The irresponsible director

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Abstract: *To improve the position of one creditor for a company in insolvency is nearly always at another creditor's expense. However, if directors could be held liable for their irresponsible behaviour, this may allow liquidators further opportunities to make directors to make good the loss to their companies or their companies' creditors. This could be done by revisiting s.172 of the Companies Act 2006 which has not, so far, been particularly effective in improving directorial decision-making. Lessons may be learned from the wording of directors' duties in other jurisdictions, in particular Ireland.*

There's a depressing website called "Who's gone bust in retail 2010-2017?" run by the Centre for Retail Research. It makes glum reading. Common reasons for shops going bust include poor pricing, selling clothes or products that are no longer fashionable, divorce of the original owners, local business rates, lack of parking facilities, over-expansion, taking on too many expensive leases, lack of working capital, competition from on-line retail, fall in demand for products as a result of increasing computerisation, oversupply of similar products, bad luck, the three generation rule, and so on.

Many of these shops go into administration. Some recover and find new owners who turn them around. Some sell off the profitable parts. Some do not recover and end up in liquidation. Then the carve-up begins, as to who gets what.

Most countries' insolvency law is pretty similar. In most countries, the liquidator gets paid first. Preferred creditors, commonly the Revenue, come next, usually followed by employees. Then secured creditors, unsecured creditors and the members last of all, if they get anything. Employees in some countries may rank higher or lower than secured creditors as the case may be.

Most countries have some method of recalling antecedent transactions, (the *actio pauliana*) particularly when they are to done to defraud creditors, and some method of making delinquent directors compensate the company.

From time to time there are changes to insolvency law, so that one formerly disadvantaged creditor gets a bit more of the corporate pie and some other creditor gets less. For example, the current form of administration in the UK, introduced by the Enterprise Act 2002, effectively wrote receivership out of the statute, and concentrated on keeping businesses going, in the fond hope of benefitting employees, who commonly lost their jobs when companies went into receivership. Receivership had been good for the banks, but less good for employees and particularly unsatisfactory for unsecured creditors. Administration changed this. The prescribed part was to be saved for unsecured creditors, provided it was not too expensive to distribute, and the administrator was expected to go through the motions of considering whether it was feasible to rescue the company as a going concern,[1] before, as tends to happen in practice, doing what he could for the secured creditors who are likely to give him or her

[1] Insolvency Act 1986 Sch. B1, 3(1)(a).

future business. Nevertheless, a successful rescue is sometimes achieved, or at any rate, the business of the company, and some of its employees, may survive in the hands of new owners. The political imperative behind this is not to be ignored: employees have votes whereas creditors, generally, do not.

The loss of the banks' favoured status under receivership, and the gain to the unsecured creditors, did not come cost-free. After many years of resistance to the idea, HMRC was obliged to give up its role as a preferential creditor. In effect, debts owed by a company in administration to HMRC were socialised. The slice of the corporate pie that unsecured creditors received was increased, and the slice HMRC, and by extension all of us as tax-payers, was decreased. As one gained, another lost.

The problem with the corporate pie that is an insolvent company is that however much one tinkers with the legislation, the pie itself doesn't get any bigger. One can give more to one set of creditors, but only at the expense of another. It appears to be a zero-sum game.

So what can we do to make the corporate pie bigger?

A start would be to look at why the company got to where it did, and see if there are any very obvious and avoidable reasons for the collapse of the company. A number of reasons why retailers go bust has already been given, but there was one reason omitted, which was poor directorial decision-making.

In the UK, directors, when making their decisions, are expected under s.172 of the Companies Act 2006 to act in what they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, while "having regard" to various stakeholder interests, including the long term consequences of any decisions, the interests of the employees, treating other members fairly and various other expectations. The idea was that this would lead to Enlightened Shareholder Value. It is thought that companies whose directors have regard to these various interests will provide better value for their shareholders and everyone else in the long run – which may well be true.

As is well known, this particular wording was put into the 2006 Act after a great deal of worthy discussion. It was eventually pushed through Parliament by guillotine, with the Conservatives not being wholly in favour and the others MPs broadly in favour. It was a form of words that acceptable to most MPs. It is not apparent that all the MPs fully appreciated that although the wording of this section is not a bad thing in itself, there is one fatal flaw, which is that under s.170 the duty to have regard to the employees and everything else is owed, not to the employees or the other stakeholders, but to the company. Only if the collective body of shareholders feel strongly enough about the matter may the members make the directors have the required regard for the stakeholders. If the MPs did appreciate this, they still were willing to vote for it, notwithstanding the flaw contained within it. The wording superficially gives the impression that it allows directors to be held to account, which made the politicians feel good, but actually it does not give any of those stakeholders a direct right against the directors. That right is only available if the members can be bothered to put pressure on the directors, or if the members wish to use the directors' failure to adhere to s.172 as grounds for a derivative claim. And there's the problem. It is most unlikely that the collective body of shareholders in most companies ever would do that. The members often do not know enough about directors' decisions to query those decisions, and in a listed company, if the members did not individually like what the directors were doing, they would sell their shares. A doughty member might be able to persuade the courts to let him or her bring a derivative action against the directors, but for most of us, life is too short, and the costs too great. So far there does not appear to have been a successful derivative claim featuring a large company.

This is not to say that s.172 and its requirements are necessarily a bad thing. A well-run company, run by decent and sensible people, does take account of stakeholders' interests, mindful of the reputational damage of not doing so, or even the danger of a boycott of its products or services. A well-run company would do what s.172 requires without the need to have legislation to encourage it to do so. The problem lies with those companies whose directors, or members, are less public-spirited. S.172 preaches to the already converted. S.172 is a good example of sanction-free law. It is what might be described as hortatory legislation. It tells the director what the director ought to do, but does not spell out what happens if the director ignores the instruction, because, most of the time, the answer is "Nothing". The heathens who cannot be bothered with it, especially if they own or control all or a majority of the shares, are unlikely to have a Damascene moment just because of s.172. There are plenty of examples of the requirements of s.172 being ignored by directors: the 2008 RBS rights issue and the more recent bribery scandals at Rolls Royce come to mind. Although the action against the directors of the Royal Bank of Scotland has now been settled, the fact that it was settled in order to give a substantial payment to the aggrieved shareholders who subscribed to the rights issue is an indication that the bank's directors' position was weak. If the directors of RBS at the time truly had addressed their minds to the requirements of s.172, would they really have gone ahead with a rights issue without even doing some form of due diligence against AMRO? Sir Brian Leveson in his verdict on the Rolls Royce bribery scandal in January 2017 specifically said that the then Board of Directors had been aware from at least 2010 of bribery taking place, but did nothing about it until the Serious Fraud Office raised the matter in 2013. Sir Brian did take pains to point out that no directors of the current board of directors was at fault. Neverthelesss it is noticeable that none of the directors on the board at the time of the bribery has been willing to comment on the matter. In each case the then directors could not pretend to be unaware of the requirements of s.172, which had been in force since 2006. Even if the Tesco directors at present (at the time of writing) being prosecuted for false accounting are acquitted, they cannot have been unaware that behaving as the company did towards its suppliers was hardly showing "the need to foster the company's business relationships with suppliers, customers and others" or helping the company maintain "high standards of business conduct". If s.172 is meant to concentrate directors' minds, it is not making much impression on those determined to ignore it.

S.172, most of the time, has few teeth. One time it may have teeth is when the majority or all of the shares are subsequently bought by someone else, who may choose to go over the previous board minutes to see if regard for stakeholders under s.172 had been had by the directors in their decision-making. A liquidator may do the same thing. However, canny directors ensure that board minutes show that some regard has taken place, even if any actual decision is a poor one. All the minutes have to do is show that some regard has taken place, but not how much regard was paid to any particular matter, or how much the regard informed the ultimate decision the directors took.

A second time it has teeth is when a member feels sufficiently strongly about a director's refusal to engage with s.172 that he is prepared to undertake a derivative claim. But this requires there to be independent shareholders and does not work if all the shares in the company are held by some-one already connected with director. This is what was seen in BHS, formerly run by Sir Philip Green. As is well known, BHS paid substantial dividends, tax-free, to Lady Green in

Monaco, while the company lost market share and direction. Although at the time, BHS could have put funds into the BHS pension fund, Sir Philip chose not to do so, instead using the money that could have been used for pensions as dividends. It is possible that he considered that this was legitimate, or he may have taken the view that the fund was already reasonably well provided for. Nevertheless, BHS began to falter under his management. When the company was going really downhill, he sold it to the former bankrupt, racing car driver, Dominic Chappell, in whose hands, and to no-one's surprise, it promptly collapsed. Many employees lost their jobs and the pension fund was found to be clearly underfunded. To his credit, Sir Philip eventually put some of his private fortune into the pension fund, possibly mindful that without such an act he might lose his knighthood. Cynics have since observed that a good reform for company law would be to make all captains of industry and the heads of large retail operations knights of the realm, with the express proviso of removing their knighthoods if they misbehave.

The reaction to the BHS scandal, and in particular to the fact that BHS did not put nearly enough into the pension fund, is two-fold. One response is that large private companies and large non-quoted plcs should be subject to some sort of corporate governance code. This latter point is not widely popular (see Sir James Dyson's views in The Times on March 27th 2017[2]) and there are questions about how large a private company would have to be before it was subject to such as code. It has been suggested that it should be the largest 350 private companies by market capitalisation.[3]

A second response is that s.172 should be amended to add the duty to have regard to the interests of the pension-fund holders. While this is not a bad idea, all is does is give moral pressure, but it wouldn't stop a determined director who was not bothered about the pension fund. Nor would it have made any difference in the case of BHS, as Lady Green owned all the shares and would not have brought a derivative action against her own husband.

A recent, more intelligent, suggestion is that there should be a mechanism, similar to the derivative claim, available to a company's pension fund's trustees, to make directors ensure that their company's pension fund is properly funded. This might have the virtue of making directors take their pension responsibilities seriously and prevent them using the Pension Protection Fund as a fund of last resort.[4] However, if one allows one interest group to be allowed to have a derivative claim, there might be a long queue of other applicants.

The essential point is the question of who holds the directors to account. The law is in a cleft stick. Either one lets stakeholders, including pension fund holders, have some sort of right against directors, which would probably be unacceptable to most directors in the UK, might destroy the whole point of limited liability, and would drive business from the UK, or one has to trust to the better nature of most directors, deny stakeholders any such right, live with the current wording of s.172 and pray that there are no more scandals – which seems naïve.

How can we resolve this matter?

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[2] Available at https://www.thetimes.co.uk/article/dyson-hits-out-at-plan-for-greater-openness-dwcw57fld

[3] See the interview with Sir Wim Bischoff, chairman of the Financial Reporting Council, in The Times, 28 January 2017. https://www.thetimes.co.uk/article/discretion-not-a-big-stick-is-the-way-to-control-spiralling-executive-pay-t6bkp2cfw

[4] See Mark Stamp *Sir Philip Green: villain or victim? An analysis of the circumstances leading up to the administration of the BHS Group* 2017 Company Lawyer, 38(6), 180-189

The answer is that it will never be completely resolvable, as it is one of the central ambiguities of company law. However, it is submitted that there are two suggestions which might help.

One suggestion for the future, aired in written evidence given by the Financial Reporting Council in the Corporate Governance and executive pay consultation being undertaken by Commons Business Energy and Industrial Strategy Committee,[5] is that both companies subject to the UK Corporate Governance Code and any other companies subject to a similar code should be required to report on how directors have satisfied themselves that their companies have taken account of the stakeholder interests in s.172. They would also have to report how these companies have allocated funds between pensions, dividends, directors' remuneration, investment and capital investment. Reporting of itself will not prevent companies collapsing, and would probably not be popular, but the report would show how the company has addressed s.172 and the reasons behind their allocations of funds. This would make the requirement to "have regard" a more demanding, thoughtful and possibly transparent exercise. It will not deter the most determined transgressors, but if they have to report what they say they did, but what they say they did is not born out by the facts, they will be in the awkward position of having publicly to justify why there is a discrepancy.

An alternative suggestion is to revisit what is expected of directors. Instead of having a list of items to which directors have to have regard, it is worth taking another look at what directors are expected to do. At present, the UK wording in s.172 requires them to act in what they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

It is always worthwhile seeing what the equivalent wording is elsewhere. In Canada, under s.122 of the Canada Business Corporations Act 1985, directors are expected "to act honestly in good faith with a view to the best interests of the corporation". In Ireland, s.228 of the Companies Act 2014 requires a directors to act in good faith in what the director believes is in the best interests of the company, but in addition requires a director "to act honestly and responsibly in relation to the conduct of the affairs of the company." Directors even have to sign a declaration acknowledging their responsibilities. Neither Canada nor Ireland bothers with the list of stakeholders that the UK has; and indeed Ireland knew perfectly well about our 2006 Act when it drafted the 2014 Act, but chose not to follow the UK example.

It is suggested that we either scrap or amend s.172, ditch the arbitrary and fashionable list of stakeholders and rewrite it simply, clearly and positively to require directors to act in good faith in the best interest of the company, but more importantly, to act honestly and responsibly in the running of the company. Who could deny the value of expecting directors to act "honestly"? Secondly, what is good about the word "responsibly" is that arrantly selfish or greedy behaviour which might be purely good for the shareholders is still not necessarily "responsible". It is easy to pay lip service to the requirement to have regard, but less so to be the requirement to be responsible and honest. Is any director going to stand up and say he wants to have the right to be irresponsible and dishonest? The word "responsible" implies a duty to exercise forethought, care and good sense, and not just purely for the shareholders' benefit. It would include all those, such as pension funds, affected by the directors' actions. It implies that though a director could take some action, as it is not illegal, sometimes the director shouldn't do so because, on a wider view, it is not a wise and considered action to take. It suggests that the director has to think of others, not just the shareholders. It is true that the word

[5] Presented to the Committee by its CEO, Steven Hadrill, on I November 2016, ref. G0078.

“responsibly” is not without its ambiguity, but inherent in the customary meaning of the word is the requirement not to act purely selfishly. The Irish were no doubt aware of the ambiguity of the word, but this did not stop them putting it in their legislation.

There is an expectation, in that word, of acting with others’ interests in mind. Whatever else “responsibly” may mean, it is more demanding that the feeble requirement to “have regard” to various stakeholders’ interests.

To put it bluntly, the requirement for directors to act “honestly and responsibly” might prevent a few insolvencies happening in the first place. Furthermore, irresponsible directors could be caught by the misfeasance provisions of s.212 (or possibly s.214, if suitably amended) of the Insolvency Act 1986 if it were amended to allow for this. While making directors compensate companies is not in general a very productive exercise, since most directors do not have the savings or may just go bankrupt anyway, the accusation of a lack of responsibility could be a weapon in a liquidator’s armoury, and the threat of being liable for lack of responsibility might just stir some directors, or their advisors, into action, and make them reconsider the wisdom of some deleterious action.

It is true that one might object to this suggestion for reform on the grounds that there already is a retrospective defence that may be brought by a director against the use of s.212 against the director if the director has acted “honestly and reasonably in all the circumstances” in terms of s.1157 of the Companies Act 2006. It may seem a small point, but this is not the same as being positively required to act honestly and reasonably in the first place. Furthermore, it would be possible to make a decision that was honest and reasonable, in that it was an understandable reaction to a difficult problem, or there was not at the time a pressing need for taking an unpalatable but necessary step - but which was nevertheless irresponsible. For example, people in a remote community might discover a particular commodity which was very marketable, such as a new and hitherto undiscovered supply of lobsters to sell at the local fish market. The local fishermen might be acting honestly and reasonably in setting up lobster pots, and catching lots of lobsters. But they would be acting irresponsibly if they failed to exercise restraint in taking up every lobster they could find until there were no more lobsters to breed. To give a less aquatic example, it was probably honest and reasonable to encourage bank customers to take out some form of insurance to help pay their mortgages if they fell on hard times. But it was not responsible to make those insurance policies largely worthless, or for the banks at the time to rely on the proceeds of sale of worthless policies to drive up their profit margins. Or to put it in another context, it was probably honest and reasonable for BHS to pay large dividends to the company’s shareholders, but it was not necessarily responsible. Over time a good deal of case law would become devoted to the exact meaning of “responsible”, and to the extent to which a person taking over a company, or a liquidator, could challenge irresponsible past decisions. But then, if a director knew he or she could be held responsible for an irresponsible decision, as it were, by a liquidator, he or she might think twice about making such a decision in the first place.

It is not suggested that the reporting requirements from the Financial Reporting Council or the proposal of the inclusion of the word “responsibly” to the requirements for directors’ decision-making would not encounter political resistance, because directors on the whole do not like being told by the Government what to do, and complain of anything that is bureaucratic or time-consuming, or makes the UK a less attractive place in which to do business. Nor am I suggesting either of these as a panacea. One cannot legislate away greed, folly, selfishness, or incompetence. All one can do is reduce the opportunities for these traits to be seen as acceptable

A requirement that directors act responsibly might make directors think twice, and in so doing diminish the number of companies becoming insolvent because the directors thought they could get away with it. Conversely, where a director has acted irresponsibly, he could be required to compensate the company, or as the case may be a particular creditor, such as his company's pension fund, for what should have been retained in the company or paid to the pension fund had the director been acting more responsibly. In this way, the corporate pie may be made a little bigger.