



Review Paper

## 'Enlightened Shareholders Value' Approach under Section 172 of the UK Companies Act of 2006: An Analysis

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### Abstract

*Section 172 of the Companies Act 2006 of the United Kingdom (UK) is claimed to be one of the significant enactments in the history of company law in the UK. By adopting the 'enlightened shareholder value' model, in comparison to the 'shareholder primacy' approach, this section requires the directors to consider the stakeholders' interests while promoting success of the company. However, in reality, the 'enlightened shareholder value' approach closely resembles with the 'shareholder primacy' approach. This is because, in practice, interests of the stakeholders are likely to be compromised in promoting the shareholders' interests.*

**Keywords:** Directors, Duties, Enlightened shareholder value, Interests, Shareholder Primacy, Stakeholders.

### Introduction

What should be the scope, content; form and nature of directors' duties are perhaps the oldest and ever growing issues in the history of company law in the UK<sup>1</sup>. It has always been argued that directors are responsible for the smooth running of the companies<sup>2</sup>. However, director's duties, before the enactment of the Companies Act (2006), in the context of company law in the UK, were not well-defined or coherently codified. They were mostly present in the form of perplexed and profound collection of case laws, and irregular statutory measures<sup>3</sup>. This vacuum is said to be filled in finally with the statutory enactment of directors' duties, particularly under section 172 of the UK Companies Act 2006 (CA 06).

Section 172 requires a director to consider interests of the stakeholders or other constituencies, such as employees, suppliers and customers, before taking any action in promoting success of the company. This duty is claimed to be based on the principle of 'enlightened shareholder value' approach, in comparison to the 'shareholder primacy' approach, as a director has to take into consideration interests of the stakeholders too. Following the debate of stakeholders' interests, this paper discusses whether the new 'enlightened shareholder value' approach associates itself with the 'shareholder primacy' approach or the 'stakeholder approach' or both. It considers whether directors' duty under section 172 is favoring shareholders or stakeholders and/or both. The paper also discusses the following issues: is it practically possible for the director to make or develop a balance between the interests of both shareholders and stakeholders; what is the nature or character of such a duty; whether the interests of other

constituencies are desirable and politically sustainable; and whether such an enactment would bring any difference in practice in relation to the company law.

### The 'Shareholder Primacy' Approach under the 'Enlightened Shareholder Value' Model

It has argued that the 'shareholder primacy' rule was failed in promoting success of the companies, and in order to generate more wealth, all the participants need to work in harmony as a team, and the larger interests of the community should also be taken into consideration<sup>1</sup>. To achieve this end, one of the objectives of the Company Law Review Steering Group (CLRSG) was to provide a straightforward, fair and cost-effective regulation, targeting on balancing the business' interests with the interests of the shareholders and others, including creditors<sup>4</sup>. However, the CLRSG, in its review phase, faced a problem in determining whose interests, in case of a clash between the interests of the shareholders and stakeholders, should be preferred or protected<sup>5</sup>. To resolve this issue, the CLRSG had to take one approach into consideration, either a 'enlightened shareholder value' approach or a 'pluralist' approach<sup>6</sup>. In relation to this, one of the views of the CLRSG was that companies were working and managed for the benefits of the shareholders, and the main objective of the companies was to maximize wealth for the shareholders<sup>5</sup>.

The above-mentioned two models or approaches differ each other on ground that what would be happened if a clash between the interests of stakeholders and shareholders arose<sup>7</sup>. The 'enlightened shareholder value' approach gives preference to the interests of the shareholders over the stakeholders' interests,

whereas the 'pluralist' approach requires the directors to maintain a balance between the conflicting interests without giving automatic preference or edge to the shareholders<sup>3</sup>.

These two approaches, referring to the 'enlightened shareholder value' and the 'pluralist', resemble to the ideas or views of Professors A Berle and E M Dodd, respectively, on corporate accountability, put forwarded in the United States (US) in early 1930s. Berle favoured 'inclusive' approach by arguing that all the powers, awarded to the management of a corporation, are exercisable only for the shareholders' benefits<sup>8</sup>. Dodd, on the other hand, said that companies, while making profits for the shareholders, also need to play a social service role, and they own responsibilities to the shareholders, stakeholders (such as employees and customers) and the general public<sup>9</sup>. This view resembles to the 'pluralist' approach. Though on paper Dodd's views got more attention, but historically and practically mostly Berle's given approach remained dominated<sup>3</sup>.

The consultation document of February 1999 to change UK company law also supported 'enlightened shareholder value' model for generating maximum value to the shareholders (the basic objective of the companies), as well as for securing overall prosperity and welfare objectives effectively<sup>5</sup>. However, in later consultations, many participants objected over the narrow scope of this approach<sup>3</sup>, and it was hoped that a duty to be framed in an 'inclusive' way, maintaining primacy of the shareholders with need to encourage effective relations over the time with stakeholders, such as employees, suppliers, customers and the community broadly<sup>10</sup>. Finally, after a series of consultations, the CLRS in its final report adopted an approach, namely the 'enlightened shareholder value' model, with intention that it would achieve basic goal of wealth maximization and competitiveness for the benefit of all<sup>11</sup>.

However, it should be mentioned here that this 'enlightened shareholder value' approach resembles more with the 'inclusive' approach, as it requires directors to act in the best interests of the shareholders<sup>10</sup>. The CLRS mostly adopted Berle's views of 'shareholder primacy' in the name of 'enlightened shareholder value' model, giving limited importance to the 'pluralist' model. In this context, Daniel Attenborough in "The Company Law Reform Bill: An Analysis of Directors' Duties and the Objective of the Company" (2006) says that the CLRS by adopting an 'enlightened shareholder value' model over 'pluralist' model, without using the expressions such as 'shareholder primacy' or 'stakeholder theory', generally associated itself with the 'shareholder primacy' approach, not with the 'stakeholder approach'.

It is stated that one of the reasons for adopting 'pluralist' approach was to avoid the risk of shifting the definition of company from an association or aggregate of shareholders to an association of other relevant groups<sup>3</sup>. In addition to this, the review on changing company law had in its mind that there was very limited possibility for the practical enforceability of such

as duty<sup>10</sup>, which was already observed in case of Berle's views over Dodd's ones. Moreover, if interests of the shareholders and the stakeholders are balanced without giving an automatic preference or edge to the shareholders' interests, then the duty of a director would possibly become subjective, which in practice would likely amount to more and uncontrolled discretion<sup>10</sup>.

The government, after adopting the so-called 'enlightened shareholder value' model in its two white papers of 2002 and 2005, respectively, and subsequently in the clause 156 of the Company Law Reform Bill with slight modifications, introduced the bill into the upper house of the UK Parliament (House of Lords) in November 2005. After passing through the required legislative procedure, clause 156 became, with minor changes, as section 172 of the UK Companies Act 2006. Section 172 states: (1) A company's director should perform his duties or act in a way that he, in good faith, considers would most likely promote the company's success, aiming to benefit the members 'As a Whole'. While doing so, the director should consider or has regard (amongst other matters) to - I. the to be expected outcome of any of his decision or act in the long term, II. the interests of the employees of the company, III. the need to strengthen the business relationships of the company with others, including customers and suppliers, IV. the effect of operations of the company on the environment as well as the community, V. the company's desirability to maintain a reputation, aiming for high values of business conduct, and, VI. the need to perform fairly between the company's members. (2) ..... (3) While performing his duties, the director also has to consider the creditors' interests.

### Critical Assessment of the Duties of Directors under Section 172 of the Companies Act (2006)

The following section critically analyzes the duties of the directors embodied under section 172 of the CA 2006 of the UK.

**Directors' Discretion to Act in Good Faith:** Section 172(1) provides a director with discretion to act in good faith, believing that his actions will most likely result in promoting success of the company. A director, as illustrated in the '*Re Smith & Fawcett Ltd*' [1942] case, should exercise his discretion bona fide in a way which he – not the court – considers is in the company's interests<sup>12</sup>. While the other important requirements, such as exercise of due care, skill and diligence in director's discretion before taking any action are missing<sup>11</sup>, section 172 fills in this gap. It states that a company's director, while performing his duties, should exercise reasonable diligence and care. It means a director needs to act in good faith as well as with reasonable skill and diligence while performing his duty under section 172 in relation to the interests of the stakeholders. This resembles with the 'Guidance on Key Clause to the Company Law Reform Bill', which suggests that a director is required to consider the factors such as interests of customers,

suppliers and community enumerated in section 172(1), and in such an action his duty of care, skill and diligence will apply<sup>13</sup>.

The test to determine whether the duty to act bona fide in the interests of company has been discharged, as seen in the '*Charterbridge Corp Ltd v Lloyds Bank Ltd*' [1969] case, should be whether an honest and intelligent person in the director's position of the concerned company, in the whole of the existing situation or circumstances, reasonably believes that the transactions are made for the company's benefit. However, this common-law objective test is not enough to assess the duty of the directors under section 172(1). This is because it is limited in scope to determine the honesty and intelligence of the directors in relation to stakeholders' interests. As a result, the directors are tended to work in favour of the shareholders, who normally appoint them and contribute heavily to the company's capital.

**To whom a director owes its fiduciary duty?:** While section 172 is not clear on point that to whom the director's fiduciary duty is owed, section 170 says that this duty is owed to the company, not to the shareholders or stakeholders. In support of this, it is noteworthy to quote the '*Percival vs. Wright*' [1902] 2 Ch 421 case. In this case, the complaining shareholders requested to set aside the purchase of shares because the defendant, the director, stood in fiduciary duty to them. The court rejected shareholders' claim, and J Swinfen Eady in the judgement stated that to hold otherwise 'would place directors in the most invidious position, as they could not buy or sell share without disclosing negotiations, a premature disclosure of which might well be against the best interests of the company'.

However, it should be mentioned here that a company is an artificial or fictitious person. But, it functions or works through the persons who have interests in it. The interests of the company cannot be distinguished from the interests of these persons<sup>14</sup>. These interested persons are defined as 'residual claimants' or shareholders, and in light of the property right theory, shareholders are owners of a company in substance, as they are the major capital contributors to a company<sup>15</sup>. The shareholders' proprietary interests entitle them as a general body, which is regarded as a company when questions in relation to directors' duties arise<sup>16</sup>. Simply put, in reality, under section 172, a director owes its fiduciary duty to the shareholders, targeting on maximizing profit for them<sup>15</sup>.

**Members 'As a Whole' and the Decision's Expected Outcome in the Long term:** Directors, while promoting the company's success, must act for the benefit of the members 'as a whole'. Benefits of the members 'as a whole' do not include the benefits of other constituencies<sup>17</sup>. The court, in the '*Brady v Brady*' [1987] case, held that the members 'as a whole' include both the present and future shareholders. But, there are situations where interests of future shareholders can become irrelevant. J Lawton in the '*Heron International Ltd vs. Lord Grade*' [1983] stated that when a director has to decide between

two different competing bidders then the company's interests must be considered as the interests of the existing shareholders of the concerned company.

It has been a frequent criticism of directors that they unduly focused on the short-term benefits for companies, in order to please the concerned shareholders. To address the issues, section 172(1)(a) needs a director to consider the likely consequences of his decision or act in the long term. However, it is practically not possible for the directors to completely ignore the short-term results of his action. A reference was also made to both long-term and short term in the earlier versions of Draft Company's legislation. Therefore, under section 172(1)(a), a director should seek to balance the short-term concerns against the long-term concerns<sup>12</sup>.

**Interests of the Stakeholders like Employees, Creditors and Community: Interests of the Employees:**

Section 172(1)(b), that deals with the interests of the employees, replaces section 309(1) of the Companies Act (1985)<sup>18</sup>. Section 309(1) states that "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". But there were two problems attached with the duty embodied under section 309(1). First, it was difficult to identify the exact scope of such a duty for determining whether it been discharged or not. Second, considering section 309(2), under section 309(1), directors owe fiduciary duty to the company, meaning hereby that either the company can sue for its breach or the shareholders by bringing derivative claim<sup>19</sup>. In the '*Re Welfab Engineers Ltd*' [1900] case, the directors of the company sold its principal assets for the third lowest competing bid because the purchaser was prepared to take on company's workforce and work in progress. Later, the company went into liquidation, and misfeasance proceedings were brought against the directors. But the directors were not held liable, as J Hoffman stated that the directors' act was based on an honest desire to protect the business from loss as well as to safeguard jobs of the employees.

Considering legal meaning of the 'interests of the company' under section 309, directors do not make the members' interests subsidiary to the interests of the employees<sup>12</sup>. Section 172(1)(b) has failed to change the interpretation of section 309, and to make any alleged breach actionable at request of the employees<sup>19</sup>. In fact, in comparison to section 309, section 172(1) provides limited protection to the interests of employees. This is because under section 309 there was only one stakeholder, the employees, whereas section 172(1) deals with the interests of employees along other stakeholders such as suppliers and customers.

Charles Wynn-Evan comments that rights or interests of the employees could be improved, if they are given direct locus to challenge the directors' decisions<sup>18</sup>. The importance of employees' interests issue was downgraded by keeping it on

same rank with other matters such as environment, long-term decisions, suppliers and customers<sup>18</sup>. Thus, the CLR, which described section 309 of CA 1985 as 'vague and unsatisfactory', and replaces it with section 172(1)(b) of CA 2006. yet, the new section, that is 172(1)(b), fails to provide any greater protection in relation to the employees' interests.

**Impact of Operations of the Company on the Community and the Environment:** Section 172(1)(d) deals with the interests of the public by enshrining directors' duties or responsibilities to the community and the environment. Social responsibilities, such as reducing prices of products, donations to charitable organisations, environmental initiatives and helping educational or health institutions, would create a very a good image of the company among its customers, consumers and the general communities. It also plays a role of better advertising on part of company, and likely brings good impact on the market.

However, sometimes, if it is known that a company is investing an awesome amount in societal welfare and environmental activities, this can make the interested person reluctant to buy shares of the company, adversely affecting the capital, which is an important essence for smooth running of the company's business. Roach says that 'Corporate social responsibility' may destroy the shareholder value by deflecting resources from core commercial activities<sup>3</sup>. In support of this proposition, Arsalidou comments that a social duty might be resulted in entrepreneurial risks, as the shareholders remain the primary beneficiary<sup>21</sup>. Furthermore, law is capable of setting least standards of socially responsible corporate activity. However, it cannot play more positive role in shaping social accountability because its capability is usually limited<sup>20</sup>.

**Interests of the Creditors:** Section 172(3) deals with the interests of the creditors. This duty has effect to any rule of law requiring a director to act in favor of the concerned creditors' interests<sup>21</sup>. This duty would be applied when the company is insolvent or at the door of insolvency<sup>12</sup>. As illustrated in the '*Kinsela vs. Russell kinsela pty Ltd*' [1986] 4 NSWLR 722, CA, when the company becomes insolvent, the interests of the creditors intervene and become entitled through the procedure of liquidation, stifling the shareholders and directors' power to deal with the assets of the company. Similarly, as seen in the '*Multinational Gas and petrochemical co vs. Multinational Gas and petrochemical services Ltd*' [1983] BCLC 461 case, directors owe fiduciary duties to the company, rather to the creditors, either present or future. Briefly speaking, section 172(3) makes the creditors' interests relevant when the interests of the shareholders are disappeared from consideration<sup>15</sup>.

**Liability of the Directors to the Stakeholders:** If the directors do not take into consideration the interests of one of the above discussed constituencies, and breach the provision, there as such no concrete penalty available against the directors. This is because only the shareholders, considering section 260 of the

'Derivative Claims in England and Wales or Northern Ireland' and section 265 of the 'Derivative Claims in Scotland', can bring derivative actions (subject to court approval) against the directors for breach of trust or duty on behalf of the company. Similarly, section 178 says that 'the consequences of breach ... of sections 171-177 are the same as would apply if the corresponding common law rule or equitable principal applied'. Considering common rules or equitable rules, it can be assumed that its practically not possible to make directors liable to the constituencies other than shareholders for breach of duty under section 172.

**Dismissal of the Directors by the Shareholders:** A question may be arisen that why directors in practice tended to favour shareholders' benefit maximization approach. This is because shareholders are the major capital contributors of the company. Likewise, shareholders play a vital role in the appointment of the directors. Furthermore, under section 168 of the CA 2006, directors can be removed by an ordinary resolution, before expiration of the period of their office, irrespective of any written agreement between them and the company.

## Conclusion

Section 172 is considered as one of the significant statutory enactments in the history of the UK company law, since it requires the directors to consider the interests of the stakeholders, such as suppliers, environment, community and employees, by virtue 'enlightened shareholder value' approach. However, after considering its vague language, past cases and common law rules, and intention of the Government, it has observed that the new 'enlightened shareholder value' model largely associates itself with the old 'shareholder primacy' approach, as the interests of stakeholders are made secondary to the interests of the shareholders. In theory, the duties of the directors under section 172 suit interests of both shareholders and stakeholders. In practice, however, it is mostly safeguarding the interests of the shareholders, as it is profit maximizing in nature. There is as such no concrete mechanism to scrutinize and assess the actions of directors in relation to the shareholders' interests. Thus, in nutshell, such an enactment is not bringing any greater difference to the company law in practice.

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