Section 172 CA 2006: the ticket to stakeholder value or simply tokenism?

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1. Introduction

Prior to the Companies Act 2006 (the ‘Act’), there had been no definitive legislative statement establishing the core objective of the UK ‘corporation’. A determination of the scope of company law and governance - i.e. in whose interests companies should be run - was, therefore, a critical aspect of the reform agenda. The outcome was the concept of ‘enlightened shareholder value’ (ESV). Central to the advancement of this principle is the duty of directors to promote company success under s172 of the Act. The aim of this paper is to determine whether the result has been a shift towards a stronger footing for non-member stakeholders in UK corporate governance. It begins by ascertaining whether s172 goes beyond a clarification of existing law. It then examines the new statutory derivative action and its ability to facilitate an enhanced position for stakeholders within the company matrix. Finally, the provision’s indirect impact on corporate governance and the correlative area of corporate social responsibility (CSR) will be considered. It will be contended that, ultimately, s172 achieves very little in terms of strengthening the position of broader stakeholders.

2. Section 172: Something Old, Nothing New?

An exact equivalent of s172 was absent in the common law. Nonetheless, it is clearly linked to the pivotal loyalty duty to act in good faith in the interests of the company. Section 172 is, perhaps logically, thought to be the successor of that duty. The classic formulation of the duty was made by Lord Greene, who opined: ‘(...) they [directors] must exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company (...)’ In an analogous manner, s172(1) imposes upon directors the duty to 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

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1 Company Law Review Steering Group (CLRSG), Modern Company Law for a Competitive Economy: The Strategic Framework (February 1999) [5.1.4]-[5.1.33].
2 Companies Act 2006, s 172(1).
4 Re Smith and Fawcett Ltd [1942] Ch 304 (CA) 306.
This first component is, therefore, relatively uncontroversial, and appears to be almost a verbatim codification of the common law. It does, however, avoid use of the ambiguous phrase ‘interests of the company’ and finally settles that, as was already profoundly believed, companies are ultimately to be run for the benefit of their ‘members’ i.e. shareholders. It is the second element of s172(1) which is more novel. In discharging the above duty, directors are required to ‘have regard’ to a non-exhaustive list of factors. Among these factors are: long-term consequences; employee interests; the need to foster relationships with customers and suppliers; and any impact on the community or environment. This second limb innovatively seeks to ‘(…) capture cultural change in the way companies conduct their business.’ It aspires to make decision-making more ‘enlightened’, advancing the aforementioned concept of ESV. ESV embodies the perception that the promotion of members’ interests is unlikely to be achieved if management conduct business in absence of any regard to employees, suppliers and the community in which it is situated; and without fostering relationships with these constituencies. For the first time, UK company law has formally recognised the residual risk borne by these stakeholders and so requires attention to be paid thereto. Finally, the section encourages decision-making from a long-term perspective. It, therefore, steps beyond the common law’s narrow focus on shareholder interests, which were frequently viewed in a short-term manner. In this way, it represents a development. Yet, as will become evident, it is one modest and subtle in nature.

The mandatory consideration of broader stakeholders may appear innovative. However, in terms of two of the constituencies, this is in fact a restatement of the common law. First, s172(1) makes no reference to creditors, albeit two potential categories – suppliers and employees – are listed. Subsection (3) does, however, provide that the overriding duty is subject to ‘any enactment or rule of law’ requiring directors to consider creditor interests in certain circumstances. This preserves existing statutory provisions affording creditor protection e.g. wrongful trading. Simultaneously, it recognises the common law position which imposed on directors a duty towards creditors’ in times of financial distress. This part of s172, therefore, reaffirms the existing law. By contrast, the interests of employees are expressly included. This has been viewed, not as a restatement, but actually a weakening of employees’ governance position. Directors were previously required to have regard to the interests of employees in the performance of their duties. This has been repealed and employee interests are now only to be considered to the extent that it would promote company success for members’ benefit. At the same time, however,

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5 Companies Act 2006, s 172(1).
7 Companies Act 2006, s 172(1)(a)-(f).
9 Keay, ‘The duty to promote the success of the company’ (n 3) 11.
10 Companies Act 2006, s 172(3).
11 Insolvency Act 1986, s 214.
13 Companies Act 2006, s 172(1)(b).
14 S Worthington, ‘Reforming Directors’ Duties’ (2001) 64 MLR 439, 446.
15 Companies Act 1985, s 309.
the common law duty lacked any enforcement mechanism and was generally considered a ‘lame duck’.\(^\text{16}\) Thus, the position of employees’ is retained as it is neither improved nor diluted under s172.

As highlighted, s172(1) formally obliges directors to consider stakeholder interests during the decision-making process. Yet, it is crucial to note that shareholder interests remain paramount. The interests of non-shareholding groups are to be considered only insofar as it is desirable to ‘(…) promote the success of the company for the benefit of its members.’\(^\text{17}\) A director will not be required to consider these factors beyond the point at which to do so would conflict with the overarching duty to promote company success.\(^\text{18}\) Stakeholder interests have no independent value in the consideration of a particular course of action.\(^\text{19}\) In addition, no separate duty or accountability is owed to the stakeholders included in the section.\(^\text{20}\) Thus, the duties of nurturing company success and having regard to the listed interests ‘(…) can be seen in a hierarchal way, with the former being regarded more highly than the latter.’\(^\text{21}\) Consequently, it would be wrong in principle to view s172 as requiring directors to ‘balance’ shareholders and stakeholder interests.\(^\text{22}\) These views are supported by industry guidance published on the effects of s172.\(^\text{23}\)

Finally, the Act itself states that the duties are ‘based on’ and ‘have effect in place of’ the respective common law rules and equitable principles.\(^\text{24}\) The duties are also to be interpreted and applied in the same way as those rules.\(^\text{25}\) Correspondingly, the few cases to date which address the section suggest that it simply codifies the existing law.\(^\text{26}\) This paradox – advocating a new ‘inclusive’ concept, while endorsing the old shareholder-centric common law – further impedes any potential s172 has to fortify stakeholders’ position. Section 172 can, therefore, ultimately be viewed as reiterating the prevailing shareholder-orientated approach to company law and governance.


\(^{17}\) Paul Davies, Gower and Davies’ Principles of Modern Company Law (8th edn, Sweet & Maxwell 2008) 509.

\(^{18}\) ibid.

\(^{19}\) Davies and Rickford (n 6) 66.

\(^{20}\) Keay, ‘The duty to promote the success of the company’ (n 3) 17.

\(^{21}\) ibid 19.

\(^{22}\) Davies (n 17) 509.

\(^{23}\) ICSA International, Guidance on Directors’ General Duties (2007) [3.2]

\(^{24}\) Companies Act 2006, s 170(3).

\(^{25}\) ibid s 170(4).

\(^{26}\) Re Southern Fresh Foods Ltd [2008] EWHC 2810; Re West Coast Capital (LIOS) Ltd [2008] CSOH 72.
3. The New Statutory Derivative Action: an ally or an obstruction to stakeholder participation?

If s172 is to be advocated as advancing the position of stakeholders in any way, enforcement thereof becomes greatly significant. After all, ‘(…) a right without a remedy is worthless.’ 27 A derivative claim may be brought in respect of breach of duty by a director and so, technically, s172 is potentially enforceable via this procedure. 28 But if a stakeholder believes that directors have breached s172, can they bring legal action to enforce this duty? Put simply, the answer is no. 29 This is for the plain reason that the duty under s172 is owed to the company. 30 Consequently, only shareholders, who are entitled to bring derivative proceedings on the company’s behalf in certain circumstances, are capable of taking action. 31

Stakeholders are, therefore, dependent on shareholders to challenge non-compliance. Any action is likely to turn on the existence of altruistic or activist members who are willing to represent and enforce stakeholder concerns. There are only a few perceived situations where a shareholder might do so. These include where a member: views their holding as a long-term investment and is concerned that directors are failing to promote business relations with suppliers/customers; is also an employee; lives in the same community and believes a proposed action – e.g. closure of a factory – will adversely affect constituents; has a particular community/environmental interest. 32 The result is that, save where a member has a heightened social conscience, the only anticipated proceedings are those brought by shareholders ‘(…) whose self-interest in another capacity will be affected deleteriously in some way.’ 33

The common law severely limited a shareholder’s right to bring a derivative claim. 34 The procedure was developed as a tightly-drawn exception to the ‘proper-claimant’ rule in Foss v Harbottle. 35 The Law Commission viewed the procedure as unsatisfactory: based on ‘complicated and unwieldy’ rules, with an unclear criterion for granting leave. 36 Against this backdrop, the reform proposed to establish a new derivative claim ‘(…) with more modern, flexible and accessible criteria.’ 37 The demanding standards of ‘fraud on the minority’ and ‘wrongdoer control’ have,

28 Companies Act 2006, s 260(3).
30 Companies Act 2006, s 170(1).
31 ibid s 260(1).
32 Keay, ‘Tackling the Issue of the Corporate Objective’ (n 16) 609.
33 ibid.
35 Foss v Harbottle (1843) 67 All ER 189.
37 ibid [6.15].
therefore, been discarded in favour of general court discretion.\textsuperscript{38} Fundamentally, there is also now a presumptive right to claim if the requisite conditions are met.

Nonetheless, a number of obstacles exist to potentially deter a shareholder from mounting proceedings and so from pursuing stakeholder interests. These include the length and complexity of the process itself. Claimants must first establish that there is a \textit{prima facie} case.\textsuperscript{39} If accepted, the claim proceeds to a full hearing for permission to take a derivative claim. Section 263(2) sets out circumstances in which the court must dismiss an application, with s263(3) listing six factors that the court is to consider when determining whether an application should succeed. The novelty is that it places the decision of whether commencing litigation is in the interests of the company with the court.\textsuperscript{40} It is at this second stage that most claims will likely fail due to the breadth of this discretion.\textsuperscript{41} The latter can be allied with a general judicial reluctance to second-guess business judgements. The courts have made it clear that they will not use hindsight\textsuperscript{42} and litigants must still face the traditional suspicion of the courts towards these claims.\textsuperscript{43} In addition, it will be hard to avoid the second stage turning into a mini-trial and so unduly lengthening preliminary proceedings. Finally, the claim is still framed in a manner which favours management, however permissive its terms might appear.\textsuperscript{44} As was intended, derivative claims continue to be subject to ‘tight judicial control’.\textsuperscript{45} They remain a ‘weapon of last resort’.\textsuperscript{46}

Cost is another practical hurdle facing shareholder litigants and acts as a major disincentive to those seeking to bring a claim.\textsuperscript{47} Legal aid has never been available and any award will be made to the company. The general common law position on costs/fee rules also remains unchanged. The latter is an area that needs to be re-evaluated if any real change is to occur.\textsuperscript{48} In light of the aforementioned complexities, there is nothing in the new procedure to incentivise members to embark on litigation. Instead, discontented shareholders will likely sell their holding and re-invest in a company more aligned with their values.

Even if a claim is permitted to proceed, it is anticipated that breach of s172 will be difficult to prove. This is because directors appear to have unfettered discretion in discharging this duty.\textsuperscript{49} It is for directors, not the court, to determine what the

\textsuperscript{39} Companies Act 2006, s 261(2).
\textsuperscript{40} Davies (n 17) 614.
\textsuperscript{41} Alan Dignam and John Lowry, \textit{Company Law} (5th edn, OUP 2009) 190.
\textsuperscript{42} Re Welfab Engineers Ltd [1990] BCC 600.
\textsuperscript{44} \textit{Ibid} 224.
\textsuperscript{45} Law Commission (n 36) [6.13].
\textsuperscript{46} D Gibbs, ‘Has the statutory derivative claim fulfilled its objectives? The hypothetical director and CSR: Part 2’ (2011) 32 Co Law 3 76, 82.
\textsuperscript{47} Dignam and Lowry (n 41) 190-191.
\textsuperscript{48} Reisberg (n 43) 239.
\textsuperscript{49} D Fisher, ‘The enlightened shareholder – leaving shareholders in the dark: will s172(1) of the Companies Act 2006 make directors consider the impact of their decisions on third parties?’ (2009) 20 ICCLR 1 10, 15
interests of shareholders are, as well as the extent to which it is appropriate to consider stakeholders in the promotion thereof. Exactly what will promote company success and, indeed, what constitutes ‘success’, are also matters for the director’s own judgement. There is also no requirement to guarantee success. In response to any claim, directors will inevitably contend that they did have regard to the relevant constituencies and simply believed that the action taken promoted the company’s success for its members’ benefit. If so, it will be strenuous to successfully assert otherwise. Interpretation and application of the section generally are also somewhat problematic given that core terms are not clearly defined. Again, the consensus appears to be that the operation of the individual components of s172 is to be left to directors and their good faith judgment. Furthermore, s172 explicitly suggests a highly subjective compliance test – requiring a director to act in the way ‘he regards’ to be most likely to promote company success. As a consequence, there is no definite standard against which to judge any given action. Taken as a whole, it is difficult to anticipate situations in which directors will be held in breach of this obligation.

Finally, it may be asserted that since both present and future members can potentially instigate a derivative claim, stakeholders could simply buy shares. Despite this possibility, the required consideration of whether the claimant is acting in good faith should filter out any vexatious claims. The procedural requirements generally are a further restraint on activist groups purchasing shares and claiming their ‘pet’ interest has not been rightfully considered. Fundamentally, it is also believed that members who have purchased shares purely to bring derivative claims will be met by a hostile judiciary. It is, therefore, unlikely that the courts will allow derivative action to become a vehicle for activists. The aforementioned points illustrate that not only will proving non-compliance be a cumbersome threshold, but there may be no one able, or even willing, to commence actual proceedings. Thus, it is highly questionable whether the statutory derivative action will support s172 in directing a stronger position for broader stakeholders in corporate governance.

51 Davies (n 17) 514.
53 Keay, ‘Tackling the Issue of the Corporate Objective’ (n 16) 609.
54 Keay, ‘Moving Towards Stakeholderism?’ (n 50) 30.
56 Companies Act 2006, s 260(4).
57 ibid s 263(3)(a).
59 Reisberg, ‘Derivative Claims’ (n 52) 361.
4. CSR: the only viable route to stakeholder influence?

Notwithstanding these doubts, s172 may serve to indirectly strengthen the position of broader stakeholders. Keay asserts that the explicit inclusion of stakeholders in s172 may persuade boards to take into account their interests in a more conspicuous manner than was previously the case.\textsuperscript{60} Others are of the opinion that it does not enshrine any radical change, given that large corporations were already taking into account broader stakeholder interests.\textsuperscript{61} Certainly, most large companies already disclosed adherence to CSR strategies and so s172 may be regarded as codifying existing commercial practices. Either way, what it does do is to statutorily recognise the importance of CSR. It emphasises that corporations do not operate in a vacuum; their activities impact and are impacted by a variety of stakeholders.\textsuperscript{62} To this extent, s172 may be viewed as a normative measure which, when combined with stakeholder/media pressure, will encourage more inclusive decision-making.\textsuperscript{63}

In a similar way, the obligation to produce an annual Business Review may to some extent compensate for the sections’ lack of direct enforceability.\textsuperscript{64} Its stated purpose is to inform members how directors have performed their duty under s172.\textsuperscript{65} Crucially, it requires disclosure of information and policies on matters including the environment, community and company employees.\textsuperscript{66} It, therefore, provides the information and transparency needed to underpin a more inclusive approach to governance and also establishes a ‘mutually reinforcing’ link between directors’ duties and narrative reporting. It is unfortunate that it lacks the comprehensive guidance framework and reporting standards that featured in the originally proposed OFR. Nevertheless, requiring information on how a company is run may have its own value. Naturally, companies would not wish to have to make public that they do not respect or consider broader stakeholders. Reputation is, after all, vital to corporate success.

Fundamentally, however, stakeholders are not granted any rights under company law or included within the UK corporate governance model. In respect of any purported breach of duty, stakeholders will ultimately need to rely on protection afforded to them by specific employment, insolvency or environmental legislation. Indeed, this is where the CLRSG believed certain safeguards to lie.\textsuperscript{67} A core governance concern is directorial accountability and consequently the appropriate allocation of rights to those affected by corporate activity. From this perspective, the\textit{status quo ante} – significant discretion and power to the board, with correlative rights for shareholders – remains intact.

\textsuperscript{60} Keay, ‘Moving Towards Stakeholderism?’ (n 50) 40.
\textsuperscript{61} Alcock (n 58) 368.
\textsuperscript{63} Fisher (n 49) 16.
\textsuperscript{64} Companies Act 2006, s 417.
\textsuperscript{65} ibid s 417(2).
\textsuperscript{66} ibid s 417(5).
\textsuperscript{67} CLRSG, \textit{Modern Law for a Competitive Economy: Developing the Framework} (March 2000) [2.12].
5. Conclusion

Section 172 provides the first legislative mandate as to in whose interests’ directors are to act. The underlying corporate objective of ‘enlightened shareholder value’ is intended to foster an inclusive approach to business relationships. Accordingly, s172 formally requires directors to have regard to broader stakeholders. It may at first blush appear to elevate stakeholders to a higher standing. But the ‘devil is in the detail’. Any consideration must be such that it does not impinge on shareholder benefits. The crux of the section is an overarching duty to promote company success for the benefit of its members. Such will be the determining question in any decision subsequently challenged. Moreover, and fatal to the hope of any stronger footing for broader stakeholders, is the absence of any enforcement mechanism. For non-member stakeholders, s172 is, therefore, a paradigmatic example of the realism that ‘(…) a duty is only as useful in law as it is enforceable’. As suggested, it is highly unlikely that shareholders will undertake an uncertain, complex and costly derivative claim on their behalf. Hence, both the ‘new’ duty and derivative claim fall substantially short of strengthening stakeholders’ position in corporate governance. Consequently, the economic agency relationship – directors as agents and shareholders as principals – continues to dominate UK corporate governance. In short, ‘(…) protection of the interests of stakeholders is left not to any specific rights (…) but wholly to the discretion of directors.’

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68 Keay, ‘Moving Towards Stakeholderism?’ (n 50) 28.
70 Keay, ‘Moving Towards Stakeholderism?’ (n 50) 35.