Enlightened shareholder value: did directors deliver?

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Enlightened shareholder value: did directors deliver?
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***Jur. Rev. 95* Introduction**
This article analyses the effectiveness of s.172(1) of the Companies Act 2006. This was introduced in order to improve directorial decision making in companies, in particular requiring company directors to have regard to the interests of various stakeholders. This approach was designed to promote "enlightened shareholder value". While having regard to stakeholders' interests is not in itself a bad idea, the manner in which this requirement was drafted proved unsatisfactory, in particular its lack of enforceability. The many financial scandals starting from around 2008 indicated that mere lip service had been paid to the requirement. Ironically, directors are now having to do what the parliamentarians hoped s.172(1) would achieve, mainly because of the reputational hazard for those companies if they continued in their previous ways, but not because of s.172(1) itself. It is suggested that s.172(1) is cumbersome and toothless, and that any review of company law should use the proposed simpler wording to be found in the forthcoming Irish Companies Bill.

The background to "enlightened shareholder value"
During the 1990s the then Department of Trade and Industry set up a Company Law Steering Group to look critically at many aspects of company law, at the time regulated under the Companies Act 1985. After much deliberation it produced *Modern Company Law for a competitive economy: the Final Report*.[1] This report took evidence from a wide range of interests and experts on how to improve company law. Existing company law was seen to be full of unnecessary rules, to be confusing for company directors, and not wholly conducive to the setting up of businesses or retaining businesses in the United Kingdom. The Companies Act 2006 eventually was developed from this report. The opportunity was taken to enshrine in statute various European company law requirements[2] and to tidy up the law relating to capital maintenance. Many other uncontroversial, sensible and worthwhile reforms were made to the process of incorporating companies, managing them and removing them from existence. However, there were some controversial partsand one that was at the time possibly the most controversial finally emerged as s.172(1):
"(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 (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company."
This sought to move the law away from the classic view that the paramount concern of directors was to maintain shareholder value: the directors were not obliged to take anything else into account except insofar as it benefitted the company and thereby indirectly the shareholders. In short, directors were not expected in their management of the company to display any particular

sense of social responsibility: that might be a job for politicians but was not the job of directors. The best known exposition of this approach was put forward by the economist, Milton Friedman.[3]In his view anything other than making profits was effectively a tax on shareholders. Such a view was not held by the advancers of the Companies Act 2006 s.172(1) who took the wider view that although directors should act in a way that benefits the shareholders, they should in the process positively take account of other stakeholders in the company, and should act in a thoughtful, inclusive way, looking to the future, considering the implications of their decisions for their customers, creditors, employees, the local neighbourhood, shareholders generally (as opposed to any favoured group of shareholders) and establishing a reputation for "high standards of business conduct". The essential duty of the directors was to promote the success of the company and in the process to "have regard" to these various requirements. This was said to lead to "enlightened shareholder value" on the grounds that directors who did this in the long run would create favourable conditions for the long term prosperity of the company itself, its shareholders and its employees.[4] This article does not propose to discuss the various academic theories of company law in relation to this concept, nor propose to discuss whether or not enlightened shareholder value is juristically sound; this is because this article's focus is purely on directors' practical application of the law, as enacted, to the management of their companies.

Controversial wording

Section 172(1) attracted controversy for various reasons, mainly because from a lawyer's point of view it is vague and confusing. It is not clear how much regarding is necessary, or how regarding needs to be evidenced. The legislation does not explain if it is necessary specifically to have regard to each item in turn and to have noted it down in board minutes. The list of matters to which the directors should have regard does not indicate what should happen if regarding one matter causes problems for another matter. The words "promote the success" of the company are not explained, nor is there any indication as to who decides what is meant by "success".

The Government indicated that the regarding should not be a mere box ticking exercise[5] and that directors should genuinely try to engage with the requirements of the legislation; it is clear that the choice of the words "have regard" was deliberate.[6] Regarding is also something more easily carried out in a large company by a large board of directors with a company secretary. It is less likely to be carried out, if at all, by a small unaudited company with one or two shareholders. In practice, at least in a large company where corporate governance is taken seriously, the minutes of board meetings will record the fact that directors duly took account of the requirements of s.172(1). If there is any particularly contentious matter that would have a significant impact on any of the matters in s.172(1) the minutes will generally go into more detail to prove that the directors genuinely did have regard to that matter and did not arbitrarily make their decision without proper consideration. The point is that directors should have been seen to have at least had "regard" to the matter, even if in fact they made a decision that was detrimental to the particular matter under consideration. It would appear that provided that there is a paper trail to show that the matter had been thought about, that would be evidence enough to a court or to a liquidator that the directors had been carrying out their task properly. Courts are well known to be reluctant to review commercial decisions. The problem with the phrase "have regard" would appear to lie in the fact that it meant one thing to politicians and another to lawyers. The phrase "have regard" is conspicuously vague. It is a portmanteau phrase, a phrase that can accommodate a wide range of meanings depending on what one wants it to mean. Such a phrase is not ideal in legislation.

The duty owed to the company

The obligation to "have regard" to the various matters in s.172(1) is a duty owed by the directors but a duty that is not owed to, say, the environment or the employees, but, as specified in s.171, only to the company. This means that a representative of the environment (a local councillor, perhaps) or an employee affected by a decision of the directors, has no standing under s.172(1) under which to sue the directors. Only the company, the collective body of shareholders (or a member exercising a derivative claim on behalf of the company) may exercise the sanction of suing the directors for the directors' failure to "have regard" to those matters. This would presuppose that the collective body of shareholders (who might, in any case, be the same people as the directors) feels sufficiently strongly about the matter to bring an action against the directors for the directors' failure to have regard to the environment or the employees. The company would normally need to have particularly altruistic shareholders for this to happen.

A graver threat to the directors is that if the company went into liquidation, the liquidator would then represent the collective body of shareholders, and could investigate the then directors' decision-making by reference to past minutes, and if necessary, take action against the directors for their failure to "have regard" to any of the matters in s.172(1).[7] The failure to have regard could also be seen as misfeasance under s.212 of the Insolvency Act 1986. Another threat to directors who have been failing to "have regard" is when the existing shareholders, or a majority thereof, sell their shares to a purchaser who then has control of the company. The purchaser might choose to examine the company's past board minutes and see the extent to which the directors had failed to "have regard". If the directors had taken some contentious decisions, and there was no evidence that in doing so they had had regard to the matters in s.172(1), it might be open to the purchaser, now representing the company, to raise an action against the directors for breach of their duty.

This approach (that in principle only the company could sue the directors for their failure to take account of the requirements of s.172(1)) was based on Companies Act 1985 s.309 which used the same principle. This was introduced into the Companies Act 1985 by the then Conservative Government. While *Professor Davies in Gower and Davies, Principles of Modern Company Law* [8]asserts that it was not clear whether the draftsmen of s.309 were adopting a pluralist approach (i.e. employees in their own right are a specific matter of consideration by directors, separate from the directors' overall concern for shareholders) or an enlightened shareholder value approach (i.e. that employees were a matter, but one of many others, that should be considered in terms of what was best for shareholders), it is suggested, though it cannot be unequivocably established, that the ambiguity of s.309 was deliberate. As part of the United Kingdom's entry to the EEC, now European Union, in 1973 there was an expectation that UK company legislation should give recognition to workers' rights,[9] a view supported by some in Europe but not a view always held by directors within the United Kingdom. The UK Government, at that time under a Conservative administration, produced a form of wording for s.309 which looked as though directors had to consider workers' interests (thus apparently satisfying the EU requirements) but the requirement to do so was actually a duty owed to the company, not to the workers themselves (thus not actually fettering directors' capacity to manage their companies).[10] In practice, this rendered the section almost worthless, as may possibly have been intended. Unless the employees formed a majority of the shareholders, there would be little occasion for the shareholders to exercise their rights under s.309. Despite the fact that s.309 was toothless, when the time came to reform the law for the Companies Act 2006, the then Government (by this stage under Labour control) chose to use the same principle for s.172(1).

The predicament for Parliament

The decision to limit the extent of directors’ responsibility to having "regard", and for only the company to be able to enforce this duty, was taken in the knowledge that anything more onerous could be seen as a positive deterrent to entrepreneurs setting up companies in the United Kingdom or existing businesses staying in the United Kingdom. If any stakeholder, as opposed to the company, could sue the directors for the directors’ failure to have regard to the stakeholders’ interests, few directors of companies would wish to keep their businesses in the United Kingdom. This was a good reason for not extending rights to the stakeholders themselves.[11] It is also possible, but probably impossible to establish, that the restricting to the company of the right to sue directors for breach of their duty to have regard to the various matters in s.172(1) was a legal point not wholly comprehended by all MPs at Westminster. Owing a duty to a company to promote the success of a company by having regard to various matters is a complex concept for those not versed in company law. However, it gives the superficial impression that stakeholders’ interests will at least be considered, or ought to be considered by the directors, and that there is a sanction for non-performance by the directors. And of course, it should not be forgotten that the directors of well-run companies generally do take account of stakeholders’ interests. If companies wish to remain successful and prosperous, it does not seem unreasonable to expect directors to do this. It is the question of compulsion that is problematic.

As already indicated, the sanction for non-compliance, an action by the company against the directors, is very unlikely to take place unless the general body of shareholders is uncharacteristically selfless. The fact that its previous iteration in s.309 of the Companies Act 1985 had not obviously proved effectual in safeguarding employee interests did not prevent its re-use in s.172(1). It is as if the politicians promoting it touchingly thought that this time it might work, or perhaps no-one could think of any better solution to the incompatible objectives of politicians’ not wishing to stifle directors’ desire to manage their companies without too much hindrance from the law, and politicians’ desire to make directors take account of wider social interests when managing their companies. Although there were attempts to clarify the meaning of the section by amendment at the time that it was being voted upon by the House of Commons, the amendment was withdrawn to avoid a potential later battle within the House of Lords, with Margaret Hodge giving a spirited defence of the existing wording, confident that it would achieve its intended purpose. The wording was duly approved without further discussion and with a comfortable majority.[12]

The extent to which section 172(1) has been discussed in the courts

Since s.172(1) of the Companies Act 2006 came into force,[13] as explained in the next paragraph, there have been a few cases that refer to s.172(1)(f), where the petitioner is a member of the company and seeking redress for the benefit of the company for not being treated properly,[14] but only one[15] where there was an attempt to raise a court action for the failure to have regard to the various matters in s.172(1)(a)(e). This could mean that:

- although the right to petition in respect of any of those matters exists, such a right is not a realistic way of solving a problem involving directors’ neglect of the stakeholder interests indicated in s.172(1)(a) â€“(e);
- liquidators have other, generally more certain, means of seeking redress from past directors (in particular, s.172(3));
- liquidators and incoming shareholders are not particularly interested in whether or not the past directors had regard to any other stakeholders, or are not prepared to spend money finding out;
- most shareholders do not know about s.172(1)(a)(e) or if they do, do not care about it enough to do anything about it;
- the cost of bringing a petition puts potential petitioners off;

- even if the petitioner has a point, the bad publicity that would be attracted to the company by a court case would probably have a deleterious effect on the company's share price;
- if there are problems with a listed company's directors, by far the easiest solution is to sell its shares[16];
- directors are often not worth suing.

The derivative claim

Hitherto it has been suggested that to enforce s.172(1), the company would have to take action against a director. This could be done by a derivative claim, a statutory procedure, provided for under ss.260 - 269 of the Act, which allows a shareholder, on behalf of the company, to raise an action on the company's behalf and for its benefit against a director. There already has been a number of cases, in every case so far in small companies, where a shareholder has taken advantage of the new derivative claim to petition the court for redress for some mischief done to the company by a director.[17] Under the derivative claim, an aggrieved shareholder who believes that a director has neglected his duty to promote the success of the company for the benefit of its members as a whole may petition the court for permission to represent the company in an action against that director. The petitioner has to persuade the court that he has a prima facie case[18] against the director for the director's breach of duty, and if the petition is successful, and the court allows the case to proceed with the shareholder now representing the company, any damages payable by the director for his failure to promote the success of the company would be payable to the company.[19] A good example is *Hughes v Weiss* [20] where a company was set up by two lawyers with the intention of providing consultancy advice on various financial matters. Both lawyers had equal shares in the ownership and management of the company, and both were directors, but Weiss took it upon himself to seize a large proportion of the company's funds, claiming that he was entitled to it for various reasons which the judge found unconvincing. The court held that *Hughes* had made out a prima facie case that Weiss had failed to act fairly as between the members in terms of s.172(1)(f).[21]

Indeed, the case law to date on derivative claims at present seems to be limited to members being treated badly by the directors in terms of s.172(1)(f) (acting fairly as between members of the company). Only one reported case so far has been an attempt to get anyone to pay attention to the matters in s.172(1)(a) â€“(e). This case was *R.(on the application of People & Planet) v HM Treasury*,[22] where a pressure group sought judicial review of the way that a Government company, UK Financial Investment Ltd, which represented the Government's interest in Royal Bank of Scotland, and which owned 70 per cent of that bank's equity, was run by the Treasury. The pressure group felt that as the Government effectively owned so much of the Royal Bank, the bank should be run in accordance with the interests of Companies Act 2006 s.172(1) in mind, in particular paying attention to climate change and human rights. The application was unsuccessful, and permission for judicial review was not granted, on the grounds that the Treasury had taken some account of such matters, but there were many other matters also to be considered by directors and due weight had to be given to them too. Climate change and human rights could not have a priority when it came to the amount of regard directors were required to pay to the various matters in s.172(1). A balance had to be found with all the other interests. In any case, while the Treasury could put its views across to the board of directors of the Royal Bank of Scotland, ultimately it was for the directors to manage the bank and not for the Treasury.[23] If this is the only case that even approaches the use of s.172(1)(a) (e) [24] it suggests that in the seven years since it has been enacted, either these provisions have not proved useful from the point of view of the various stakeholders concerned, or that no-one has been willing to launch a test case.

However, merely because stakeholders have paid little attention to s.172(1) in the courts does not mean that directors are completely unaware of stakeholders' interests, or are unaware that the legislation is trying to persuade directors to consider stakeholders' interests. The Government commissioned a review of the Companies Act 2006 in 2010. The review established that most company directors were aware of s.172(1) of the Act, but were not necessarily putting it into practice.[25]

Apart from section 172(1), what other guidance for directorial decision making is there?
There is no lack of guidance in the United Kingdom to encourage the proper and honest management of companies by directors. The Financial Reporting Council has a strong interest in ensuring the probity of accounts. Listed companies are obliged to follow the UK Corporate Governance Code.[26] Its requirement for directors to "comply or explain" with generally accepted good practice within the terms of the code is well understood. Finally, many large companies over the last few years have adopted "statements of values" or internal ethical codes in an effort to make directors and employees treat their customers, suppliers and fellow staff members properly.[27]

Scandals
However, notwithstanding the existence of Companies Act 2006 s.172(1), the Corporate Governance Code and various statements of values, recent business history suggests that in certain sectors of business, in particular banking, directors of companies have not been paying any attention to any of these requirements. Some recent scandals include the following:

- The sub-prime mortgage scandal. The scandal is well known and much analysed.[28] Because of the complexity of the business, the lack of transparency in what was being traded, and over-reliance on rating agencies, few people in the financial institutions that traded in subprime paper really appreciated what was involved. In retrospect questions might have been asked about the long term value of these investments and whether it was wise to be so reliant on them. What may never be known is the extent to which banks' directors took the trouble to find out about sub-prime paper and its true worth.
- A report for the US Senate indicated that HSBC had been laundering money (particularly of "hot" South and Central American money) for years.[29] The report indicates that the US arm of the bank was woefully understaffed and out of its depth in its compliance and anti-money laundering departments.[30] While the bank did not hide its involvement in these questionable practices in its 2010 annual report,[31] its compliance statement did not reveal any difficulties.[32] Its compliance statement in that report said that all group companies were required to comply with the requirement to observe the letter and spirit of all relevant laws, but it did not indicate that they had actually done so.
- Standard Chartered Bank, despite the existence of sanctions against dealing with Iran, persistently ignored those sanctions over a period of 10 years up to 2010.[33] This is in contrast to the values espoused by the bank in its annual report for the year 2010.[34]
- At the time of writing, there is an unfolding scandal about interest rate swaps being forced upon borrowers by banks as a condition of loan.[35]
- The US subsidiary of UK company, GlaxoSmithKline, was fined $3 billion in July 2012 for deliberately withholding vital safety data about its best-selling diabetes drug, Avandia, and in particular the effect of that drug on hearts. The company had also been paying bribes to doctors and recommending unsuitable anti-depressants to children.[36]
- SSE, formerly South of Scotland Electricity, formally admitted breaches of mis-selling electricity and was fined £10.3 million by Ofgem on 3 March 2013. While there was

no suggestion that senior management actively participated in the mis-selling or was wilfully in breach of the company's licence conditions, senior management was criticised for its non-involvement in compliance and oversight of sales activities, and its reluctance to consider that commission-hungry salesmen might not be treating the company's customers properly.[37]

These are some scandals that are known. There may be others still hidden or sufficiently successful that they have yet to surface. All these scandals took place within British banks and other British companies or in their foreign but British-controlled subsidiaries. With regard to Companies Act 2006 s.172(1), these scandals have not been good either for the shareholders or customers, let alone the banks' reputations for high standards of business practice. New management has been imposed in some of these banks since the scandals, and there have been protestations of the need for new standards of conduct, a new culture, retraining and no repetition of improper behaviour.[38] But while the improper practices were taking place, there was little suggestion in the annual reports that anything was amiss. The question then arises: to what extent did the directors of the banks at the time know what was going on? If they did, they were in breach of Companies Act 2006 s.172(1); and if they did not know, the question arises of why they did not know.

Awareness of section 172(1)

It will probably never be known whether the various directors in the various companies above genuinely were unaware of unsatisfactory practices within their firms, vaguely knew what was going on, encouraged or turned a blind eye to the more disreputable practices, or even delighted in their "gaming".[39] There may have been a culture of wilful ignorance, so that directors could plead ignorance of their employees' misdeeds and thus escape liability, or of creative compliance.[40] While no director working at a senior level can be expected to know every dubious activity of his employees, it may be worth asking what steps directors took to ensure that any dubious activity was stamped out. All these companies had audit and risk committees on which directors will have sat. Those directors should have been mindful of the requirements of s.172(1), in particular the requirement to have regard to the interests of customers and to maintain a reputation for high standards of business conduct. It is most unlikely that the UK directors of the major banks above, or of GlaxoSmithKline and ESS, could have been unaware of s.172(1) and its requirements. These companies had company secretaries who would have ensured that directors had been told about the changes in the law from October 2007 to reflect s.172(1) coming into force.

However, being told about s.172(1) is one thing: paying attention to it is another. A proper adherence to s.172(1) should have ensured that certain lucrative but questionable activities, such as money laundering and mis-selling, did not take place. However, if, as described earlier, the sanction for non-adherence to s.172(1) is weak, and if there is a general culture of creative compliance with legislation anyway, a director has much to lose by adherence to s.172(1). Many of the directors, and other employees, were shareholders themselves, had generous bonus schemes and were entitled to share options which could be triggered on certain targets being achieved. It would not be in those persons' interests to query anything that in the short term might adversely affect the share price or their bonuses or their promotion prospects; and it is interesting to note that one of the remedies that is now being proposed, particularly for the banks, is that directors and other senior executives should only be able to obtain certain benefits or bonuses if the company obtains long term gain, not merely short term market share or an increase in the share price obtained by rent-seeking officials.[41]

To put the matter succinctly, the sort of directors who would have taken account of s.172 would not need to be told to do so, and the sort of directors who ought to have been reminded of s.172would not have troubled themselves about it anyway, because, it is suggested, there was no compulsion to adhere to its terms and little likelihood of any punishment for their failure to do so.[42] It is possible to point to companies that probably did, and probably still do, all that is required under s.172(1) â€"the John Lewis Partnership is a good exampleâ€"but they would have done so anyway because a company where the directors do take account of a wide range of stakeholder interests probably is quite a thoughtfully run company. Staff are valued, customers and suppliers treated properly, and the business is well regarded in the community. The irony of s.172(1) is that intrinsically what it expects directors to do makes a good deal of sense, but in the absence of effective sanctions, if directors wish to ignore it for their own perceived short term advantage, or their employees' or shareholders' advantage, they will do so, and the problems, when they arrive, will be for someone to sort out at some stage in the future, long after they have moved on, having cashed in their bonuses and their share options.

The failure of section 172

It has already been explained that s.172(1)(f) of the Companies Act 2006 can work well at a small company level in ensuring redress for some shareholders being treated badly by directors in terms of s.172(1)(f). In this respect one can take some small issue with the view of Elaine Lynch[43] who asserts that "s. 172 brings little or nothing to the table". But Lynch's view in respect of the other parts of s.172, namely s.172(1)(a)(e), would appear to be correct, in that those provisions have proved in practice completely ineffective, at least as far as the large companies referred to earlier are concerned. This view is also well advanced by Professor Andrew Keay.[44] If this is correct, it suggests the requirement for directors to have regard to the various matters in s.172(1)(a) â€"(e) has moral suasion but no more. It is like patting a wolf on the head and asking it to be good. This does not mean that the provisions of that subsection are worthless, but rather that they are in practice sanctionless and therefore can afford to be ignored.

Section 172(1) was designed to make directors, in effect, behave well and to be good and thoughtful people when making directorial decisions. If directors did follow the precepts of s.172, the law might well alter business and social behaviour for the better. The evidence, so far, is that while s.172(1)(f) may be effective at a small company level, and as between directors and disgruntled shareholders, the rest of s.172(1) in the past was ignored by the directors of certain larger companies, did not alter business and social behaviour and that the gap between the intention of the legislation and the actuality is indeed wide.

The redundancy of section 172(1)

Notwithstanding all of the above, at the time of writing the banks are receiving such opprobrium that a cultural change is needed in order to regain customers' trust. It will be commercial common sense that will now ensure that directors take more trouble to find out what is happening within their companies. It is not the fear of shareholder litigation under s.172(1) that will cause directors to adopt the very behaviour that s.172(1) hopes to instil. It is the fact that the reputational damage of treating customers badly, and not playing by the rules, not surprisingly, in the long run has turned out to be bad for business. If a bank mistreats its customers, as Barclays and UBS did with LIBOR, and SSE did with those to whom it supplied electricity, it may well encourage at least some customers not to use those banks and companies again once the customers have found out what was happening.[45] Misleading customers, or treating them with contempt, either by not genuinely giving the best deal they should be getting, or deliberately confusing them, can be, in thelonger run, unprofitable. The cost to SSE of the fine (£10.5 million) and the reimbursement of the customers who were mis-sold electricity is greater than the amount of money that the company made by mis-selling (estimated to be £4 million).[46]

A bank relies on the trust that the bank's creditors, its depositors, will not all demand their funds back at once, thus causing a run on the bank, as happened with Northern Rock. The bank has to convince its customers/creditors that its funds are in safe hands. The evidence of the scandals above suggests that the hands of the directors (as the ones ultimately responsible) were not in those cases as safe as they might have been, and that some directors have now realised that they also need to be seen as clean and trustworthy hands.[47] The paradox is that it has been commercial pressure and market forces, not s.172(1), that has ensured that lessons will have been learned, those lessons, ironically, being the same as those matters in s.172(1) to which directors are objured to "have regard". The climate seems to be altering in favour of greater integrity in banking practice, at least as regards ordinary consumers. That it has altered is not as a result of s.172(1). It is because to continue as before is no longer commercially tenable. If this is the case, it almost suggests that the provisions in s.172(1)(a) â€“(e) are unnecessary. Sensible directors of a company would do what s.172(1) expects, without those requirements having to be put in legislation.

Whether or not these provisions are unnecessary, s.172(1)(a)(e) is not going to go away. Even if the statute is not effective, it is what is on the statute book and it is unlikely that parliamentary time would be found for its amendment. Instead, at the time of writing the Parliamentary Commission on Banking Standards is considering the Treasury's proposal that directors of a bank should face criminal sanctions if found guilty of serious misconduct in the management of that bank.[48] This suggestion is not without its difficulties, but the active threat of imprisonment and fines, not to mention the ignominy of conviction, may concentrate directors' minds more effectively than s.172(1) appears to have done.

One may then ask why the politicians and their civil servants allowed such ineffective legislation as s.172(1) on to the statute book. There were warnings, particularly from some Conservative MPs,[49] that what eventually became s.172(1) would cause more difficulties than it solved. What did not appear to have been anticipated, at least in public, was that the section would be ignored. It was complied with to the extent that the board minutes could demonstrate that directors had had regard to it, but the fact that the scandals referred to above took place at all suggests that amongst the many other tasks directors have to contend with, actually paying attention to s.172(1) was a very low priority. As for the politicians, it could be said that there was an emotional and sentimental attachment to what seemed a socially desirable objective, irrespective of the practical feasibility of that objective.[50] By the time that the voting on the second reading of the Bill was to take place, they had persuaded themselves that it was worthwhile, and as the Labour Party, which was supporting the Bill, was in a majority in the House of Commons at the time, there was no difficulty in getting the motion passed.[51]

It is possible to say that the confusion of aims and absence of sanctions fatally undermined the benefit of this section, and that politicians should have been more alert to this. However, in the heat of the moment on the parliamentary floor, one should not underestimate the understandable feeling for politicians of "something being done" towards a desirable objective even if there is no realistic penalty for the failure to achieve that objective.[52]

Comparison with proposed legislation in Ireland

It is telling that the current company law reform Bill being discussed in the Republic of Ireland has made significant changes to many areas of company law, that country's law being in many respects similar to UK law, but has expressly not introduced any attempt to draft directors' duties in the manner shown in Companies Act 2006 s.172(1).[53] The (Irish) Companies Bill s.229(1), at present being discussed in the Dail, is the nearest equivalent to Companies Act 2006 s.172(1), but there is no mention of the need to have regard to the various stakeholders. There is instead a requirement to: (a) act in good faith in what the director considers to be the interests of the company; (b) act honestly and responsibly in relation to the conduct of the affairs of the company; (c) act in accordance with the company's constitution and exercise his or her powers only for the purposes allowed by law; (d) not use the company's property, information or opportunities for his or her own or anyone else's benefit unless (i) this is expressly permitted by the company's constitution; or (ii) the use has been approved by a resolution of the company in general meeting.

The simple but wide words "act honestly and responsibly in relation to the conduct of the affairs of the company" have much to commend them. It is evident from elsewhere in the Bill that the Irish have adopted much from the Companies Act 2006, but for good reason they did not replicate s.172(1). The words "honestly and responsibly" are particularly apt, and their lack of specificity is useful because it suggests that the directors should act honestly and responsibly not just to their companies, but to all those party to the "affairs of the company". It does not resolve the irresoluble question of the duty to act responsibly only being owed to the company, but unlike s.172(1), as a duty it is easy for directors to understand and hard to avoid. It would be easy for a shareholder to point out that a directors' reluctance to ask, say, what its mis-selling sales representatives were doing, or why money laundering was taking place, showed a failure to act honestly and responsibly. Were s.172(1) of the Companies Act 2006 ever to be amended, there is much to be said for adopting the wording of the Irish Companies Bill s.229(1)(b).

Conclusion

The well-intentioned legislation on directors' duties at s.172(1) of the Companies Act 2006, designed to encourage better decision making by directors, turned out to be ignored because there were no realistic sanctions for non-observance and no standing to sue for the stakeholders whose interests were apparently being protected.

Ironically, the effects of the reluctance of directors to engage with the duties outlined in the legislation have been so detrimental to some companies' interests that the only solution is for directors to start engaging with those very duties. However, this is not because the law says that they should do so, but because commercially there is no other option. In essence, in the United Kingdom, market forces policed directors a great deal better than the legislation did. The wording of s.172(1) has been ineffective. Simpler and less ambitious legislation would have been desirable. Instead of a complex series of requirements and a list of all the stakeholders to whom the directors should have had regard, ideally the current legislation should be repealed and the wording from s.229(1)(b) of the Irish Companies Bill used instead.

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1.

Department of Trade and Industry, Modern Company Law for a competitive economyâ€"the Final Report (The Stationery Office, 2001).

2.

In particular Directive 2004/25 on takeover bids [2004] OJ L142/12.

3.

"There is one and only one social responsibility of business: to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud", *Milton Friedman,* *"The Social Responsibility of Business is to Increase its Profits", New York Times, September 13, 1970*.

4.

See *Lord Sainsbury of Turville's speech in the House of Lords, Hansard, HL Vol.677, col.244 (January 11, 2006).*

5.

See *Lord Sainsbury above at Hansard, HL Vol.677, col.245 (January 11, 2006).*

6.

See *Alastair Darling's speech in the House of Commons at Hansard, HC Vol.447, col.125 (June 6, 2006).*

7.

It may also be open to the liquidator to use the provisions of s.172(3) against directors who under the common law had failed to consider the interests of creditors when the directors could see the company was in financial difficulties: *Re HLC Environmental Projects Ltd [2013] EWHC 2876 (Ch)*.

8.

Laurence C.B. Gower and Paul L. Davies, Principles of Modern Company Law, 9th edn (London: Sweet & Maxwell, 2012), para.16.33.

9.

Employee participation and company structure in the *European Community COM (75) 570, November 12, 1975, Bulletin of the European Communities, Supplement 8/75*.

10.

The wording of s.309 was as follows:

(1)

"The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.

(2)

Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.

(3)

This section applies to shadow directors as it does to directors."

11.

At the time of the House of Commons second reading discussion on this section of what was then the Companies Bill (October 17, 2006) various MPs alluded to lobbying by the Trade Justice Movement and the Corporate Responsibility Coalition: see http://www.tjm.org.uk/trade-issues/past-campaign-success/28-massive-public-campaign-changes-accountability-law-for-corporations-2006/229-companies-act-a-move-forward-to-right-corporate-wrongs-.html [Accessed March 21, 2014]; http://corporate-responsibility.org/wp-content/uploads/2013/11/Companies_Bill_Supporter_Verdict_Long_Nov061.pdf [Accessed April 22, 2014].

12.

Hansard, HC Vol.450, col.790 (October 17, 2006).

13.

October 1, 2007.

14.

For example, *West Coast Capital (LIOS) Ltd, Petitioner [2008] CSOH 72*.

15.

R.(on the application of People & Planet) v HM Treasury [2009] EWHC 3020 (Admin), discussed shortly. This was not actually an action against the directors but a review of the way that the Government as the majority shareholders was running the company.

16.

Petitioning the court about the directors' decision making would be expensive and might even lead to the share price being adversely affected.

17.

For example, *Wishart, Petitioner [2009] CSOH 20; 2009 S.L.T. 376*; *Re Phoenix Contracts (Leicester) Ltd [2010] EWHC 2375 (Ch)*.

18.

For an explanation of what would be considered a prima facie case, see *Gillespie v Toondale Ltd [2005] CSIH 92; 2006 S.C. 304*.

19.

Not to the member himself. He is merely acting on the company's behalf and obtains little personal benefit except insofar as any redress from the director benefits the company and thereby indirectly the value of the member's shares.

20.

Hughes v Weiss [2012] EWHC 2363 (Ch).

21.

Hughes v Weiss [2012] EWHC 2363 (Ch) at [34]-[41]. A similar case exemplifying the use of s.172(1)(f) is *Phillips v Fryer [2013] B.C.C. 176*.

22.

R.(on the application of People & Planet) v HM Treasury [2009] EWHC 3020 (Admin).

23.

R.(on the application of People & Planet) v HM Treasury [2009] EWHC 3020 (Admin) at [35]. For a critique of this decision, see Stephen F. Copp, "S.172 of the Companies Act 2006 fails people and planet?" (2010) 31(12) Comp. Law. 406.

24.

In any case, this application was for judicial review, and was not a derivative claim.

25.

Samantha Fettiplace and Rebecca Addis, Evaluation of the Companies Act 2006 (The Stationery Office, 2010), at p.3 of summary, available at http://www.bis.gov.uk/assets/biscore/business-law/docs/e/10-1363-evaluation-companies-act-2006-summary-main-findings.pdf [Accessed March 21, 2014].

26.

Available at http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx [Accessed March 21, 2014].

27.

For example, see the ethical code produced by *Barclays Bank, "The Barclays Way: How we do business", issued in September 2013*.

28.

In particular, *Michael Lewis, The Big Short, Inside the Doomsday Machine (London: Penguin, 2011)*.

29.

Permanent Subcommittee on Investigations, US Senate, "US Vulnerability to Moneylaundering, drugs, and terrorist financing: HSBC case history" (Homeland Security and Governmental Affairs, 2012), available at http://www.hsgac.senate.gov/subcommittees/investigations/media/levin-statement-on-hsbc-settlement [Accessed March 21, 2014].

30.

David Bagley, the UK head of compliance during the time of the money laundering, resigned during the Senate Subcommittee hearing on HSBC'ss money laundering activities, blaming the bank's rapid growth and challenging circumstances, implicitly admitting his own inability to prevent the abuses that had been taking place under his watch.

31.

See HSBC's annual report for 2010 at p.82.

32.

The following is from the 2010 HSBC annual report at p.154 under the heading of "Compliance risk": "Compliance risk falls within the definition of operational risk. All Group companies are required to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice. These rules, regulations, other standards and Group policies include those relating to anti-money laundering, counter terrorist financing and sanctions compliance. The Group Compliance function supports line management in ensuring that there are adequate policies and procedures, and is responsible for maintaining adequate resources to mitigate compliance risk. The GMO Compliance department oversees the global compliance function and is headed by the Head of Group Compliance who in turn reports to the Group Chief Risk Officer. There are compliance teams in all of the countries where we operate. These compliance teams are principally overseen by Regional Compliance Officers located in Europe, North America, Latin America, the Middle East and Asia-Pacific. Group Compliance policies and procedures require the prompt identification and escalation to GMO Compliance of all actual or suspected breaches of any law, rule, regulation, Group policy or other relevant requirement. These escalation procedures are supplemented by a requirement for the submission of compliance certificates at the half-year and year-end by all Group companies detailing any known breaches as above. The contents of these escalation and certification processes are used for reporting to the Risk Management Meeting, the Group Risk Committee and the Board and disclosure in the *Annual Report and Accounts* and *Interim Report*, if appropriate."

33.

See *BBC Business News, December 10, 2012* at http://www.bbc.co.uk/news/business-20669650 [Accessed April 22, 104].

34.

See in particular, HSBC 2010 annual report, p.39, where the following is stated: "Our brand promise, Here for good, reaches out to all our stakeholders, including our employees, through a simple and compelling promise. It says who we are, what we stand for and what makes us different. Here for good captures our genuine commitment to our customers and clients, our staff and the communities where we operate; our focus on consistently doing the right thing and acting responsibly; and our aim to continually lead the way across Asia, Africa and the Middle East. It has raised the bar on how we demonstrate our values through our everyday business activity."

35.

See http://www.telegraph.co.uk/finance/rate-swap-scandal/9840946/Banks-face-10bn-bill-over-swaps-mis-selling-scandal.html [Accessed March 21, March].

36.

BBC News, United States and Canada, July 2, 2012 at http://www.bbc.co.uk/news/world-us-canada-18673220 [Accessed April 22, 2014].

37.

See the *Ofgem, "SSE Notice of Intention to impose a financial penalty on SSE for failure to comply with Standard Licence Conditions 23 and 25" (Ofgem, 2013), paras 134, 149*.

38.

For example, Sir Anthony Jenkins, the chief executive of Barclays Bank, in an echo of Barclays Banks original Quaker roots, wrote to all the bank’s employees on January 16, 2013 about his new mantra called TRANSFORM, promoting the values of "respect, integrity, service, excellence and stewardship". Similar assertions were made by the directors of the Royal Bank of Scotland to the Treasury Select Committee on February 11, 2013.

39.
Andrew Bailey of the Financial Services Authority told the Treasury Select Committee on July 16, 2012 that Barclays had a "culture of gaming" (i.e. sailing close to the wind in its compliance with regulations) and implied that that culture came from Bob Diamond, its then chief executive officer.

40.
Doreen McBarnet, Corporate Social Responsibility Beyond Law, Through Law, for Law, (University of Edinburgh, 2009), School of Law Working Paper Series 2009/03, available at http://papers.ssrn.com/sol3/papers.cfm?abstract-id=1369305 [Accessed March 21, 2014]. *Doreen McBarnet, Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and the Banking Crisis (University of Edinburgh, 2010), School of Law Working Paper Series 2010/02*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract-id=1546486 [Accessed March 21, 2014].

41.
BBC News, February 5, 2013, available at http://www.bbc.co.uk/news/business-21333527 [Accessed March 21, 2014].

42.
For an expanded view of the same point, see Ngozi Okoye, "The BIS review and section 172 of the Companies Act 2006: what manner of clarity is needed?" (2012) 33(1) Comp. Law. 15.

43.
Lynch, "Section 172: a ground-breaking reform of directors’ duties, or the emperor’s new clothes?" (2012) 33(7) Comp. Law. 196.

44.
Professor Keay has written extensively on this area (see *Andrew Keay, "The Duty to Promote the Success of the Company: Is it Fit for Purpose?"*, available at http://www.law.leeds.ac.uk/assets/files/research/events/directors-duties/keay-the-duty-to-promote-the-success.pdf [Accessed March 21, 2014] and Andrew Keay, "Moving towards stakeholderism? Constituency statutes, enlightened shareholder value, and more: much ado about little?" (2011) 22(1) E.B.L. Rev. 1, in particular) and his view is that s.172 has, frankly, not worked. He is not alone in this view: see Deryn Fisher, "The Enlightened Shareholderâ€”Leaving Stakeholders in the Dark: Will Section 172(1) of the Companies Act 2006 make Directors Consider the Impact of their Decisions on Third Parties" (2009) 20(1) I.C.C.L.R 10.

45.
Customers are notoriously reluctant to change theirs banks, but even if they do not change their banks, they are much more likely to be cautious about buying its products.

46.
See *Ofgem, "SSE: Notice of Intention to impose a financial penalty on SSE for failure to comply with Standard Licence Conditions 23 and 25" (2013), para.159*.

47.
Anthony Jenkins, current chief executive officer of Barclays Bank, said it would take five to 10 years to rebuild trust in banks (speech to Brooke House Sixth Form College, East London, December 31, 2013) reported at http://www.independent.co.uk/news/business/news/antony-jenkins-admits-it-could-take-10-years-to-rebuild-trust-in-barclays-9031350.html [Accessed March 21, 2014].

48.
See the *Treasury discussion document, Sanctions for the directors of failed banks (The Stationery Office, 2012)*, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81565/consult_sanctions_directors_banks.pdf [Accessed March 21, 2014].
49.
See *Hansard, HC Vol.447, cols 204â€“205 (June 6, 2006)*.
50.
One can compare this to another famous example of well-intentioned but completely unworkable legislation, namely the 18th Amendment to the American Constitution, being the prohibition in 1920 on the production, sale and transport of alcohol. The 21st Amendment in 1933 repealed the 18th Amendment.
51.
See *Hansard, HC Vol.447, col.219 (June 6, 2006)*.
52.
The Companies Act 2006 is not the only example of sanction-free legislation. For example, the Child Poverty Act 2010 sets out laudable targets for the reduction of poverty but the sole "threat" is that if the targets are not met, Parliament has to be told why. The now-abolished Fiscal Responsibility Act 2010 set out certain targets for the reduction of public sector net borrowing but expressly provided no sanction for the failure to meet those targets. There is a wider question to be asked as to whether imposing rules without penalties is an effective use of legislation.
53.
The author is not aware of the adoption of the wording of s.172(1) in the company law of any other Commonwealth country.