all of these aspirations been reflected in the current reform proposals, the final scheme defining directors' duties might have been predicted to be a relatively slim package which collected together rules of a similar character, described the content of the relevant obligations, and designated the most appropriate enforcement mechanism (and perhaps remedial consequences). It is still not clear how the drafting will appear in its final form, but as yet there is no suggestion that related issues will be collected together in this fashion. To take perhaps the simplest example, there are certain transactions to which the directors are not at liberty to commit the company. Many of these arise because of proscriptions in the general law, and clearly it would be inappropriate to list them in any statutory formulation of directors' duties, whatever the resulting benefits of 'accessibility'. But there are other limitations contained in the companies legislation itself. With these, it seems more in line with the adopted guiding principles of reform to collect them together, rather than to leave them littered throughout the hundreds of sections currently comprising the Companies Act 1985. This would mean, for example, that limitations relating to capital maintenance rules, share issues, loan transactions, substantial property transactions and specific remuneration options for directors, and limitations derived from a company's own objects and articles, would all be collected together as transactions barred absolutely, or barred subject to meeting particular enabling provisions, or barred subject to compliance with certain disclosure obligations. These statutory rules could then be linked to rules defining the consequences of breach for the company, for affected third parties, and for the defaulting directors, with specific indications of how (and by whom) those consequences should be

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[24] Law Commission, *Shareholder Remedies* (1997, Law Com No 246), paras 1.9-1.12.
[25] LCR para 3.4.
[26] LCR para 3.16.
[27] LCR para 3.2.
[28] SF p v and paras 2.21-2.26.

enforced. It would seem easy enough to incorporate the edict to 'think small first' within such a streamlined statutory framework, and to concentrate on deleting excessive and unnecessary proscriptions in a company-specific context. Moreover, it would also seem possible – logically necessary, in fact – to address the issue of who is best placed to enforce these proscriptions, and what remedy is best designed to secure compliance. The goal is to demand compliance only where restrictions are deemed essential, and to secure that compliance in the most cost-effective and measured way possible. In part, this goal requires that the rules be easily accessible to the parties affected.

The use of economic analysis

In a novel move, both the Law Commissions and the CLRSG have overtly incorporated economic analysis into the reform project. The Law Commissions' consultation paper attracted criticism for this, but the report proceeded undeterred, although with some paragraphs devoted to explaining and justifying the stance.[29] In the end the criticisms seem unwarranted and the justifications unnecessary. Disappointingly, beyond providing a technical justification for some fairly common-sense propositions, it is difficult to see what the analysis adds to the project. This is notwithstanding the sophisticated specialist advice given to the reform bodies. Again, this result seems to follow from an overly narrow focus at the start of the project. Economic analysis should have been used, if at all, to help define and justify the grand scheme, not to deal with each detail in a relatively ad hoc fashion. This is not to deny the value of other theoretical inputs. Both the Law Commissions and the CLRSG concede that 'law and economics' is only one of several potential perspectives that might be used to evaluate the existing law and any alternative proposals. Other policy issues may be equally important, or even more important, in the final analysis. However, none of these other inputs is given serious analysis. Instead, 'economic efficiency' is itself defined so widely that this model alone could be used to advance any one of a huge range of commercial or social objectives. The Law Commissions suggest that outcomes can be judged economically efficient not merely on the traditional Pareto or Kaldor-Hicks tests, but equally where the outcomes deliver technical efficiency,[30] allocative efficiency,[31] or dynamic efficiency.[32] Which is to be preferred in any given context is not described. The resulting breadth is such that any programme could surely be judged 'efficient' on one or other of these tests. Some other theory or policy is needed to prioritise the various issues and interests at stake.[33]

One possibility, favoured by the Law Commissions, is a theory of risk. There is little sense that economic efficiency underpins their normative classification of exposure to risk, although economic analysis is then used to select the most appropriate – the most efficient – form of rules.[34] Using this approach, the Law Commissions suggest that 'mandatory rules' should be reserved for situations where third parties are clearly at risk; that 'strong default rules' (e.g. requiring shareholder approval for disapplication) should apply where shareholders are at exceptional risk; and (most commonly) that 'weak default rules' (requiring nothing more than meaningful disclosure, subject to confidentiality and cost, for their disapplication) should apply where shareholders are at only limited risk.[35]

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[29] LCR paras 2.4-2.9.
[30] i.e. 'minimisation of waste' (without defining 'waste'): LCR para 2.11.
[31] i.e. 'allocation of resources to those who are able to make best use of them in the sense of valuing them most highly': para LCR 2.11.
[32] i.e. 'promotion of systems (in this context, companies and industries) which can compete and survive in a rapidly changing environment': LCR para 2.11.
[33] Given that the aim is to devise 'a modern company law for a competitive economy', the goal is surely not only an 'efficient allocation of resources', but also the encouragement of options and opportunities for innovation.
[34] See S. Deakin and A. Hughes, 'Economic Efficiency and the Proceduralisation of Company Law' [1999] CfiLR 169.
[35] LCR paras 2.16-2.17, 2.28, 2.32, 3.57, 3.72; LCCP paras 3.72.

In this limited ‘positive’ sense, directed at providing a theoretical analysis of the most appropriate enforcement mechanisms, economic analysis comes into its own.[36] The CLRSG expressly adopts the relevant learning.[37] Even here, however, there seems to be little more than a recognition that pressure will produce a response – and the greater the pressure the more likely the desired response, since all parties are presumed to behave as rational self-interested actors. More subtlety is needed if this principle is to be balanced against the desire to have minimal regulation and the presumption against criminal sanctions.

Foundation assumptions and the core duty of compliance and loyalty

As already noted, directors’ duties are defined and circumscribed by the way in which the company is conceived. The CLRSG saw the alternatives as being to equate the company with the shareholders or, alternatively, with wider, ‘pluralist’, interests.[38] The CLRSG plumbed for the ‘enlightened shareholder value’ approach, seeing this as requiring directors to maximise shareholder value, but to do so in the light of social and ethical constraints – i.e. in an ‘inclusive’ manner.[39] This might seem like having your cake and eating it too, especially since the CLRSG expressly conceded that its objectives were pluralist: companies should be run in a way which maximises competitiveness, wealth and welfare of all.[40] This intermediate strategy was seen as most likely to advance competitiveness because it best reflected the needs of companies to meet up with contemporary concepts of value in the modern economy.[41] Accordingly, the CLRSG’s proposal is that this core duty of loyalty should appear as a statutory obligation imposed on directors to achieve the success of the company for the benefit of the shareholders by taking proper account of all relevant considerations. The proposed formulation (‘Principle 1’) is worth setting out in full:[42]

1. **Compliance and loyalty**
   a. A director must exercise his powers honestly[43] and for their proper purpose, and in accordance with the company’s constitution and decisions taken lawfully under it [or under the general law[44]].
   b. Subject to that requirement, he must (so far as he practically can) exercise his powers in the way he believes in good faith is best calculated in the circumstances, taking into according both the short and the long term consequences of his acts, to promote the success of the company for the benefit of its members as a whole.
   c. The circumstances to which he is to have regard for that purpose include, in particular, (as his duties of care and skill may require):
      aa. the company’s need to foster its business relationships, including those with its employees and suppliers and the customers for its products and services;
      bb. the impact of its operations on the communities affected and on the environment; and

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[36] A. I. Ogus, ‘Economics and Law Reform: Thirty Years of Law Commission Endeavour’ (1995) 111 LQR 407, 407, 417, 420.
[37] See, e.g., CS ch 13 (Sanctions), but not, surprisingly, ch 12 (Regulatory and Institutional Framework). Also see the DTI’s website for S. Deakin, ‘Economic Effects of Criminal and Civil Sanctions in the Context of Company Law’, www.dti.gov.uk/cld/review.htm.
[38] SF para 5.1.15.
[39] SF para 5.1.41; DF paras 2.11 – 2.17; CS para 3.5. The American Law Institute has adopted a provision which confers discretion on directors to subordinate the interests of shareholders to the wider ethical considerations which may reasonably be regarded as appropriate to the responsible conduct of business: *Principles of Corporate Governance*, 1994, para 2.01 b (2).
[40] DF para 2.21.
[41] DF para 2.3.
[42] DF para 3.40; and CS paras 3.11-3.24, confirming that the statement was intended to provide a hierarchy of obligations, beginning with compliance with the constitution.
[43] Although this requirement appeared in DF para 3.40, some responses to the consultation suggested that its ambit was uncertain, and the CLRSG now proposes to delete the requirement: CS para 3.13.
[44] CS para 3.15 suggests the need to add further words to include informal decisions which may be taken by shareholders.

cc. its need to maintain a reputation for high standards of business conduct.

This duty of 'compliance and loyalty' seems intended to modify, not emasculate, the traditional duty imposed on directors to act bona fide in the interests of the company and for proper purposes.[45] As reformulated, directors have a primary duty to act within the law and for proper purposes (the duty of compliance) and a secondary duty to act in good faith to promote the success of the company for the benefit of the members as a whole (the duty of loyalty). The duty of compliance is not controversial, although it leaves it to the courts to determine which purposes are 'proper', a task which has proved difficult in the past.[46] The duty of loyalty deserves further comment.

The CLRSG was persuaded that there were strong policy arguments against adopting the pluralist approach.[47] In particular, if the directors were given a *power* to decide issues in a 'pluralist' manner, then there would be too much unpoliced discretion residing in the board of directors; on the other hand, if the directors were given a *duty* to decide issues in this fashion, there would be too much unpoliced discretion in the courts. Both results were seen as unacceptable. In any event, the strategy was seen as unnecessary to achieve pluralist objectives. These, it was argued, could be better addressed by specifically directed, independent legislation (e.g. specific environmental or labour laws).[48] This view closely mirrors that adopted by the Hampel committee. In its view a pluralist conception would leave directors with no accountability to anyone and no yardstick against which their performance could be measured.[49] This is no doubt why the CLRSG insists that the overriding interest of the members is central to its concept of the duty of loyalty; its aims cannot, it says, be equally well achieved simply by reference to the success of the company.[50]

Two comments can be made in response to this. The CLRSG suggests that it is merely reformulating the traditional duty so as to encompass wider (more modern) perspectives. This is doubtful. First, it seems that the proposed duty of loyalty is potentially *narrower* than the existing law. At present the directors are obliged to consider the interests of the company's employees.[51] Under the proposed reforms it seems that they will be obliged to consider these interests only to the extent that this will promote the success of the company *for the benefit of its members*. Take a stark example. With this refinement, it is not at all clear whether the famous Henry Ford could have decided, legitimately, to pay his employees more and charge his customers less.[52] If he could not, then it seems we have returned to 'the bad old days'. If he could, because his proposals could be justified by 'taking account of both the short and the long term consequences of his acts', then the discretion residing in directors to favour different interests is so wide as to be ungovernable – a complaint which defeated straightforward adoption of the 'pluralist' vision of the company.[53]

Secondly, this formulation involves a radical departure from the traditional conception of the duty. The duty is equitable, derived from rules applying to trustees managing trust funds for the benefit ('in the interests') of beneficiaries. In this context, the traditional duty does not oblige trustees to select the optimum possible investment for the benefit of the beneficiaries,[54] nor does it make them liable for the marginal losses where there is a failure to do so. The trustees are simply liable to restore the

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45 *Hogg* v. *Cramphorn Ltd* [1967] Ch. 254; *Howard Smith Ltd* v. *Ampol Petroleum Ltd* [1974] A.C. 821 (PC). Historically, "bona fide" was seen as equivalent to "genuine": L. S. Sealy, "'Bona Fides' and 'Proper Purposes' in Corporate Decisions" (1989) 15 *Monash University Law Review* 265. It might even be possible to see the restriction as demanding only "proper purposes": see *Peter's American Delicacy Co. Ltd* v. *Heath* (1939) 61 C.L.R. 457, at pp. 511-512 *per* Dixon J.
46 *Howard Smith Ltd* v. *Ampol Petroleum Ltd* [1974] A.C. 821 (PC).
47 DF para 3.24.
48 DF para 2.12.
49 Hampel Committee Report para 1.7.
50 CS para 3.16.
51 Companies Act 1985 s 309.
52 *Dodge* v. *Ford Motor Co* 170 NW 668 (1919).
53 CS para 3.5.
54 Whether assessed objectively or subjectively.

trust fund if they intentionally (i.e. dishonestly) exercise their management discretion *contrary* to the beneficiaries' interests.[55] In short, the duty – described here as a duty of 'loyalty'[56] – is proscriptive, not prescriptive.[57] Furthermore, it defines the process, not the end result. If this duty is translated into the corporate context, then it should prohibit directors from intentionally[58] exercising their management discretion contrary to the *company's* interests (or contrary to the success of the company). It seems certain that the CLRSG would prefer this to be formulated to address the *members'* interests, but that seems to introduce unnecessary complexity. When directors exercise a discretion to devote the company's assets to stakeholders who are not legally entitled to insist on the additional benefit – be they shareholders,[59] employees, customers, or the community at large – it seems far simpler to judge the directors' actions as 'loyal' if they are designed to advance the success of the *company* and disloyal if they are not. This can be assessed directly without adding the gloss that the directors' intention ought to be to benefit the members as a whole, whether in the short or long term. With commercial companies, success is measured in money – the relevant aim is to increase the value of the company.[60] If 'members' are nominated as the primary focus, it will never be clear whether the directors ought to favour members' short or long-term interests, or their interests in income or capital generation. A 'body of shareholders', even a theoretical one, will rarely be sufficiently homogenous to provide clear-cut guidance. Moreover, there is no need to nominate the members as the focus of the duty solely to ensure an appropriate enforcement mechanism. The duty is owed to the company, whatever formulation is adopted.[61] The company has the right to sue, and any compensation recovered from defaulting directors will accrue to the company. The shareholders will be motivated to ensure that breaches are restrained and claims are pursued[62] because it is they who are entitled to the residual value in the company, not because the duty demands that the directors focus on their consolidated benefit.

The CLRSG, and many reform bodies before it, have tried to use the law to improve the standards of behaviour of directors. They have turned to the duty 'to act in good faith in the interests of the company' (however 'the company' might be conceived) as the appropriate vehicle to advance this project. This seems misconceived. Historically, the duty was not designed to perform this function. It had an altogether more limited function, as described above. It is one thing for the law to prevent directors acting *against* the interests of the company, or for *im*proper purposes, or *without* reasonable care, or *self*-interestedly;[63] it is quite another to impose upon them an enforceable duty to act in a manner 'best calculated to … promote the success of the company…'.[64] The law does not generally

[55] This is a subjective limitation on exercise of the discretion; the proper purposes doctrine provides an additional objective limitation.
[56] More accurately, and more usually, described as a duty of 'good faith'. The duty of 'loyalty' is the fiduciary duty imposed on directors and trustees requiring them to prefer their duty to the company, or to the beneficiaries, over their own personal interests. The CLRSG's use of the familiar terminology of 'loyalty' to mean something quite different is likely to cause confusion.
[57] Of course, even when the trustees' discretion is exercised legitimately in the beneficiaries' interests, the trustees will be liable for any losses caused by the negligent exercise of their discretion. However, this sounds in a different duty, the duty of care (see DF para 3.40, principle 5).
[58] Adopting the broader equitable concept of fraud.
[59] Shareholders certainly belong in this series: although they have residual rights to the company's assets on a solvent winding up, they are not entitled to demand a particular dividend distribution from a solvent company. This is true even for preferential shareholders. Their entitlement is to preferential payment *if* a dividend is declared.
[60] The fact that the members will benefit is incidental, as is the fact that the stock market – if it is involved – will reflect the increased value of the company as an increase in the price of the shares.
[61] DF ch 3 and paras 3.20-3.31.
[62] Whether by installing a board of directors prepared to take the necessary action, or by pursuing a derivative action if the circumstances warrant it.
[63] This is the nub of the fiduciary duty of loyalty – not the director act in the interests of the company (with the then impossible task of determining whether this has been done), but that where there is a *conflict* between his *duty* to the company and his own *personal interests*, he should favour his duty to the company. This is an enforceable proscription.
[64] DF para 3.40 (Principle 1(b)).

attempt to compel good behaviour in this fashion; it merely sets minimum acceptable standards. True, it can *encourage* good behaviour. It does this in many ways. Tax incentives are used to encourage environmentally friendly practices or charitable giving; disclosure regimes (such as the proposed OFR[65]) and internal monitoring systems[66] encourage adoption of best practices. But these aspirational behaviours are not formulated as binding legal *duties*. This, it is suggested, is the real reason why there has been so much rather fruitless debate on the 'scope' issue. We do indeed want to know the answer to the question posed, but not in order to translate it into a legal duty in manner suggested by the CLRSG. If the proposed statutory duty of 'loyalty' is to have teeth, then it might be advisable to demand less of it, and to ensure that the lesser demands are enforceable.

Other duties imposed on directors

The draft statement of directors' duties[67] also sets out Principles relating to independence of judgement, conflicts of interest, fairness, and care, skill and diligence. The draft might have been expected to attract most controversy in relation to conflicts of interest, but it has not: there appears to be general approval of the suggested rules.[68] This duty deserves closest attention, but something should also be said of the other duties.

Principle 2, describing a duty to exercise independence of judgement, is not controversial. Independence is essential to proper performance of a director's functions, so much so that it is surprising the duty was not incorporated within Principle 1 (discussed in the previous section). A duty of compliance and loyalty surely obliges directors to exercise their powers *independently*, in good faith, for proper purposes and in accordance with the law. As it is, the draft statement does not expressly demand that directors exercise independence, merely that they do not restrict their powers to do so. Any other formulation would probably be impossible to police separately from the existing duty of compliance and loyalty.

Principle 4, describing the duty of fairness, requires directors to 'act fairly as between the company's members'. It is designed to restate the existing law,[69] which requires directors not to discriminate unreasonably between shareholders.[70] This formulation also puts in a positive way the incantation underpinning the Companies Act 1985 s 459, which can provide shareholders with a remedy where the directors (or others) have acted in a manner which is 'unfairly prejudicial'. It may seem that nothing changes where a double negative is replaced by a positive, but on one view a law which gives shareholders the *possibility* of a remedy where the directors have acted in an unfairly prejudicial manner is something different from a law which places directors under a positive duty to act fairly. Articulating the remedy for breach of this duty would go a long way towards clarifying the intended reach of this provision.

Principle 5, imposing on directors an obligation to act with care, skill and diligence, comes as no surprise and appears to have attracted no adverse comment.[71] This duty is simply one manifestation of the general duty of care imposed on all individuals in conducting their activities. If an individual is negligent and thereby causes harm to someone, then the law requires the individual to pay

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[65] The disclosure required by the Combined Code (appended to the Stock Exchange Listing Rules) works in the same way.
[66] This, it seems, is the function of the shareholders' power to dismiss directors without reason (Companies Act 1985 s 303). But while the directors are in post, their activities (and the shareholders' rights) are regulated by law, not by shareholder directives: see Worthington, note 66 above.
[67] DF para 3.40.
[68] CS paras 3.25-3.29.
[69] DF para 3.65.
[70] Certainly they cannot use their powers for this *purpose*: that would be in breach of their duty of compliance, which requires them to act for proper purposes. If this duty is intended to mean nothing more than that, then there is no need for a separate statement.
[71] It is not mentioned in CS.

compensation. All of this is straightforward, and there would seem to be no reason to exempt directors from the general operation of the law. However, two specific matters have caused concern in the corporate context for much of the history of this duty.

The first is that the standard of care imposed is commonly perceived as too low to be effective in regulating the conduct of directors. Shareholders suffer; and, if the company fails, creditors suffer too.[72] The role of directors has changed dramatically in the past 100 years. Then, directors were usually part-time, non-executive members of the board, not expected to devote much of their time to company business and not expected to bring any special skill to bear on their deliberations.[73] Judges and commentators generally seemed unable to recognise that the relevant law was capable of adapting to contemporary commercial expectations to demand more of directors and to assess those demands objectively.[74] The draft statutory statement will side-step this debate and effectively ensure that directors adhere to a minimum, objectively assessed, reasonable standard of care.[75] Notably, however, the CLRSG has not adopted the Law Commissions' recommendation that the statutory duty explicitly recognise not only the function of the director but also the circumstances of the company – i.e. its size and type.[76] As well, if directors have even greater skills or knowledge than this minimum requirement, then they will be expected to use those greater skills for the benefit of the company and the standard of care in those circumstances will be assessed subjectively. The Companies Act 1985 s 310 will continue to apply, so that companies will be unable to opt out of this requirement. All of this is perfectly acceptable, although it does seem that even this dual standard duty of care is not as onerous as the standards effectively demanded by the Company Directors Disqualification Act 1986.[77] Alignment seems desirable.

The second difficulty in applying the law of negligence to directors is that it is unusually difficult to say what sort of conduct should count as negligent when directors are carrying out their management functions, at least where their conduct is neither grossly negligent nor fraudulent. Companies are set up to take risks; directors are employed because they are good at this – they are entrepreneurs. The fact that a company makes a loss, or even fails totally, is not of itself indicative that its directors have been negligent in the management of the company's affairs. This led to earlier calls for the introduction of a statutory 'business judgement rule', as operates in the United States and several other countries. Such a rule would confirm that directors who make loss-generating decisions reasonably, after collecting all the appropriate evidence, and after appropriate consultation and evaluation, will not be found guilty of negligence in the management of the company, and so will not be held liable to compensate the company for the losses suffered. The CLRSG has not adopted this approach, rightly it seems.[78] There appears to be no need for such a rule. The normal rules of negligence clearly admit that damage and harm do not, of themselves, prove negligence; and a director who offered proof of the matters outlined above would clearly not be found negligent, even in jurisdictions without a business judgement rule in place. The same analysis applies where a director delegates particular functions, and loss results.[79] What is notable, however, is that this commercial assessment is clearly left entirely to the courts.

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[72] The company's creditors in fact received better protection, by statutory fiat, some years earlier than the shareholders: see Insolvency Act 1986 s 214.
[73] See, e.g., *Re City Equitable Fire Ins Co* [1925] Ch. 407.
[74] Although see *Re D'Jan of London* [1994] 1 B.C.L.C. 561 (Hoffmann J.); S. Worthington, 'The Duty to Monitor: A Modern View of the Director's Duty of Care', in F. Patfield (ed.), *Perspectives on Company Law: 2* (1997, London) ch 11, and the references cited there.
[75] The format will follow that of Insolvency Act 1986 s 214, although with simplified wording.
[76] LCR para 5.15.
[77] See, e.g., the discussion in *Re Barings Plc (No 5)* [1999] 1 B.C.L.C. 433 (Jonathan Parker J.); [2000] 1 B.C.L.C. 523 (CA).
[78] DF paras 3.69-3.71.
[79] The CLRSG does not propose to deal with the issue explicitly in the statute: DF para 3.71. Similarly, LCR para 5.36. The Law Commission reached this view on the basis that, since the law was still developing, it was impossible to state the position simply and accurately.

The draft statutory statement of directors' duties contains one further Principle, Principle 3. It states the duty which is to apply in relation to conflicts of interest. Although it seems not to have attracted adverse comment, it does raise concerns. These concerns can best be addressed in the light of the text of the proposed duty:[80]

> **3. Conflict of duty and interest**
>
> 3. A director must not:
>   a. authorise, procure or permit the company to enter into any transaction in which he has an interest unless the interest has been disclosed to the relevant directors to the extent required under the Act;[[81]] nor
>   b. use any property, information or opportunity of the company for his own or anyone else's benefit, nor obtain a benefit in any other way in connection with the exercise of his powers, unless he is allowed to make such use or obtain such benefit by the company's constitution, or the use or benefit has been disclosed to the company in general meeting and the company has consented to it.

This draft text clearly separates two distinct factual situations in which conflicts of duty and interest are likely to arise. Paragraph (a) deals with cases where the director contracts with the company; paragraph (b) with cases where the director contracts (or has some other arrangement) with third parties, not with the company. This division is commonly adopted for pedagogic purposes: the remedies in the first cases may, it seems, be limited to rescission of the underlying contract, with no option to request an account of profits should rescission be unavailable according to prevailing equitable rules; the remedies in the second case are not so limited, with disgorgement of the director's profits being effected either by means of a constructive trust or a personal obligation to account.[82] Despite these remedial differences, it is clearly recognised that both situations are simply fact patterns raising the possibility of directors being tempted to act in their own personal interests rather than in accordance with their duties to the company. The law seeks to ensure that the company's interests are favoured by adopting a strict [fiduciary[83]] rule that whenever a director acts in these circumstances, any profits he might make will have to be disgorged to the company. The risk to the company is the same in both cases. The way for the director to avoid this consequence is to obtain the fully informed consent of the person to whom he owes his duty – i.e. the company. Historically, it has been seen as necessary for the general meeting, not the board of directors, to provide this consent. This may not be defensible.[84] However, it seems even less defensible to suppose that one fact pattern warrants the protection delivered by a general meeting vote while the other does not. This is even more so when the interested director is to be permitted to vote at the board of directors' meeting.[85] This will mean that, provided the appropriate disclosure is made, and regardless of the influence exercised by the interested director, it will be impossible to challenge a self-dealing transaction on the grounds of conflict of duty and interest. It may, of course, be possible to mount a challenge based on improper purposes,[86] absence of good faith, or negligence – but the remedies for those breaches do not include disgorgement. The primary rule needs to be articulated in a more defensible fashion. This could be a rule which requires approval by a (disinterested) general

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[80] DF para 3.40, Principle 3.

[81] This is a reference to Companies Act 1985 s 317, requiring a director to disclose [material] interests to the board of directors.

[82] See Worthington, note 66 above, and the references cited there. The traditional statement in the text is currently under attack by both academics and the judiciary. The article describes and evaluates the current state of play.

[83] The word 'fiduciary' is deliberately omitted from the statutory statement of duties. It is not clear what, if anything, this adds to the statement, especially since the intention is that the judges will have resort to existing 'fiduciary' and 'non-fiduciary' case law: DF para 3.44.

[84] See the arguments in Worthington, note 66 above.

[85] See DF para 3.62, indicating that the duty will not even arise unless the interested director authorises, procures or permits the transaction.

[86] And if the defaulting directors carry the board's decision to approve, then it seems the argument will become circular – the approval will not have been properly given, so the directors will have breached their duty not to profit in circumstances of conflict.

meeting,[87] *or* one which requires approval by a disinterested board of directors – but a rule which requires this procedure in *all* cases of conflict of duty and interest.[88]

On the other hand, it may be true that the real agenda being pursued by the CLRSG is to re-classify these self-dealing transactions as transactions in which the company cannot participate unless the board of directors has notice of the director's interest. If this is the case, then the breach of duty in issue is not (or not solely) a breach of fiduciary duty. It is, instead, a breach of the duty of compliance, and the remedies should follow accordingly. These remedies would require *all* the directors involved (knowingly?) in committing the company to the impugned transaction to compensate the company for its losses, but no more than that; they would not require the interested director to disgorge his profits.

The difficulties do not end there. Paragraph (b) of Principle 3 describes what is traditionally termed the 'corporate opportunity doctrine'. It restates the doctrine in an orthodox fashion, without attempting to address the practical difficulties which have dogged application of the equitable rule. In particular, the proposed statement does nothing to assist the courts in resolving the perennially difficult issues of whether an opportunity is 'the company's' or not, especially where the director heard of the opportunity in his private capacity, or where the company declined to, or could not, exploit the opportunity itself, whether for practical or legal reasons. Nor is any consideration given to the quantification of the profit the director will be deemed to have made as a result of the breach, rather than as a result of the exercise of his own skill and energy. In short, the court will be left with the same discretion – and the same difficulties – which mark the present equitable duty. This Principle therefore provides a stark illustration of the magnitude of the input which will be required from the courts in order to define these duties. It also makes it doubtful whether any statement can do more than alert directors to the potential scope of their duties.

The CLRSG considered and rejected the case for a sixth general principle requiring directors to consider the interests of creditors where the company's solvency was threatened. This was seen as unnecessary, being already covered by the inclusive loyalty principle.[89] Nevertheless, the duty was recognised as sufficiently distinctive to warrant adding a warning on Form 288, which directors need to sign on their appointment.

Interestingly, and notwithstanding all this detail, the functions of the *board* of directors are not addressed explicitly. The draft statement refers only to individual directors; the collective duty of the board to supervise and monitor the management of the company is not mentioned, even though this is widely recognised as the key function of this body.[90]

Role of Part X

Part X of the present Companies Act 1985 contains almost forty sections regulating fair dealing by directors. The provisions are principally concerned with directors' remuneration, substantial property dealing with the company, loans from the company (and related dealings), and share dealings. These provisions far exceed the equivalent regulation in Canada or in other EU member states.[91] Nevertheless, the CLRSG sees retention of Part X as necessary to prevent abuse, even

[87] And of course the general meeting of a particular company could delegate its power to the board of directors (as is commonly done in a limited context by adoption of Table A art 85), unless this were prohibited by statute. Whichever body voted, however, the vote would have no weight unless it was judged to be an *effective* exercise of voice by the company: see Worthington, note 66 above.
[88] Again, see Worthington, note 66 above.
[89] DF paras 3.72-3.73. Such a duty was also seen as cutting across the rules in Insolvency Act 1986 s 214, which allow action by a liquidator. This conclusion seems to misunderstand the role of liquidator.
[90] *Re Barings Plc (No 5)* [1999] 1 B.C.L.C. 433, 487, 489 *per* Jonathan Parker J., approved by the CA, [2000] 1 B.C.L.C. 523.
[91] LCR para 2.7.

though it concedes the provisions are complex and rather incoherent. The proposed statutory rules discussed in the previous section were seen as clarifying the law, but not as sufficiently strengthening it so as to deal with these issues. In general, the CLRSG saw fit to adopt the Law Commissions' proposals in relation to Part X, and simply annexed those proposals to its own report.[92]

The preferred view is that one or two of these sections be repealed as no longer relevant, but that in the main the provisions should stand,[93] although with some substantial drafting amendments to clarify both the duties themselves and the relevant remedies. Here, attention is directed only at section 317 and the remedial provisions.

The Law Commissions devoted considerable attention to Companies Act 1985 s 317.[94] As it currently stands, this section imposes a fine on directors who fail to disclose to the board of directors any interests they have in transactions with which the company is involved. It is proposed that the section be clarified to indicate that the necessary disclosure need only be of material interests of which the director is (or ought to be[95]) aware and which are not already known to the board, and that disclosure need only be to the directors present at the relevant board meeting.[96] Again, as the law currently stands, breach of the section does not render the transaction voidable, although that is the separate consequence of the application of non-statutory fiduciary rules. The Law Commissions recommended that criminal penalties be removed and civil penalties be introduced. The CLRSG has deferred its decision on criminal sanctions, but considers that civil penalties ought to be imposed. In addition, the CLRSG proposes that the section provide for the transaction to be voidable if the interest is not disclosed, and that the director be liable to account for profits and compensate for losses. It further proposes that this civil liability be mandatory, regardless of the terms of the company's constitution. The CLRSG saw all of this as restating the common law.[97] This is doubtful. As already noted, it is not even clear whether liability for self-dealing transactions extends beyond rescission to include an account of profits when rescission is unavailable;[98] certainly directors in breach of their fiduciary duties of loyalty are not liable (under this head[99]) for losses suffered by the company. This loss-recovery response would be more appropriate if the section were directed at corporate capacity, or at directors' authority, rather than at fiduciary duties of loyalty designed to generate disinterested decision-making. As noted earlier, the CLRSG is also of the view that, provided disclosure is made, interested directors should not be prohibited from voting on the self-dealing transaction.[100] This too seems wrong.[101] At present the matter is regulated by companies' articles, although the articles of listed companies *must* prohibit interested directors from voting on matters in which they have a material interest (subject to limited exceptions). In Australia, too, directors of public companies are prohibited from voting in these circumstances.[102] This section (which, in its revised form, seems to be repeated in the proposed general statutory provisions dealing with directors' duties[103]) seems overly lenient in its statement of the duty, and may therefore prove

[92] DF Paras 3.86-3.89 and Annex C; LCR Part 6ff.
[93] This means that a new Companies Act will still contain provisions dealing with payments in connection with loss of office (ss 312-316), declaration of interest (s 317), disclosure of, and period for, service contracts (ss 318-319), substantial property transactions (ss 320-322), and credit transactions (ss 330-344).
[94] LCR Part 8.
[95] LCR para 8.31: there should be no obligation to disclose where the director does not know of the interest and could not reasonably have been aware of it. The same sort of disclosure is required of the interests of connected persons.
[96] DF Appendix C para 11-13.
[97] DF Appendix C, para 18.
[98] See the earlier discussion of Principle 3.
[99] They may, of course, be concurrently liable for other breaches which have as their remedy the obligation to compensate for losses.
[100] DF Appendix C para 17. LCR paras 8.89-8.91.
[101] See the earlier discussion of Principle 3.
[102] Australian Corporations Law s 232A, although this prohibition may be lifted by the board.
[103] DF para 3.40, Principle 3(a).

inadequate in dealing with the practical problems it seeks to address, and yet it seems excessive in the remedies it imposes for breach.

On the remedies front, and again adopting the Law Commissions' view, the CLRSG proposes a comprehensive code of civil remedies to deal with all the provisions in Part X. The argument for this is that it will allow comparisons to confirm consistency and remove anomalies, and will only require one lot of litigation to determine the meaning in several contexts.[104] As far as the particular remedies are concerned, the Law Commissions' proposals largely follow the model currently familiar in the context of ss 320-322, although there are some important deviations:[105] self-interested transactions will be voidable subject to the usual bars, including when the court so directs;[106] whether the transaction is avoided or not, the director concerned will be liable to account for profits and /or compensate for losses, again subject to any limitations or restrictions on quantum imposed by the court in their discretion.[107] The particular suggestions about the differential applications of this discretion are not yet clear.[108] The potential impact on defaulting directors has already been seen in cases such as *Re Duckwari plc (No 2)*,[109] where the defaulting director was held liable for the losses suffered by the company due to falls in the property market. The only concession seems to be that directors will not be held liable for losses that the company would have suffered in any event.[110]

These ideas (bar the discretion to be given to the courts) have been around for a long time and seem to have caused few real problems, and yet they seem to confuse two quite distinct regulatory impulses. A company law statute might wish to bar certain types of transactions, or bar them unless they meet certain hurdles. This decision can be made for any number of valid reasons, and may be designed to protect any one of a wide range of stakeholders. In these circumstances it seems entirely appropriate to look to the directors who committed the company to a transaction in breach of such restrictions and require them to cover the losses thereby incurred. Alternatively, the regulation may be designed to prevent directors using their wide discretionary powers, or even their positions as directors, to line their own pockets rather than to promote the company's business. Here there is no defined end goal which directors must reach. The issue is not entry into prohibited ventures, or negligent assessment of corporate commitments; it is the drive to obtain disinterested service from directors. The appropriate remedy is disgorgement of any profits a director makes from acting self-interestedly. It may be that the situations dealt with in Part X ought to be classified under both heads. It seems, however, that a specific statutory rule is needed only in relation to the first type of regulation; the second type will be covered automatically by the more general conflicts provisions.[111] There is no problem with this form of concurrent liability, although such separation would effectively modify the breadth of the remedies currently contemplated by Part X. In addition, there seems to be no real reason to give the court a particular statutory discretion in these cases when the general provision in Companies Act 1985 s 727 appears apt to cover the concerns raised. In fact, it might be thought that these very concerns which militate in favour of a strong judicial discretion also serve to suggest that the remedial provisions are drafted too widely.

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[104] LCR paras 15.1-15.7.
[105] LCR para 8.97ff.
[106] LCR para 8.113.
[107] LCR paras 8.113-8.115, 8.119, the last paragraph suggesting that the court's discretion should also be able to modify the duty to account.
[108] LCR para 15.5. The suggestion is that so far as s 322 is concerned, the discretion to limit liability should not be exercised even if the company suffered no prejudice; however, so far as s 317 is concerned, the court should exercise a discretion, and it should be a relevant consideration that the company suffered no loss. The logic of this is not apparent, unless it relates to the 'seriousness' of the breach. Both transactions are self-dealing transactions, one is a substantial property transaction requiring shareholder approval, the other an interested transaction requiring disclosure to the board of directors.
[109] [1998] 2 B.C.L.C. 315 (CA).
[110] LCR para 8.117.
[111] Although then the inadequacies of Principle 3(a) become readily apparent: see the earlier discussion.

In short, it seems that the better way to deal with these Part X provisions is to deal with them in the section of the Act which is devoted to corporate capacity (including the powers of the various organs), not in the section on directors' duties.[112] This section could readily accommodate a complete list of restrictions on corporate activity and an indication of who is limited by them and who is liable under them. This separate treatment would seem to fit better with the economic efficiency arguments presented in all the reform documents and discussed earlier.

Statutory statement of duties

One of the central issues for corporate law reform has been whether matters would be improved with a statutory statement of directors' duties. Over the course of the review process, each alternative has at some stage enjoyed preferred status. The Law Commissions' consultation document suggested that a statutory code would be too restrictive, inhibiting the essentially dynamic and evolving nature of the law on directors' duties.[113] It preferred, instead, to have non-binding, educative, authoritative pamphlets outlining the principal duties owed by directors. After consultation, however, the Law Commissions' report advocated partial (i.e. non-exhaustive) codification of the 'settled' duties, leaving the courts to develop any unsettled or new duties.[114] The advantages of this approach were seen to lie in its flexibility and potential dynamism.

The CLRSG advocates a third option. It proposes an exhaustive[115] statutory statement of directors' general duties,[116] drafted at a sufficiently high level of generality to overcome the Law Commissions' criticisms of statutory codes. The statement is intended to combine flexibility with accuracy and accessibility, and to embrace the CLRSG's views on 'scope', thereby giving comprehensible and useful guidance to company directors and others.[117]

This does appear to be the best option. The arguments in favour of the alternatives are not persuasive. The suggestion is also in line with several other Commonwealth jurisdictions.[118] However, the justification for this approach is surely only to improve the clarity and accessibility of the law. The CLRSG's aim is not (for the most part) to alter the law;[119] nor, it seems, will the statement greatly affect the law's development. It is unlikely that the old cases will lose their force as illustrations of the proper application of the law. Indeed, given the generality of the principles (a generality deliberately designed to enhance flexibility), it is unlikely that the statement will do anything to impeded developments and refinements in the law which might otherwise have taken place at common law.[120]

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[112] See, too, the earlier discussion of Principle 1 (duty of compliance) and Principle 3(a).
[113] LCR para 4.27, although the Law Commission was also of the view that some duties were not still 'evolving' but were now 'settled' – LCR para 4.28 – so that a statutory formulation of them would improve accessibility. This approach, and its detailed articulation, present some surprises. The Law Commission suggested that a director's duty to act bona fide and in the interests of the company was a paradigm example of a settled duty which could be codified; by way of contrast, a director's duty not to misuse corporate property was seen as still too unsettled to be appropriately subjected to codification (LCR 4.15-4.18). Many might have thought that quite the reverse was true, especially in light of the vehement and ongoing 'stakeholder' debate, which is all about the proper remit of the 'interests of the company'.
[114] LCR paras 4.28-4.44. It continued to recommended non-binding pamphlets for information: LCR paras 4.64-4.67.
[115] DF paras 3.15, 3.82. The statement is not intended to be exhaustive outside its stated field: see the similar arguments in *Re Wait* [1927] 1 Ch. 606 in relation to the then current Sale of Goods Act.
[116] DF paras 3.37–3.73.
[117] By contrast, the Law Commission was of the view that a general statutory statement could not be informative: LCR para 4.15-4.18.
[118] Australia, Canada and New Zealand – SF ch 4. Canada also has a statutory scheme of remedies, and Australia has a system of civil penalties.
[119] DF para 3.43.
[120] This is despite the CLRSG's conviction to the contrary: DF para 3.15 n 22.

If the primary function of the statutory statement is to make the law clearer and more accessible, then there are some potential flaws in the proposed regime. The heading to the proposed statutory statement, 'The general duties of a director of a company', is intended to reinforce the idea that there are other specific duties imposed on directors of companies.[121] This is counter-productive. It seems preferable to collect together (at least) the Companies Act provisions which impact on the duties of directors, whether the provisions affect the existence or the exercise of their authority.

In addition, two other matters require further attention. First, the Law Commissions' and CLRSG's papers suggest the provisions are to apply only to directors formally appointed to the board. There is no discussion of other parties involved in corporate governance who might equally well be subjected to the same regime.[122] Unless the net is cast wider, two classes of management will evolve: directors subjected to the Act, and other officers subjected to the common law and equitable rules, especially the rules relating to fiduciaries. Secondly, there is no detailed discussion of the extent to which these duties can be ameliorated or avoided. The issues are controversial. It seems better to address the problems in the context of each specific duty, rather than trying to re-draft the Companies Act 1985 s 310 to provide a comprehensive general rule.[123]

Finally, and notably, although the DTI recognised that governance can be imposed by primary or secondary legislation, codes of practice, Stock Exchange Listing Rules and such like,[124] all the documents to date concentrate exclusively on the first route.

Statutory statement of civil remedies for directors' breaches

The proposal for a statutory enactment of directors' duties is being combined with a move to enact civil remedies for their breach. Space prevents a full discussion of the issues here. The CLRSG invites responses on the general desirability of codification, and asks for specific comments on the approach advanced in a paper prepared by Mr Richard Nolan and published on the DTI website.[125]

As with the statutory statement of directors' duties, a statutory enactment of remedies seems to be an achievable goal, and one worth working towards. Again, as with the duties themselves, the aim should be to make the law clearer and more accessible, not to reform it. To that end, it seems that all that is needed is a simple indication of the party liable, and the consequences of liability – be it rescission of the underlying transaction, compensation for losses incurred by the company, or disgorgement of the profits generated by the breach. The general law would continue to provide refinements to the quantification exercise undertaken by the courts. In this way, the statute would not need to specify rules relating to remoteness of damages, contributory negligence, general defences, tracing consequences, and so forth. In essence this is what is proposed in respect of the statement of duties, and if the duties are to be allowed to develop in the usual common law, incremental fashion, then so too must the remedies, otherwise application of the law is likely to become distorted.

Although the general idea of a statutory statement of remedies seems warranted, the particular form proposed in the paper adopted by the CLRSG is not in line with the arguments advanced here. The paper affirms the importance of aligning specific remedies with specific duties.[126] Nevertheless, it then adopts what is largely a 'Part X-style' regime, so that most breaches of duty (bar the duty of care and skill) attract a 'menu' of remedies – i.e. rescission, liability for losses and gains – available against a wide class of defendants. The problems associated with this approach have already been

[121] DF para 3.43.
[122] Contrast the width of the statutory provisions in Australia, where the law is designed for a widely defined class of corporate 'officers': Australian Corporations Law s 232(1).
[123] Of course, a general provision may suffice to deal with the important issue of D&O insurance.
[124] MCL para 5.8.
[125] CS paras 13.71-13.74, and R Nolan, 'Enacting Civil Remedies in Company Law', www.dti.governance.uk/cld/review.htm.
[126] *Ibid*. para 18.

discussed.[127] It effectively reallocates risk in a potentially unwarranted and unacceptable fashion. The various duties are fundamentally different in their objectives, and the traditional remedies by and large seek to achieve the law's aims in the least interventionist manner possible.[128]

The statutory statement of remedies will presumably incorporate the proposed revised Companies Act 1985 s 727, which gives the court a discretion to excuse directors who have behaved honestly and ought fairly to be excused.[129] It is then a matter of policy whether the statute should also describe the rules which permit a company, rather than the court, to excuse its defaulting directors. The drive to provide clear and accessible rules suggests a positive answer, but the technical issues are difficult.[130]

Enforcement mechanisms

Only two points need to be made in relation to the enforcement mechanisms proposed for directors' duties. So far as civil enforcement is concerned, the reform documents confirm that directors' duties are owed to the company and are to be enjoyed collectively. Whether or not a breach should be pursued depends upon the collective interests of the members, not their individual interests. It follows that it is for the board to decide whether or not to sue.[131] This is orthodoxy, but it needs to be carefully integrated with the newly proposed duties of compliance and loyalty (Principle 1) and fairness (Principle 4).

So far as criminal enforcement is concerned, there is an unexpected preference for the retention of criminal sanctions for a wide variety of wrongs. This is unexpected because the DTI views the current legislative regime as over-burdened with unnecessary criminal provisions where civil sanctions would be preferable. Indeed, one of the specific reform principles adopted by the DTI was a principle against creating criminal offences; another was to allocate the enforcement jurisdiction to the most suitable regulatory body.[132] This view persisted in the *Strategic Framework Document*, where it was predicted that rationalization of the framework would result in fewer statutory prescriptive rules with criminal sanctions.[133] The Law Commissions, too, had suggested that criminal sanctions ought to be retained only where there would otherwise be problems in achieving necessary compliance, or where there were cost disincentives which mitigated against shareholder litigation.[134] This conclusion was in line with one of the Law Commissions' guiding principles, the 'appropriate sanctions principle', which indicated that there should be a range of effective and realistic sanctions backed by appropriate oversight and enforcement machinery.[135]

Basic economic analysis might suggest that criminal sanctions are only warranted where the social cost of non-compliance is high, and where cost-benefit analysis suggests that enforcement by a non-State party is unlikely. The two parts of the equation are in balance: a very high social cost of non-compliance might suggest that criminal sanctions are appropriate even if alternative enforcement mechanisms are available and likely to be utilised; as the social cost goes down, however, the argument for criminal sanctions can only be sustained if that appears to be the only available enforceable mechanism. It goes without saying that a rule need not, and should not, be imposed unless its enforcement (by whatever mechanism) is regarded as desirable. It follows that the need to

[127] See the earlier discussion of Part X.
[128] See S. Worthington, 'Fiduciaries: When is Self-Denial Obligatory?' [1999] CLJ 500; Worthington, note 66 above.
[129] DF paras 3.76-3.77.
[130] DF paras 3.79-3.81, 4.120-4.126. See Worthington, note 66 above, for one assessment of the rules.
[131] DF para 3.79.
[132] SF p v.
[133] SF para 5.5.5.
[134] LCR paras 2.35-2.36.
[135] LCR para 3.4.

impose criminal sanctions often depends upon how effective civil sanctions are.[136] Certainly, some directors' duties are sufficiently important that public enforcement is warranted (the duties of disclosure, for example), but the current proposals suggest an over-dependency on criminal sanctions which appears out of line with the reform principles adopted at the outset.[137]

Conclusions

The stated aim of the DTI's current review is to produce a simple, rational framework which is modern and competitive, and which facilitates enterprise and promotes transparency and fair dealing.[138] It is against that ambitious goal that its efforts will be assessed. As yet the rhetoric seems not to be matched by the substance, at least in the area of directors' duties. Nevertheless, there is much that can be built on. The criticisms articulated in this note can, in substance, be boiled down to an assertion that the framework must build unambiguously on coherent general principles. The core ideas must be refined and particularised to reveal practical rules. Much will rest in the drafting. The framework structure will be as important as the particular provisions. The devil is not entirely in the detail.

[136] LCR para 2.18.
[137] This is notwithstanding the analysis provided in CS ch 13.
[138] MCL Foreward and para 3.8.

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