A Critique of Enlightened Shareholder Value: Revisiting the Shareholder Primacy Theory

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The statutory re-conceptualisation of the traditional common law shareholders' primacy into 'enlightened shareholders' value' emblematic of section 172 of the Companies Act 2006 has generated a universe of views amongst scholars. While some scholars hypothesise that the enlightened shareholder value concept epitomised by section 172 is no more than a re-affirmation of the traditional common law shareholder primacy under a different guise, others theorise that it inches towards a 'pluralist theory' of continental European tradition. Still further, others argue that the re-conceptualisation is emblematic of the convergence of principles from both the traditional 'primacy theory' and 'pluralist theory'. Against the background of this theoretical debate, constraints upon the operation of section 172 have made it difficult for the courts to enforce the section pragmatically. It is contended that despite the laudable statutory re-conceptualisation, section 172 only added little improvement (if any) on the traditional common law shareholder primacy; and its greatest shortcoming lies on the enforcement constraints. Nevertheless, the courts can still adopt a teleological interpretative approach that plugs the loophole in the stakeholders' protection.

Introduction

Law is a dynamic aspect of society's life. Whereas in the last century Friedman could boldly assert that the corporation's social responsibility was to maximise wealth earning a profit conflating two discrete issues and Kraakman in a blaze of neo-classical economic glory declare that human evolution had reached its zenith in shareholder primacy, the facts tell a different story. Even as they were undertaking their research, the planet was going in a different direction – a

> *direction in which corporate social power carries corporate social responsibility. From the international and transnational soft law of the UN's Global Reporting Initiative and corporate sponsored initiatives such as the Kimberley Process aimed at improving social performance, to the hard law of legislated regulatory reform and judgments of courts supporting and imposing such social initiatives. Far from precluding expenditure of corporate wealth on social issues as these scholars may suggest, not only does the law allow attention to social issues, but actually mandates such attention.*[1]

The graduation from the traditional common law shareholders' primacy to enlightened shareholders' principle now encapsulated in section 172 of the UK Company Act 2006 has led to so many postulations as to the potential implication of the section.[2] The Company Law Review Steering Group (CLRSG)[3] considered the pluralist approach characteristic of some continental European countries[4] but abandoned it in favour of an enlightened shareholder approach. The directors are now constrained to have regard to stakeholders' interests as well as observe the tenets of corporate social responsibilities while promoting the success of the company for the benefit of members as a whole. However, the preceding has

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[1] Benedict Sheehy, 'Directors' Legal Duties and CSR: Prohibited, Permitted or Prescribed in Contemporary Corporate Law' [2013] <http://works.bepress.com/benedict_sheehy/17/> accessed 14 February 2014.

[2] Andrew Keay, 'The Enlightened Shareholder Value and Corporate Governance', (2013) 76(5) Modern Law Review 940. On the relevance of shareholder primacy in Anglo-American corporate law and the need for a stakeholder theory of corporate governance see, Jingchen Zhao, 'The Curious Case of Shareholder Primacy Norm: Calling for a more Realistic Theory' (2012) 15 International Trade and Business Law Review 2.

[3] The Explanatory Notes to the Companies Act 2006 indicates that section 172 is a product of effort to codify the directors' duties in statutory form, unlike the common law position that was largely not codified.

[4] Continental European countries with a pluralist approach include, inter alia, Germany, The Netherlands, and Austria, amongst others. See also Luca Cerioni, 'The Success of the Company in Section 172 (1) of UK Company Act 2006: Towards an 'Enlightened Directors' Primacy?' (2008) 4 Original Law Review 37.

equally thrown up conceptual arguments of various strands. Thus, while some scholars postulate that the enlightened shareholder concept epitomised by section 172 is coterminous with the traditional shareholder 'primacy theory' that underpinned the common law paradigm,[5] others hypothesise that it inclines towards the 'pluralist theory' characteristic of a significant number of continental European countries.[6] Still further, others argue that the re-conceptualisation is emblematic of the confluence of principles from both the traditional 'primacy theory' and 'pluralist theory' typical of continental European.[7] While the arguments on the contours of the substantive rules linger, others have gone further to express scepticism on the enforcement of shareholder and/or stakeholder rights consequent on procedural constraints. These divergences tend to challenge the philosophical premise behind the reformulation of the section; and may as well have far reaching implications for the practical fallout of its construction. A critique of the foregoing trajectories therefore forms the focus of this article. It will be argued that despite the laudable statutory re-conceptualisation, section 172 only added little improvement (if any) on the shareholder 'primacy theory'; and its greatest shortcoming lies on the procedural enforcement constraints. However, the courts can salvage the situation through teleological interpretations of the section.

The article is divided into eight parts to underscore the significance of each of the concepts as well as to enhance better understanding by the readers. Introduction aside, Part II first and foremost examines the conceptual premise of the shareholders versus stakeholders debate. Apart from laying out the constituent components of section 172 for easy reference, Part III delves into the background preceding the reform; then analyses the contours of 'promoting the success of the company' in relation to the common law position. Part IV dwells

[5] David Collison and others, 'Financialization and Company Law: A Study of the UK Company Law Review' (2014) 25 Critical Perspectives on Accounting 5.

[6] Roman Tomasic, 'Company Law Modernisation and Corporate Governance in the UK – Some Recent Issues and Debates' [2011] Victoria Law School Journal 43; Luca Cerioni 'The Success of the Company in S.172(1)' (n 4).

[7] Stephen Brammer, Gregory Jackson and Dirk Matten, 'Corporate Social Responsibility and Institutional Theory: New Perspectives on Private Governance' (2010) 10(1) Socio-Economic Review 12.

on the concept of good faith. Part V then examines the core concept of enlightened shareholders as it relates to the conjunctive terms of 'have regard (amongst other things) to'. Part VI explores whether the position of stakeholders, particularly employees and creditors, is better protected under the current framework compared to the traditional common law position. Part VII then argues that the raging controversy characterising the section could be ameliorated if the courts could adopt a teleological interpretative paradigm. Part VIII concludes that section 172 added little (if any) to the traditional common law shareholder primacy theory, unless the courts adopt a purposeful interpretative approach anchored on a teleological paradigm.

Conceptual Framework of the Shareholders versus Stakeholders Debate

Before delving into the trajectories of section 172, it would be pertinent at the outset to examine in general the competing theories of corporation to underscore the normative foundation cum divergent postulations that underpin shareholder versus stakeholder debate. The doctrinal conception of corporation in early years had been as an artificial entity (a derivative of the concession or grant theory of corporation)[8] which came into being by virtue of substantive laws of the state - demonstrated in the chartered nature of corporation then.[9] However, as the state continued to loosen legal strictures making the incorporation of companies easier, a new doctrinal conception emerged therefrom, in the form of natural entity theory.[10] In contrast to artificial entity, natural entity theory postulates that corporation is a natural creation consequent upon the agglomeration of private initiatives of individuals, and thus can only exercise such powers as are extended to it by the shareholders. The state should refrain from the imposition of regulatory constraints as

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[8] Morton J Horwitz, 'Santa Clara Revisited: The Development of Corporate Theory' (1986) 88 West Virginia Law Review 184.

[9] David Millon, 'Theories of the Corporation' (1990) 2 Duke Law Journal 206;

David Millon 'New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law' (1993) 50 Washington & Lee Law Review 1373.

[10] Millon, 'Theories of the Corporation' (n 9) 211.

the corporation, governed by private law, exists to serve shareholder interests as against stakeholder interests.[11]

This doctrinal premise provided the theoretical framework for the shareholder versus stakeholder debate between Berle[12] and Dodd[13] in the early 1930s that significantly shaped subsequent legal discourse on the scope of directors' duties. Neo-classical proponents of Berle's position contend that shareholder value maximisation constitutes the only theory of corporation consistent with free market economy.[14] In their provocative article, *The End of History for Corporate Law,*[15] Hansmann and Kraakman in rooting for shareholders' primacy theory, posit that other stakeholders such as creditors, employees, customers, suppliers, and environmentalists, amongst others, can only be part of the corporate governance equation if they are party to the express and unambiguous contract with the corporation. Failing that, they can only lay claim to protections of other bodies of law, otherwise their interests are not to be the concern of corporate management. Specifically, the corporate accountability of directors is only owed to the shareholders who invested their money in the corporation and not otherwise. Thus, the members of society affected by corporate activities may avail themselves of the protection of environmental law or the law of tort but not to expect corporate management to have them in contemplation in running the company.[16]

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[11] For a review of these theories see David Millon, 'Theories of Corporation' (n 9) 211-216. Note that the aggregate theory of the corporation provided the theoretical basis for natural entity theory but was unsustainable due to the separation of ownership from management as well as the crystallisation of majority rule as a voting procedure for shareholders as against the prior unanimity rule.

[12] Adolf A Berle, 'For Whom Corporate Managers Are Trustees: Note' (1932) 45(8) Harvard Law Review 1365.

[13] Edwin Merrick Dodd, 'For Whom Are Corporate Managers Trustees?' (1932) 45(7) Harvard Law Review 1145.

[14] Stephen Bainbridge, 'In Defence of Shareholder Wealth Maximization Norm' (1993) 50 Washington & Lee Law Review 1423; Milton Friedman, 'The Social Responsibility of Business is to Increase its Profit' *The New York Times Magazine* (New York, September 13 1970) 122.

[15] Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2001) 89 Georgetown Law Journal 442.

[16] ibid.

In contrast to the above, progressive writers, particularly Cynthia A Williams, argue that in the context of increasing globalization, the argument that corporations exist purely to maximise the shareholders' wealth is illusory.[17] In other words, the so-called regulatory rules and explicit contract to regulate company relationships with stakeholders are inadequate. Equally, Margaret Blair and Leon Stout question the validity of shareholder primacy theory.[18] Blair and Stout argue that the existence of the corporation is a by-product of team production involving the input of various interests not limited to shareholders simpliciter.[19] Thus, the team production theory rejects shareholder primacy theory.

Shareholder versus stakeholder debates can further be analysed from the standpoint of the contractarian versus communitarian debate;[20] the predominant versus progressive position;[21] or the monist versus pluralist debate, amongst others, reflecting the diversity of perspectives.[22] Thus, these conceptual frameworks shaped the evolution and continue to shape the growth of corporate law and by implication the directors' duties which are the touchstone of corporate governance. It can be argued therefore that the statutory re-conceptualisation of section 172 of the Companies Act 2006 might have been influenced, in part, at least conceptually, by the preceding. Analysis of the core substantive import of the section forms the focus of the following parts punctuated, first and foremost, by laying out the constituent components of the section for easy reference.

[17] Cynthia A Williams, 'Corporate Social Responsibility in an Era of Globalisation' (2002) 35 University of California Davis Law Review 705, 720.

[18] Margaret M Blair and Lynn A Stout, 'Team Production Theory of Corporate Law' (1999) 85 Virginia Law Review 246, 278.

[19] ibid 280.

[20] Benedict Sheehy, 'Scrooge the Reluctant Stakeholder: Theoretical Problems in the Shareholder-Stakeholder Debate' (2006) 14 University of Miami Business Law Review 226.

[21] Williams (n 17) 711-16.

[22] Thomas W Dunfree, 'Corporate Governance in a Market with Morality' (1999) 62 Law Contemporary Problems 130.

Section 172

Section 172 provides:

> (1) A director of a company must 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, and in doing so have regard (amongst other matters) to -
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> (a) the likely consequences of any decision in the long term,
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> (b) the interests of the company's employees,
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> (c) the need to foster the company's business relationships with suppliers, customers and others,
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> (d) the impact of the company's operations on the community and the environment,
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> (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
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> (f) the need to act fairly as between members of the company.
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> (2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.
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> (3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

Background to the Company Law Reform of 2006

The company reform of 2006 was an agglomeration of the efforts to reform the UK corporate governance model, inspired collectively by the Cadbury Committee Reports of 1992; the Greenbury Committee Report of 1996; and the Hampel Committee Report of 1998, which consolidated the preceding into a Combined Code.[23] Following the preceding Reports, the Department of Trade and Industry (DTI)[24] commissioned the Company Law Review Committee, charged with modernising the UK company law to make it a 'simple, efficient and cost effective framework for British business in the twenty-first century'.[25] The Committee submitted its Final Report involving the recommendation options to the Secretary of State for Trade and Industry on 26 July 2001. After series of further consultations, the government finally issued the White Papers 'Modernising Company Law' (July 2002) and 'Company Law Reform' (March 2005). Following public comment on the Government's intention as embodied in the White Paper of 2005, the Government finally introduced the Company Law Reform Bill to the House of Lords on 4 November 2005, setting the stage for the reforms that included section 172.

Promoting the Success of the Company

Traditionally, directors under common law owe the fiduciary duty to act bona fide for the interest of the company.[26] This, by and large, translates into balancing the short term interests of present members with the long term interests of future members,[27] with shareholders' interest construed from the prism of advancing shareholder value.[28] The statutory reformulation substituted 'interest of the company' with 'promoting the success of the company'. However the Act offers no definition of what would constitute promoting the success of the company for the benefit of its members as a whole.

[23] Note also that reports such as those emanating from the Turnbull Committee, and the Higgs Review added to the build up to the company law reform. These reports in one way or the other tended to offer recommendations to improve the UK corporate governance model including the workings of the board of directors and disclosure of directors' remunerations.

[24] Replaced in 2007 by the Department of Business, Enterprise and Regulatory Reform and the Department of Innovation, Universities and Skills.

[25] Explanatory Notes to the Companies Act 2006.

[26] *Percival v Wright* [1902] 2 Ch. 421.

[27] Brenda M Hannigan, *Company Law* (2nd edn, Oxford University Press 2009) 205.

[28] *Re Smith & Fawcett Ltd* [1942] Ch 304, 306; *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286.

This is likely to create a significant problem for the court in construing it.

Section 170(4) provides that the general duties shall be interpreted and applied in the same manner as common law rules and equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties. This could mean that the meaning ascribed to 'interest of the company' under the common law, namely the benefit for the present and future shareholders, may be relevant in interpreting 'promoting success of the company for the benefit of its members as a whole', embedded in section 172.

Although parliamentary debate described success as long term increase in shareholder value evidencing the economic success of the company,[29] that by no means constitutes a clear-cut parameter of measurement. It has been posited that promoting the success of the company for the benefit of its members equates to observance by the directors of the objectives of the company set out in its constitution.

However, where a company is a charity and/or community interest-based, or incorporated for a specific object, determining the success of the company may be difficult. Although it has been suggested that the measurement of success of the company in such circumstances could be determined based on achieving its intended object,[30] that by no means settles the issue, particularly where the 'intended object' does not satisfactorily incorporate external constituent components. Indeed, such non-commercial or charitable companies might, perhaps, be required to promote the companies' charitable objects having regard to stakeholder interest. Nonetheless, success would still be difficult to calibrate where companies exist for interests other than those of its members.[31] As has been noted, subsection 2 is intended to preserve non-commercial objectives of companies as illustrated by *Horsley v Weight*. It remains to be seen how courts will construe this subsection given the 'different hierarchy of

[29] HL Deb (6 February 2006) vol 678, cols 255-286.

[30] Hannigan (n 29) 209.

[31] ibid.

priorities'[32] that have to be weighed in determining the success of the company.

One potential guide to determining the success of the company might be that directors' actions must not *ipso facto* promote the success of the company in objective terms as long as they acted in good faith believing their action to be likely to promote the success of the company.[33] This argument is, perhaps, reinforced by the *Guidance on Key Clauses in the Company Law Reform Bill*[34] which states that '[t]he decision as to what will promote success and what constitutes such, is one for the directors' good faith judgment...'. The foregoing no less encapsulates the wide discretionary powers of directors in the exercise of management decisions.

Nonetheless, where the actions of a director are devoid of consideration of the company's interest and there is no ground on which he or she could reasonably arrive at such a conclusion that the action was done for the company's interest, he or she would be in breach.[35] Furthermore, the director's action would not be justified where, irrespective of the fact that the board would have arrived at the same decision as the director, their action, considered in context, could not be said to be in the interest of the company.[36] This however does not detract from the wide discretion of directors embedded in section 172(1) which must be exercised in good faith.

It is settled that embedded in section 172(1) is a subjective element in promoting the success of the company for the benefit of all the members in contrast to the common law duty that directors 'act in good faith for the benefit of the company which has an element of objectivity'.[37] Subjective test may prove cumbersome for the court to

[32] Paul Omar, 'In the Wake of Company Act 2006: An Assessment of Potential Impact of Reforms to Company Law' (2009) 20(2) International Company and Commercial Law Review 44.

[33] Andrew Keay, 'Section 172 (1) of the Companies Act 2006: An Interpretation and Assessment' (2007) 28(4) Company Lawyer 5.

[34] *Guidance on Key Clauses to the Company Law for a Competitive Economy: Developing the framework* (Department of Trade and Industry 2000) para 63.

[35] *Item Software UK Ltd v Fassihi* [2005] 2 BCLC 91.

[36] *Re W & W Roith Ltd* [1967] 1 WLR 432.

[37] Ji Lian Yap, 'Considering the Enlightened Shareholders Value Principle' (2010) 31(2) Company Lawyer 36.

construe. Consequently, it has been postulated that just like under common law, courts will ultimately introduce an objective test for construing acting in 'good faith' to promote the success of the company for the benefit of its members as a whole.[38] Thus, illustrative of this position was the case of *Chatterbridge Corp. v Lloyds Bank*, where it was held, inter alia, that the duty to act in good faith for the company's interest could be faulted where the actions of the directors could not be reasonably considered to be in the interest of the company by any reasonable and intelligent person.[39]

Apart from the stakeholders' interests enumerated in section 172, directors should, in promoting the success of the company, have regard to the need to act fairly between members of the company.[40] Subsection (1)(f) in effect probably entails that directors have to take into consideration the effect of their proposal on different classes of shareholders,[41] and act fairly amongst all in a manner without preferential treatment or sectional interest.[42] Failure of the directors in this regard may trigger minority action under unfair prejudice provisions. However, it would appear that directors could be justified under section 172(1) to defend any decision to promote the success of the company for the benefit of the whole membership even if it favours employees' interest over short term profit.[43]

Similarly, where a director's actions will ultimately promote the success of the company but, invariably, affect certain shareholders, their action could still be upheld notwithstanding. Thus, in *Mutual Life Insurance Co of New York v Rank Organisation Ltd*,[44] despite discrimination in the issue of shares to hedge the cost of regulatory

[38] Keay, 'Section 172 (1) of the Companies Act 2006' (n 33).

[39] *Chatterbridge Corp Ltd v Lloyd Bank Ltd* [1970] Ch 62.

[40] Companies Act 2006, s 1(f).

[41] *Re BSB Holding Ltd (No 2)* [1996] 1 BCLC 155.

[42] *Mills v Mills* [1930] 60 CLR 150.

[43] John Lowry, 'The Duty of Loyalty of Company Directors: Bridging the Accountability Gap through Efficient Disclosure' (2009) 68(3) Cambridge Law Journal 607; see also *Re Welfab Engineers Ltd* [1990] BCLC 833 (per Hoffmann J).

[44] *Mutual Life Insurance Co of New York v Rank Organisation Ltd* [1985] BCLC 11.

compliance by the company, it was held, inter alia, that directors honestly believed that raising capital as such would benefit the company with consequential benefit to all the shareholders.

It should be noted that the duty to promote the success of the company for the benefit of the members as a whole is subject to subsection 3, and other overriding legislation (particularly employment, consumer safety and discrimination legislation) even if non-compliance with these would promote the success of the company for the benefit of members as a whole.

Good Faith

Good faith is not defined by the Act. Thus, since regard must be had to common law rules and equitable principles in construing the section, it would appear that the directors' discretion embodied in the section, in a similar fashion as under common law, is uninhibited. As illustrated by Lord Greene MR in *Re Smith & Fawcett Ltd*, directors are bound to exercise their powers 'bona fide in what they consider, not what a court may consider, is in the interest of the company'.[45] Although the preceding ruling might be informed by the fact that directors are better positioned to make value judgments on what course the company might take, such an unfettered discretion might equally lead to potential abuse of powers by the directors.

The *Guidance on Key Clauses in the Company Law Reform Bill*[46] stipulates that good faith should be exercised in a manner characteristic of a reasonable man of skill, care and diligence. Nonetheless, it has been postulated that directors ought not to be liable in breach of their fiduciary duties where their actions are unreasonable but he or she honestly believed they were done in good faith for the interest of the company.[47] This is because good faith is, inter alia, anchored on honesty and loyalty, not necessarily competence. However, courts may invalidate directors' actions done

[45] *Re Smith & Fawcett Ltd* [1942] Ch 304, 306.

[46] *Guidance on Key Clauses* (n 34) 63.

[47] Davy KC Wu, 'Managerial Behaviour, Company Law and the Problem of Enlightened Shareholders Value' [2010] Company Lawyer 2.

for collateral purposes, irrespective of the powers of the board to ratify them subsequently.[48]

Moreover, as argued, where a director fails to exercise power in good faith to promote the success of the company, their action may be open to review; and if loss resulted to the company, he or she will be liable to make good the loss.[49] In this regard, non-executive directors have been advised not to allow themselves to be dominated by directors lest they would not be able to convince the court that they had acted in good faith.[50] It can be argued, on the contrary, that where bad faith characterises action of the directors, it ought to ground liability.

Enlightened Shareholder Principle

The common law position was based on the primacy of shareholder value[51]—what can be termed the 'primacy theory'. It is arguable whether section 172(1), encapsulated as 'enlightened shareholder value', significantly differed from the existing legal position. According to Gower and Davies, section 172 is an improvement on the common law but only a modest one.[52] However, it has been held that the section did 'little more than set out the pre-existing law'.[53] Although this decision has been challenged as not reflecting the correct legal position, it does indicate the divergence that underpins this sphere.[54] Nonetheless, it has been contended that section 172(1) is in accord with the OECD *Principles on Corporate Governance* which emphasises, amongst other things, cooperation between the

[48] *Ultraframe (UK) v Fielding* [2005] EWHC 1638.

[49] John Birds and others, *Boyle and Birds' Company Law* (7th edn, Jordan Publishing 2009) 597.

[50] Ji Lian Yap, 'Hear No Evil, See No Evil, Speak No Evil: The Total Inactivity of Non-Executive Directors' (2009) 20(11) International Company and Commercial Law Review 412.

[51] *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286; see also *Hutton v West Cork Rly Co* [1883] 23 Ch D 654.

[52] Paul Davies and others, *Gower and Davies: Principles of Modern Company Law* (9th edn, Sweet and Maxwell 2012) 509.

[53] *Re West Coast Capital Ltd* [2008] CSOH 72 (per Lord Glennie).

[54] Robert Goddard, 'Directors Duties' (2008) 12 Edinburgh Law Review 468.

corporation and stakeholders in creating wealth, and that the full import of such accord will come into effect upon directors' internalisation of the section.[55]

It is considered that section 172(1) represents a significant improvement, since amongst other things, the interest of a wider scope of stakeholders will now be considered by directors than was hitherto the case. However, it would be hard to claim that the section replicates the 'dual consideration theory' in its entirety, characteristic of a significant number of continental European countries, particularly the German co-determination model that accords dual consideration to both shareholders and stakeholders in management decisions.

Undoubtedly, the directors in promoting the success of the company for the benefit of the members as a whole should have regard to: the likely consequences of any decision in the long term; the interests of the employees; the interests of suppliers, customers and others; the impact of their operation on the environment; the need for high standards of conduct; and the need to act fairly between members of the company.[56] It is settled that the stakeholders' interest encapsulated in the above subsection by no means equates to the shareholders' interest.[57] Rather, directors are called upon to take into account stakeholders' interests so long as such action will promote the success of the company for the benefit of members as a whole.

Under common law, it was possible for directors to take into account stakeholders' interests so long as it promoted the interest of the company for the benefit of shareholders as a whole. This was illustrated by the case of *Hutton v West Cork Railway Co,*[58] where it was held that, 'the law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company'.

The stakeholders' interest may appear, prima facie, to be better protected under section 172 than was hitherto the case. However, the shortcoming of section 172(1) becomes more apparent when one

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[55] Cerioni, 'The Success of the Company in Section 172 (1)' (n 4) 37.

[56] Companies Act 2006, s 172(1)(a-f).

[57] Davies, *Gower and Davies* (n 53) 510.

[58] *Hutton v West Cork Rly* [1883] 23 Ch D 673 (per Bowen LJ).

inquires as to whether stakeholders can directly enforce the observance of their interest. Consequently, it has been postulated that, besides shareholders or where a stakeholder doubles as a shareholder, other stakeholders lack the capacity to enforce the observance of their interests embodied in the section.[59] Similarly, shareholders bringing derivative action on the company's behalf must obtain court approval,[60] as well as encountering other (almost insurmountable) hurdles.[61] The above shortcomings have led to questions as to whether the lots of shareholders and stakeholders are better protected under section 172 than was hitherto the case. It has been argued that the inability of stakeholders to enforce the observance of section 172(1) directly may entail that the section will hardly be litigated.[62] It could be argued that, perhaps, empowering direct stakeholder enforcement could lead to vexatious actions against directors. Nonetheless, a duty is only useful in law if it is enforceable.[63]

The encapsulation of what is generally known as corporate social responsibility (CSR) in section 172(1)(d-e) is a giant stride in law making. However, as noted, corporate governance that is shareholder-centric as is the case with section 172(1) may not adequately cater to CSR.[64] Nonetheless, it has been argued that

[59] Companies Act 2006, s 261; Parker Hood, 'Directors Duties under the Companies Act 2006: Clarity or Confusion?' (2013) 13 Journal of Corporate Law Studies 47.

[60] Companies Act 2006, ss 261-262.

[61] Andrew Keay and Joan Loughrey, 'Derivative Proceedings in a Brave New World for Company Management and Shareholders' (2010) 2 Journal of Business Law 152-161, where they discussed potential hurdles a shareholder may face in bringing derivative action such as, establishing prima facie case; implication of company filing response and effect of s 263; and possibility of applicability of equitable doctrine of clean hands. See also *Wishart v Castlecroft Securities Ltd* [2009] CSIH 65; *Franbar Holdings Ltd v Patel* [2008] EWHC 1534, on what appears to be conflicting threshold set by the court.

[62] Lisa Linklater, 'Promoting Success: the Company Act 2006' (2007) 28(5) Company Lawyer 129. See also Yap, 'Considering the Enlightened Shareholders Value Principle' (n 37) 3 (arguing that the inability of stakeholders to enforce directly makes s 172 toothless against directors).

[63] Peter Loose, Michael Griffiths and David Impey , *The Company Director: Powers, Duties and Liabilities* (10th edn, Jordan Publishing 2008) 285.

[64] Adefolake Adeyeye, 'The Limitations of Corporate Governance in CSR Agenda' (2010) 31(4) Company Lawyer 4-5.

shareholders are deemed 'to be enlightened and to want to take into account issues of' CSR.[65]

Perhaps, as submitted, members will only bring action where directors fail to act in good faith to promote the success of the company for the benefit of members as a whole, and, where they fail to act fairly between members,[66] rather than bringing action for the protection of stakeholders' interests *stricto sensu*. If the foregoing becomes the eventuality, then it means that 'parliament has created a right without a remedy which the law abhors'.[67] As noted by a commentator, it appears lawmakers by section 172(1), have 'mistakenly encapsulated the shareholder value principle into the objective of companies'.[68] This conclusion, it is submitted, is inevitable since stakeholders' interests remain subordinate to shareholders' interests.

Members of the company will be able to assess directors' compliance with the provisions of section 172(1) when business review is tendered.[69] Although business review has now become a part of financial reporting, the contours of what constitutes an ideal business review remain blurred, and could be amenable to manipulation by the directors.[70] Indeed, it has been hypothesised that directors may adopt a cynical approach to stakeholders' interests by adopting mechanical compliance with the business

[65] Bill Perry and Lynne Gregory, 'The European Panorama: Directors' Economic and Social Responsibilities' (2009) 20(2) International Company and Commercial Law Review 25. By contrast, shareholders might as well act in 'unenlightened manner' thereby detracting from the substance of the CSR paradigm. See Carrie Bradshaw, 'The Environmental Business Case and Unenlightened Shareholder Value' (2013) 33 Legal Studies 141.

[66] Companies Act 2006, s 172(1)(f).

[67] Deryn Fisher, 'The Enlightened Shareholders — Leaving Stakeholders in the Dark: Will S.172(1) of the Companies Act 2006 make Directors Consider the Impact of their Decision on the Third Parties' (2009) 20(1) International Company and Commercial Law Review 10.

[68] Daniel Attenborough, 'How Directors Should Act When Owing Duties to Companies' Shareholders: Why We Need to Stop Applying *Greenhalgh*' (2009) 20(10) International Company and Commercial Law Review 339.

[69] Companies Act 2006, s 417(2).

[70] Michael Page, 'Business Models as a Basis for Regulation of Financial Reporting' [2012] Journal of Management and Governance 1.

review regime.[71] One just hopes that the preceding eventuality does not become a reality.

'Have Regard (Amongst Other Matters) To'

The Act provides no definition of 'have regard to'. It has, however, been suggested[72] that directors should 'have regard to' an array of other codified duties such as: the company's constitution;[73] creditors' interests;[74] the exercise of reasonable care, skill and diligence;[75] the avoidance of conflicts of interest;[76] to not accept benefit from third parties;[77] and the disclosure of interests in any transaction.[78]

Keay, on the other hand, has submitted that to 'have regard to' entails having regard to the interest of constituent components other than those referred to in section 172(1) so far as this promotes benefits to members.[79] Keay's position has been echoed as being sensible.[80]

The inclusion of 'amongst other matters' means that the catalogues of matters directors should take account of in promoting the success of the company for the benefit of the members as a whole are not exhaustive. This was buttressed by Government statements emanating from Lord Goldsmith: 'we have included the words, "amongst other things". We want to be clear that the list of factors

71 Charles Wynn-Evans, 'The Companies Act 2006 and the Interest of Employees' (2007) 36(2) Industrial Law Journal 192.

72 J Paul Sykes, 'The Continuing Paradox: a Critique of Minority Shareholders and Derivative Claims under the Companies Act 2006' (2010) 29(2) Civil Justice Quarterly 5.

73 Companies Act 2006, s 171.

74 Companies Act 2006, s 172(3).

75 Companies Act 2006, s 174.

76 Companies Act 2006, s 175.

77 Companies Act 2006, s 176.

78 Companies Act 2006, s 177.

79 Keay, 'S.172 (1) of the Companies Act 2006' (n 33) 8.

80 Sophia Wesley-Key, 'Companies Act 2006: Are Cracks Showing in the Glass Ceiling' (2007) 18(12) International Company and Commercial Law Review 428.

[for a director to have regard to] is not exhaustive'.[81] Such ministerial statement, no doubt, helps in understanding the section, but as noted, it is doubtful if such ministerial clarification will douse the anxiety of directors seeking to avoid falling foul of section 172.[82]

Employees

Section 172(1)(b) provides for the protection of the interests of employees as part of the stakeholders. There was a similar provision under the Company Act 1985.[83] However, the difficulty of demonstrating a breach, and the inability of the employees to directly enforce the right since only the company could bring an action, rendered that section almost useless.

Similarly, under section 172(1) the interest of employees is clearly subordinate to the promotion of the success of the company for the benefit of the members as a whole. Equally, employees do not have direct enforcement powers except where they double as shareholders. And even then they must seek court approval which carries the danger of being refused. On account of the above shortcomings, it has been argued that section 172 'will not necessarily improve directors' substantive engagement with employees' interests'.[84] In other words, the employees' position is even worse now than was hitherto the case since their interest would have to compete on the same pedestal with other stakeholders' interests. However, it has been argued that myriad employee statutes can offer protection to employees.[85] It is submitted that the protection afforded to employees by section 172(1) is inadequate even though they might

[81] *Companies Act 2006: Duties of Directors: Ministerial Statement* (Department of Trade and Industry 2007) 8 at column 846, quoting statement of Lord Goldsmith at the Lords' Grand Committee, 9 May 2006.

[82] Chizu Nakajima, 'Whither "Enlightened Shareholder Value"?' (2007) 28(12) Company Lawyer 354.

[83] Companies Act 1985, s 309.

[84] Wynn-Evans, 'The Companies Act 2006 and the Interest of Employees' (n 71) 192.

[85] Deryn Fisher, 'The Enlightened Shareholder - Leaving Stakeholders in the Dark: Will S.172(1) of the Companies Act 2006 Make Directors Consider the Impact of Their Decisions on Third Parties' (2009) 20(1) International Company and Commercial Law Review 11-12.

be protected elsewhere by other legislations. One just expects that the section would not turn out to be nothing but a mere piece of legislative decoration, with little or no enforcement value, in the same manner as the corresponding section 309 of the Company Act 1985.

Creditors

There is a remarkable absence of creditors in section 172(1)(a-f). It can be argued that the 'others' mentioned in subsection (1)(c), in the company of suppliers and customers, incorporates creditors, based on the ejusdem generis canon of interpretation, since they belong to the same genus.

However, a better argument is that creditors were tactically omitted in subsection (1)(a-f) because their interest is already protected by subsection 3; which states that section 172 is subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interest of creditors of the company. Apparently, the efficacy of subsection 3 comes into operation during insolvency or threatened insolvency when directors must cease trading lest they be guilty of wrongful trading[86] and/or misfeasance.[87] Thus, section 172(1) is subject to Insolvency Act of 1986. In other words, during threatened insolvency directors must consider creditors' interest which takes priority[88]. Indeed, it has been suggested[89] that section 172(3) seems to have preserved such cases[90] that require directors to consider creditors' interest on imminent insolvency, though owing no such duty to creditors.[91] It is doubtful whether section 172 added anything new to the interests of creditors.

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[86] Insolvency Act 1986, s 214.

[87] Insolvency Act 1986, s 212.

[88] Derek French, Stephen Mayson and Christopher Ryan, *Company Law* (26th edn, Oxford University Press 2010) 485.

[89] Andrew Hicks and Say H Goo, *Cases and Materials on Company Law* (6th edn, Oxford University Press 2008) 385.

[90] *Liquidator of West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250.

[91] *Yukong Line Ltd v Rendsburg Investment Corporation (No2)* [1998] 1 WLR 294.

Teleological Construction of Section 172

Although significant scepticism underscores the potential of section 172 to cater to stakeholders' interests, nevertheless, there could still be ways of ameliorating the situation. Two options readily come into perspective. Firstly, should lawmakers embark on another legislative reform? Secondly, should reliance be placed on the courts to adopt a pragmatic and purposeful interpretation of section 172 known as teleological construction?

Although initiating another legislative option that would significantly take into account the stakeholders' interests might be a useful policy option, such a fulsome enterprise might not be the optimal option under the current circumstances. First and foremost, it would be unwise to embark on another holistic legislative exercise simply to rectify a perceived anomaly (or misalignment) inherent in one section, which has not even become a subject of substantial judicial interpretation. Secondly, it appears that lawmakers, while craving for greater appreciation of the stakeholders' interests by directors, were reluctant to state so categorically.

In other words, it appears the legislative philosophy behind enlightened shareholder value might have been to situate the UK's corporate governance model somewhere between the traditional common law shareholder primacy theory and the dual consideration theory of some continental European countries; even though some scholars seemingly think otherwise. Thus, the Commission on the Public Policy and British Business have suggested that the Company Law Review Steering Group (CLRSG) adopts a pluralist approach to corporate governance.[92] However, this was rejected by the CLRSG on the ground that it might result in directors not being 'effectively accountable to anyone since there would be no clear yardstick for judging their performance'.[93]

Nevertheless, the CLRSG did not set out simply to codify the traditional shareholder primacy theory characteristic of the common law paradigm. Indeed, it was thought that the shareholder primacy model should be modernised to incorporate stakeholders' interests in

[92] Commission on Public Policy and British Business, *Promoting Prosperity: A Business Agenda for Britain* (Vintage 1997) 107.

[93] Committee on Corporate Governance, *Final Report* (Gee 1998) para 1.17.

line with contemporary practice.[94] However, the end result of the preceding legislative effort appears to have been blurred and even obfuscated by the divergences characterising its understanding. It is, however, contended that the divergences that characterise the import of the section (the intention of the lawmakers on how best to integrate stakeholder interest into the UK's corporate governance model) can be settled by the court through the adoption of a teleological approach to construction of the section.

Teleological construction in this vein entails that the courts construe the section pragmatically to integrate fully the stakeholders' interest in similar vein as that of the shareholders. One useful means of achieving such a result is for the courts to adopt the approach that the actions of directors that are inimical to the interest of the stakeholders do not promote the interest of the shareholders. The implication would be that directors acting in good faith 'to promote the success of the company for the benefit of its members as a whole'[95] must take into account the interests of the stakeholders otherwise the resultant actions are not 'to promote the success of the company for the benefit of its members as a whole'.[96] Arguably, this approach could provide the required interpretative elixir that would lessen the controversy characterising the section. Similarly, it would coalesce stakeholders' interests with those of shareholders. Apart from the fact that the preceding teleological interpretative approach obviates the necessity of further legislative reform, such an approach would further align the UK corporate governance model with that of a significant number of continental European countries. Indeed, the divergences that underpin this sphere of corporate governance would continue to hold sway for a while attenuated only by judicial pronouncement and clarification on the real import of the section.

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[94] Stephen Girvin, Sandra Frisby and Alistair Hudson, *Charlesworth's Company Law* (18th edn, Sweet and Maxwell 2010) 331; *OECD Guidelines for Multinational Enterprises* (OECD 2011) 17-26.

[95] Companies Act 2006, s 172(1).

[96] Companies Act 2006, s 172.

Conclusion

The enlightened shareholder approach marks a watershed in the protection of stakeholders' interests. Similarly, the scope of the constituent components of stakeholder interests that directors must have regard to has laudably been widened. Nonetheless, section 172 still suffers from the inability of the stakeholders and even shareholders to directly enforce it, raising doubts as to the potential usefulness of the reform. A stakeholder that doubles as a shareholder, along with shareholder(s) *per se* that have the interest of stakeholders at heart, might, however, enforce the section which may constitute an ameliorating factor to the above shortcomings, subject of course to the vagaries of court approval. Indeed, the debate on whether the primacy theory or pluralist theory or even the amalgam of the crystallised theories of both holds sway would, no doubt, continue to dominate the mind of commentators for the foreseeable future. However, courts could lessen the foregoing divergences by adopting a teleological interpretative paradigm that adequately caters for the stakeholders' interests. This could be achieved by a judicial approach premised on the fact that the actions of directors that are inimical to the stakeholders' interests do not 'promote the success of the company for the benefit of its members as a whole'. Apart from the fact that the foregoing approach would streamline the expectations of the stakeholders, such a position would equally align the UK's corporate governance model with contemporary continental and OECD practice.[97]

[97] *OECD Guidelines for Multinational Enterprises* (n 94) 17-26.