**Centre for Business Law & Practice**
**School of Law**
**University of Leeds**

# BUSINESS LAW & PRACTICE REVIEW

# 2004 – 2005

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## 1. ABOUT THE CENTRE

The Centre for Business Law and Practice is located in the School of Law at the University of Leeds and its aim is to promote the study of all areas of Business Law and Practice, understood as the legal rules which regulate any form of business activity. It seeks to promote all forms of research, including doctrinal, theoretical (including socio-legal) and empirical research and to develop contacts with other parts of the academic world, as well as the worlds of business and legal practice in order to enhance mutual understanding and awareness. The results of its work are disseminated as widely as possible by publishing monographs, articles, reports and pamphlets as well as by holding seminars and conferences with both in-house and outside speakers.

Staff members have acted as consultants to law firms, accounting bodies and international bodies such as the International Monetary Fund. Research has been undertaken in many areas of business law including banking and financial services, business confidentiality, corporate (general core company law as well as corporate governance and corporate finance), employment, financial institutions, foreign investment, insolvency, intellectual property, international trade, and corporate and economic crime (including money laundering and the financing of terrorism).

One of the primary functions of the Centre is to oversee the research undertaken at postgraduate level and to manage postgraduate taught programmes in International and European Business Law. In addition, the Centre offers several undergraduate business law modules to law and non-law students.

## 2. INTRODUCTION

This report covers the activities of the Centre for Business Law and Practice ("the Centre") during the period from August 2004 until August 2005. The Centre has been gradually expanding the scope of its activities, and this was very much in evidence in the 2004/2005 year. The Centre is now in a position to develop strongly as a result of the increased number of staff who are members and we look to the future with confidence. The past year has been another very productive year for the Centre in terms of activity of staff, research, research outcomes and growth of its postgraduate taught programmes and postgraduate research students. The publications of members of the Centre once again manifest the finalisation of some very high quality and relevant research work which spans diverse parts of business law. The number of postgraduate students recruited (for both doctoral research and taught masters programmes) indicates the popularity and strength of the Centre's programmes and is testimony to the standing of the Centre's staff.

In accordance with the aim of the Centre to broaden its activities, within its remit, a series of high profile lectures took place during the period under review and we intend to continue to do this again in future years. Plans have been put in place for the Centre to invite some internationally renowned speakers during the academic year 2005/2006. During the year under review speakers presented seminars on a variety of business law topics: money laundering and lawyers; employment issues relating to the transfer of businesses; recent developments in insolvency law; the role of the United Kingdom in world financial law and the recent case law and other developments in the international syndicated loans markets. The seminar series is designed to appeal to the legal profession, business professionals (including bankers and directors), academics and students, both undergraduate and postgraduate. The seminars attracted large audiences and we were pleased at the response from the legal community in West Yorkshire. The seminars were also popular with our own postgraduate and undergraduate students, whose learning experience was enriched by being able to hear, and ask questions of, internationally acclaimed speakers on the relevant matters addressed.

The Centre has enjoyed links with the Leeds University Business School, including the sharing of Academic Fellowships and discussions on research objectives. Two members of the Business School act as members of the Executive of the Centre. The Centre has also been in dialogue with legal practitioners in Leeds in order to improve links between the Centre and practice and to establish how the Centre might serve the interests of those in the legal profession who practice in the business law field. There have been some discussions concerning the possibility of law firms sponsoring certain research projects.

At the end of the year under Review Andrew Keay handed over the directorship to me and I am pleased to be supported by Roger Halson as Deputy Director.

**Andrew Campbell**
**Director of the Centre for Business Law and Practice**

**November 2005**

# 3. RESEARCH DEGREES AND TEACHING PROGRAMMES

## A. Research Postgraduates

The Centre is keen to supervise postgraduate research students in any of the areas of business law in which it has expertise. Business law is a broad area of the law and the Centre is able to offer supervision in a wide range of business law and business law-related fields because its staff members have undertaken research in diverse fields with the use of various research methodologies. The Centre offers supervision at the level of Doctor of Philosophy (Ph.D.), Master of Philosophy (M.Phil) and Master by Research (M.Res). The Ph.D involves the writing of a major piece of research, namely a thesis of up to 100,000 words. The M.Phil also involves the writing of a thesis, but of up to 60,000 words. Finally, the M.Res involves the writing of a thesis of up to 30,000 words. Both Ph.D and M.Phil theses are written under the supervision of a member of staff with the appropriate expertise. We have excellent study facilities and the University provides for full training in all aspects of research. The Director of the Centre, Andrew Campbell (a.campbell@leeds.ac.uk) is always happy to discuss research proposals with prospective candidates.

## B. Taught Postgraduate Programmes

During the academic year 2004 – 2005 the Centre offered several programmes, all majoring in International and European Business Law. The most popular were the Master of Laws (LL.M.) and the Master of Arts (M.A.). The LL.M is for those who hold an undergraduate law degree (commonly an LL.B) and the M.A. for those who hold an undergraduate degree in some discipline other than law. In the next academic year 2005 – 2006 there will be significant changes to the programmes offered and details of these will be contained in next year's report but in the meantime can be accessed at www.law.leeds.ac.uk .

In all programmes, modules are taught by seminars, and there are two 11 week semesters in each academic year. Assessments are by written work.

The numbers of people applying for entry into the LL.M and M.A. programmes has been increasing significantly over the past couple of years, as have the number of students actually registered. A high proportion of the students enrolled are foreign students who come to Leeds from a wide range of countries.

### *The Master of Laws in International and European Business Law*

This LL.M. programme involves the completion of some compulsory modules (60 credits) that are taken in Semester 1, and some optional modules (60 credits) that are taken in Semester 2, with a dissertation (worth 60 credits) being completed in the Summer following Semester 2. (180 credits in total) In the compulsory modules students undertake a study of principles and rules that are able to provide foundations for both the study of more specialised modules in Semester 2, and the writing of the dissertation.

The compulsory modules consist of modules that are believed to form a critical base for the study of business law, nationally and internationally. Students have a broad choice when it comes to the optional modules, and this reflects the breadth of expertise in the Centre.

The dissertation, constituting 60 credits, is a compulsory and major part of the programmes, and reflects one of the aims of the programme, namely to foster research capabilities. The dissertation requirement permits students to engage in some detailed research of a particular issue that warrants investigation. Research for, and the writing of, the dissertation is undertaken in conjunction with a supervisor, who is a member of the law staff. The members of the law staff have a wide range of research interests and are able to supervise a broad spectrum of topics in different areas of the law.

The overall objective of this programme is to provide students with a firm grounding in many of the basic principles and rules regulating business activity in the UK Europe and around the world. The programme also aims to enable students to develop the following: analytical legal skills, ability to work independently, writing skills, and ability to undertake research. The compulsory modules are European Business Law, Business and Institutional Transactions Law, Insolvency Law and Research Methods.

The entry requirement is a good Honours degree in law.

***The Master of Arts in International and European Business Law***

The structure of the programme is the same as for the LL.M, with mandatory modules, optional modules and a dissertation.

The overall objective of this programme is to provide students with a firm grounding in many of the basic principles and rules regulating business activity in the UK, Europe and around the world. Also, the aim is for students to develop skills in legal analysis, writing and presentation, and independent research. The compulsory modules are European Business Law, Business and Institutional Transactions Law, Corporate Law and Research Methods.

The entry requirement is a good Honours degree in any discipline.

***The Diploma in International and European Business Law***

Students need 120 credits for the completion of the programme. The framework is the same as for the LL.M or M.A. except that no dissertation is written. The same entry requirements exist as for the LL.M or the M.A.

***The Certificate in International and European Business Law***

Students need to pass 60 credits for the completion of the programme. These credits are the compulsory modules for the Masters degree.

The same entry requirements exist as for the LL.M or the M.A.

As mentioned above the Centre has decided to introduce important changes to the programmes for the new academic year 2005 – 2006 and details of these will be included in next year's Review. These changes are aimed at giving a wider choice of options to students and to ensure that we are providing an up-to-date and meaningful range of courses for students.

**C. Undergraduate Teaching**

While the Centre does not directly run any undergraduate programmes, it makes an important contribution to teaching of the Bachelor of Laws degree, in particular. The Centre has developed modules that are taught to both law and non-law undergraduates. These modules have been very popular with students, and have attracted good enrolments. The modules that are taught in the Bachelor of Laws programme (although students from other programmes with the necessary prerequisites can enrol for them) are Business Law, Company Law, Banking and Financial Services Law, Intellectual Property Law, Employment Law, and Corporate Finance and Insolvency. Members of the Centre also either act as leaders, or contribute to the teaching, of the following modules : Law of Contract, International Law, Equity and Trusts, Constitutional Law and Jurisprudence. Offerings to non-law students include Introduction to Company Law and Introduction to Obligations.

## 4. GENERAL ACTIVITY

There have been some notable achievements by members of the Centre in the past year, and not always reflected in a published piece, that are worthy of mention. What follows is a selection of some of the activities of the Centre and its members.

**Andrew Campbell** has acted as Consulting Counsel to the Legal Department of the International Monetary Fund. In this capacity he has provided expert advice on the reform of bank insolvency laws. He also participated in a conference at the Kuwait Institute for Judicial and Legal Studies in December 2004 on *Financial Regulations Relating to the Banking and Financial* Sector. He presented sessions on bank insolvency issues at the *Financial Transactions for Lawyers* seminars held at the Joint Vienna Institute in April 2005, organised by the Legal Department of the International Monetary Fund and the IMF Institute. He also participated in a Seminar on *Creditor Rights in Emerging Economies* at the IMF Regional Training Institute in Singapore in August 2005. The participants were officials of central banks and government departments from a number of developing countries (mainly from the republics of the former Soviet Union and from south-east Asia). In his position of Convenor he organised, with his co-convenor Joanna Gray of the University of Newcastle, the Banking and Financial Services Law Subject Section of the Society of Legal Scholars at the Annual Conference at the University of Sheffield in September 2004.

**Jane Frecknall-Hughes** has acted as academic adviser to the National Audit Office, with reference to their proposed programmes of auditing various streams of taxation revenue. She is President of the Tax Research Network (TRN), which is the only academic network of tax researchers in the UK, its key aim being to promote taxation research. The TRN comprises approximately 400 members, including 180 UK tax academics, 80 representatives from the HM Revenue & Customs, including heads of departments and government policy advisers. It also includes 50 members from the accounting institutes, policy-makers, and 90 leading tax academics from overseas.

**Roger Halson** submitted a formal response to the Law Commission's Consultation Paper into Unfair Terms in Contracts which was acknowledged in their Final Report and proposed legislation (Law Com No 292) published in 2005. He was granted study leave for Semester 2 2004-5 in order to pursue a historical and policy based study of penalty and liquidated damages clauses. He is currently completing an article based upon this study. In recent years there has been a seemingly irresistible convergence between the law relating to liquidated damages clauses and the forfeiture of deposits and advance payments which has been almost unanimously endorsed by academic studies and law reform bodies. Roger Halson is currently completing a major article that uses modern behavioural decision theory to challenge this development. He accepted an invitation to visit the University of Canterbury in New Zealand to deliver a paper on Contract Law and the Textbook Tradition. The paper will be published as an article in the Canterbury Law Review in 2005-6.The Texas Wesleyan Law Review published a Symposium on The Common Law of Contracts As a World Force in Two Ages of Revolution: A Conference Celebrating the 150$^{th}$ Anniversary of *Hadley v Baxendale* (2005 11(2) Tex Wesleyan L Rev) including a Roundtable Discussion with contributions from Roger Halson.

**Andrew Keay** had a busy time in his final year as Director of the Centre both in relation to the administration of the Centre and in a wide range of academic activity. He made a successful application to the Arts and Humanities Research Board under its Study Leave Scheme and has been granted study leave by the School of Law for the academic year 2005/2006. The purpose of the study leave grant is to assist in the completion of a book on the responsibility of company directors responsibilities to the creditors of the company. He has been involved with the Insolvency Lawyers' Academic Interest Group. He acted as a member of the Nominations Committee of the Society of Legal Scholars and as a member of the Panel of Academic Advisers of the Commonwealth Scholarship Commission. He acted as a member of the Advisory Boards for the journals *Insolvency Intelligence* and the *QUT Law and Justice Journal*.

**Dr. Paul Lewis** is a senior lecturer in Leeds University Business School who has been undertaking research into the difficulties faced by small firms with regard to contractual relationships. He has also been working on a study of human rights and the litigant in person in the county court as well as revisiting the theory of the small claims procedure.

**John McMullen** was a member of the Council of the Advisory Conciliation and Arbitration Service. He is Editor of the Oxford University Press' *Employment Practitioner Series.*

**Surya Subedi** was made an honorary OBE by HM the Queen for his services to international law. He was invited to take up the inaugural Ingram Visiting Fellowship at the Faculty of Law of the University of New South Wales, Sydney, Australia in 2005 in recognition of his contribution to international law and development. During his visit to Australia he was also invited to give lectures at the Australian National University, Canberra and the University of Sydney. He gave a major public lecture at Metcalfe Auditorium of the State Library in Sydney. The WTO Dispute Settlement Body has decided to include him in its roster of Panellists on the nomination of the Government of Nepal. He acted as a consultant to : Mishcon de Reya, a commercial law firm in the City of London on international law of trade and investment matters; Associates for Research & Resources Development Ltd. (London) on Foreign Investment Law and Policy in Africa; the Ministry of Foreign Affairs of Indonesia on the strengthening of the teaching of international law in Indonesia; the Nepalese Ministries of Law and Justice and Foreign Affairs in relation to treaty-making law and practice. Surya Subedi also acted as a member of the International Law Association's Committees on International Law on Sustainable Development, and Water Resources.

## 5. PUBLIC LECTURE SERIES

**The Centre** ran a series of public lectures which attracted large audiences consisting of undergraduate and postgraduate students as well as legal practitioners, both solicitors and barristers. Each lecture attracts Continuing Development Points (one hour for each lecture) for both the Law Society and the Bar Council.

The speakers were:

- Ross Delston, of the Legal Department of the International Monetary Fund, Washington, D.C. - *The Role of the Legal Profession in the Anti-Money Laundering Framework: Are Lawyers the New Guardians of Governance?* October 11th 2004.
- Stephen Davies Q.C. - *Recent Developments in Insolvency Law: Keeping your Eye on the Right Ball*. December 7th 2004.
- Prof. John McMullen – *The New Law on Transfer of Undertakings: Balancing the Interests of Management and Labour*. November 16th 2004.
- Philip Wood, Partner, Allen & Overy, Solicitors, London. – *World Financial Law & the Role of the United Kingdom*. February 22nd 2005.
- Prof. Agasha Mugasha – *International Syndicated Loans – Recent Case Law and Other Developments.* February 8th 2005.

# 6. RESEARCH ACTIVITY

Members of the Centre have been very active undertaking research during the period under review. Members have presented conference papers in the U.K. and overseas, published articles in a range of journals and have had chapters published in books.

What is included here is a sample of published research and conference papers given. Members of the Centre are actively working at present on a wide range of projects

Published work includes:

**Andrew Campbell**

- 'Issues in Cross-Border Insolvency: The European Directive on the Reorganization and Winding-Up of Credit Institutions' in *Current Developments in Monetary and Financial Law Vol. 3* (2005) (IMF, Washington, D.C.) 515 – 535;
- 'Protecting Bank Depositors: Some International Comparisons' in (2005) *Contemporary Issues in Law* 140 -156 and "Emergency Liquidity Financing by Central Banks: Systemic Protection or Bank Bailout?" in *Current Developments in Monetary and Financial Law Vol. 3* (2005) (IMF, Washington, D.C.) 429 – 441 and 961 – 976. (With Ross Delston).

**Roger Halson**

- The *Texas Wesleyan Law Review* published a Symposium on The Common Law of Contracts As a World Force in Two Ages of Revolution: A Conference Celebrating the 150th Anniversary of *Hadley v Baxendale* (2005 11(2) Tex Wesleyan L Rev) including a Roundtable Discussion with contributions from Roger Halson.
- He submitted a formal response to the Law Commission's Consultation Paper into Unfair Terms in Contracts which was acknowledged in their Final Report and proposed legislation (Law Com No 292) published in 2005.

**Andrew Keay**

- "What Future for Liquidation in Light of the Enterprise Act Reforms?" [2005] *Journal of Business Law* 143-158;
- "Making Company Directors Liable : A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia" (2005) 14 *International Insolvency Review* 27-55 (with Michael Murray);
- "A Theoretical Analysis of the Director's Duty to Consider Creditor Interests : The Progressive School's Approach" (2004) 4 *Journal of Corporate Law Studies* 307-344; "Do Recent Canadian Developments Require a Re-Think in the United Kingdom on the Issue of Directors' Duties to Consider Creditor Interests?" (2005) 18 *Insolvency Intelligence* 65-68.

**Joan Loughrey**

- "Legal Advice Privilege and the Corporate Client" in (2005) 9(3) *International Journal of Evidence and Proof* pp. 183 – 203;
- "The Confidentiality of Medical Records: Informational Autonomy, Patient Privacy and the Law" in (2005)

**Surya Subedi**

- "The Challenge of Managing the `Second Agricultural Revolution' through International Law: Liberalization of Trade in Agriculture and Sustainable Development", in Nico Schrijver and Friedl Weiss (ed.), *International Law and Sustainable Development: Principles and Practice* (International Law Association, Dutch Branch and the University of Amsterdam), Martinus Nijhoff Publishers, The Hague, 2004, pp.161-184.
- "The Legal Regime Concerning the Utilization of the Water Resources of the River Ganges Basin" in (46) *German Yearbook of International Law* (2004) p. 452 – 493;
- "The Problems and Prospects of Offshore Banking in Nepal" in 34 (141) *Nyaydoot* (A bi-monthly *Journal of the Nepal Bar Association* (English Special Issue of 2004), pp. 1 – 8.

## Conference Papers and Public Lectures

Members of the Centre were very active in giving conference papers and public lectures and this is a selection:

**Andrew Campbell**

- "Emergency Liquidity Finance to Banks in Distress" to the Annual Conference of the Society of Legal Scholars at University of Sheffield in September, 2004.
- "Money Laundering: Lawyers as Launderers?", Chinese People's Security University, Beijing, China, May 2005
- "Money laundering and China: Some Developments", Heilongjiang University, Harbin, China, May 2005.

**Andrew Keay**

- "The State of Liquidation in Light of the Enterprise Act 2002" presented at Insolvency Conferences, held in Manchester (October 2004) and Leeds (February 2005) and organised by Exchange Chambers.
- "Wrongful Trading : A Theoretical Perspective" presented at the Society of Legal Scholars' Conference held at the University of Sheffield (13 September 2004).

**Roger Halson**

- He accepted an invitation to visit the University of Canterbury in New Zealand to deliver a paper on Contract Law and the Textbook Tradition. The paper will be published as an article in the Canterbury Law Review in 2005-6.

**Surya Subedi**

- "A Critique of the Human Rights Policy of the World Bank and the IMF" presented at an International Conference on Human Rights and Development: Approaches to the Reform of Governance in Asia, at the School of Law, City University, Hong Kong, 9 May 2005.

- `The Social Dimension of Free Trade', delivered at the *Doha Forum on Democracy and Free Trade,* organised by the Government of Qatar in Doha on 29 March 2005.
- "Law of the Sea and Environmental Protection", remarks made as the Chair of a panel at a Symposium on the Law of the Sea organised jointly by the University of Hull Law School and British Institute of International and Comparative Law in London, 22nd March 2005.
- "UN Reform and the UN Secretary-General's High-Level Panel Report", remarks made as a Resource Person at a public forum on UN Reform organised jointly by the Foreign and Commonwealth Office and the United Nations Association at the Leeds Civic Hall, Leeds, 17th March 2005.
- `Erosion of State Sovereignty under the Law of Foreign Investment: The Challenge of Balancing Investment Protection with Environmental Protection' presented as a Key Note Speaker at an international conference on "Issues of International Legal Trade Policy and Implementation: Challenges for the World Trade Organisation", organised jointly by University of Hull and the Free University of Brussels (VUB), Brussels, 23 November 2004.
- `The Role of the World Bank in Promoting Human Rights', a seminar presentation at the Faculty of Law, University of Sydney, Sydney, Australia, 29 August 2005.
- `A Critique of the Human Rights Policy of the World Bank and the International Monetary Fund', a seminar presentation at the Centre for International and Public Law, Australian National University, Canberra, Australia, 26 August 2005.
- `Levelling the Playing Field: Is the GATT/WTO system up to it?' a public lecture delivered at Metcalfe Auditorium, State Library of New South Wales, Sydney, Australia (organised by the Faculty of Law, University of New South Wales) on 24 August 2005.
- `The Law of Foreign Investment and Developing Countries' a talk delivered at a senior/staff seminar at the Faculty of Law, University of New South Wales, Sydney, Australia, on 23 August 2005.
- `Sustainable Development and the Law of Natural Resources', a research seminar presentation at the Faculty of Law, University of New South Wales, Sydney, Australia, 18 August 2005.

## 7. EDITORIAL WORK

Many members of the Centre are actively involved as members of editorial boards and editorial activity includes:

**Campbell, A.,** Member of the Editorial Boards of the *Journal of International Banking Regulation; the Journal of Money Laundering Control*; and *Amicus Curiae* (Institute for Advanced Legal Studies).

**Keay, A. ,** Member of Editorial Boards of *International Insolvency Review* **(**Wiley), *Insolvency Law Journal* **(**Law Book Co)., *Insolvency Intelligence* **(**Sweet and Maxwell) and *QUT Journal of Law and Justice* (Queensland University of Technology)**.**

**McMullen J.,** General Editor, *Employment Practitioner Series*, Oxford University Press.

**Subedi, S.,** General Editor, *Asian Yearbook of International Law* (Martinus Nijhoff, the Netherlands).

**Walker, C**., Member of the board of editors, *International Journal of Risk Management* (Perpetuity Press).

# 8. WORKING PAPERS BY CBLP MEMBERS

The following papers represent aspects of the work of some of the members of the Centre for Business Law & Practice during 2004 – 2005.

## FORMULATING A FRAMEWORK FOR DIRECTORS' DUTIES TO CREDITORS : AN ENTITY MAXIMISATION APPROACH


## ANDREW KEAY[*]


I. INTRODUCTION

It is now well settled in English law,[1] as well as in several other common law jurisdictions,[2] that when their company is in some form of financial difficulty, directors cannot ignore the interests of their companies' creditors, but rather they have a duty to their company to consider those interests. This is all well and good, but while this general principle has been stated on many occasions by various courts, the courts have been slow to define important aspects of this responsibility. There are two major issues that have not been clarified. The first is : from what point is the duty to consider creditor interests imposed on directors? There has been no unanimous judicial pronouncement on this issue, and this has produced some uncertainty.[3] We know with some certainty that the duty does not operate where a company is clearly solvent.[4] At the other extreme, we have certainty in that courts have said that the duty does apply where a company is insolvent.[5] However, there have been several

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* Professor of Corporate and Commercial Law, Centre for Business Law and Practice, School of Law, University of Leeds.


1 *Brady v Brady* (1988) 3 B.C.C. 535; *Liquidator of West Mercia Safetywear v Dodd* (1988) 4 B.C.C. 30; *Facia Footwear Ltd (in administration) v Hinchliffe* [1998] 1 B.C.L.C. 218; *Re Pantone 485 Ltd* [2002] 1 B.C.L.C. 266; *Gwyer v London Wharf (Limehouse) Ltd* [2003] 2 B.C.L.C. 153; [2002] EWHC 2748; *Re MDA Investment Management Ltd* [2004] 1 B.C.L.C. 217 ; [2004] B.P.I.R. 75; [2003] EWHC 227 (Ch).

2 Such as in the Republic of Ireland (*Re Frederick Inns Ltd* [1991] I.L.R.M. 582 (Irish H.C.) and affirmed at [1994] I.L.R.M. 387 (Irish S.C.); *Jones v Gunn* [1997] 3 I.R. 1; [1997] 2 I.L.R.M. 245 (Irish H.C.), Australia (*Ring v Sutton* (1980) 5 A.C.L.R. 546; *Grove v Flavel* (1986) 4 A.C.L.C. 654; 11 A.C.L.R. 161; *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 A.C.L.C. 215; (1986) 10 A.C.L.R. 395; *Jeffree v NCSC* (1989) 7 A.C.L.C. 556; 15 A.C.L.R. 217; *Galladin Pty Ltd v Aimnorth Pty Ltd (in liq)* (1993) 11 A.C.S.R. 23; *Spies v the Queen* (2000) 201 C.L.R. 603; (2000) 173 A.L.R. 529) and New Zealand (*Re Avon Chambers Ltd* [1978] 2 N.Z.L.R. 638; *Nicholson v Permakraft (NZ) Ltd* (1985) 3 A.C.L.C. 453; *Hilton International Ltd (in liq) v Hilton* [1989] N.Z.L.R. 442).

3 The issue is discussed in detail in A. Keay, "The Director's Duty to Take into Account the Interests of Company Creditors : When is it Triggered?" (2001) 25 Melbourne University Law Review 315.

4 *Brady v Brady* (1987) 3 B.C.C. 535 ; *Liquidator of West Mercia Safetywear v Dodd* (1988) 4 B.C.C. 30. A position clearly accepted in the United States : *In re Revco D.S Inc* (1990) 118 B.R. 468 (Ohio).

5 *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 A.C.L.C. 215; (1986) 10 A.C.L.R. 395; *Liquidator of West Mercia Safetywear v Dodd* (1988) 4 B.C.C. 30; *Re Pantone 485 Ltd* [2002] 1 B.C.L.C. 266, 285; *Gwyer v London Wharf (Limehouse) Ltd* [2003] 2 B.C.L.C. 153, 178; [2002]

decisions that have held that the duty might arise where companies are not insolvent, but in some form of financial distress, perhaps where the company is near insolvency, of doubtful solvency, there is a risk of insolvency or the company is in financial difficulty. The problem is that we do not know exactly at what point directors are to be responsible. It has been argued, in an attempt to try and make the operation of the duty more precise, that a director is under the duty, and consequently must consider creditor interests, when it can be reasonably expected that the action upon which he or she is going to embark could lead to the insolvency of the company.[6]

The second critical aspect of the operation of the duty, and one that this article seeks to tackle, is that the law has failed to define in what way directors are to act when they are subject to a duty to take into account creditor interests? What does it mean to say that directors are to consider creditor interests? The fact of the matter is that there are profound difficulties in working out how such a responsibility would operate, and this is one of the primary reasons for some commentators criticising the imposition of a responsibility on directors. Professor Len Sealy has stated that when you have a position where duties are owed to different persons, "with potentially opposed interests, the duty bifurcates and fragments so that it amounts ultimately to no more than a vague obligation to be fair…"[7] The essential problem is that, hitherto, directors have been given few signposts by the courts. This is recognised by one commentator, who has said that the nature of the duties of directors, when subject to an obligation to consider creditor interests, are "vague and diaphanous."[8]

The main concern of those directors who are aware of their responsibilities, and that may not, admittedly, be a large portion of all directors, is that there is no certainty for them. These directors know that at some stage in the future their actions *might* be reviewed by a court. This issue is a governance issue that follows from the fact that the directors' duty is not one owed to creditors, but to the company, so it is not creditors alone whom directors have to consider when subject to the responsibility addressed in this article. The article examines the issues raised above, elaborating on the problems encountered by directors, and formulates a framework for determining how the actions of directors should be evaluated. This should go some way to enabling directors to know what to do or what not to do in order to avoid liability, as well as providing some specific points on which courts may base their decision as to whether directors have breached their duty.

Part II of the article briefly articulates the nature of the duty that is owed by directors when creditor interests intrude. Part III addresses some of the issues that apply when directors are obliged to take into account creditor interests, and then it examines how directors are to operate when their company is insolvent. Following this, the Part then moves on to discuss the problems associated with the idea that when under this responsibility to creditors the directors have to balance both the interests of shareholders as against those of the creditors, and the interests of creditors *inter se*.

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EWHC 2748, para 74. Again, a position clearly accepted in the United States : *Geyer v Ingersoll Publications Co* 621 A. 2d 784 (1992) (Delaware).

6 Above, n 3 at.334-338.

7 L. Sealy, "Director's Wider Responsibilities – Problems Conceptual Practical and Procedural" (1987) 13 Monash University Law Review 164 at 175.

8 Harvey Miller, "Corporate Governance in Chapter 11 : The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations" (1993) 23 Seton Hall Law Review 1467.

Part IV then formulates a framework, known as the entity maximisation approach, which can be used for determining how directors are to act when obliged to take into account creditor interests. Part V briefly considers the situation where directors disagree with a course of action at a time when they have to consider creditor interests. Finally, Part VI offers some concluding remarks. It is important to note that the article does not seek to address the normative issue of whether directors should have to consider creditor interests at any stage. That has been done elsewhere.[9]

## II. THE DUTY OWED

In English corporate law, directors of companies owe duties of loyalty to their companies as a whole.[10] What is meant by "companies as a whole" is a vexed question, for it has been an extremely difficult phrase to interpret. However, it is fair to say that it has been traditionally interpreted as meaning that the duties are owed to present and future shareholders.[11] This is often referred to as the shareholder primacy principle.[12] Whether in fact English case law actually supports shareholder primacy is a moot point and not within the scope of this article. The principle is frequently justified on the basis that the shareholders "own" the company and are, as a consequence, entitled to have it managed for their benefit.[13] But notwithstanding this, the courts have said that the interests of creditors intrude in certain circumstances, such as when the company is insolvent or near to being insolvent. Consequently, at times the directors' fiduciary duties involve taking into account the interests of creditors, as well as those of the shareholders.

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9 A. Keay, "A Theoretical Analysis of the Director's Duty to Consider Creditor Interests : The Progressive School's Approach" (2004) 4 Journal of Corporate Law Studies 307.

10 *Percival v Wright* [1902] 2 Ch. 421; *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] Ch. 258.

11 Lord Wedderburn, "The Legal Development of Corporate Responsibility" in K. Hopt and G. Teubner (eds), *Corporate Governance and Directors' Liabilities* (Berlin, 1985), p5; B. Hannigan, *Company Law* (London, 2003), p203; *Gower and Davies' Principles of Modern Company Law*, 7th ed, (London, 2003), p372; H. Hirt, "The Company's Decision to Litigate Against its Directors : Legal Strategies to Deal with the Board of Directors' Conflict of Interest" [2005] J.B.L. 159, 164-165. Section 309 of the Companies Act 1985 does require directors to take into account the interests of employees, but the section has been generally regarded as impotent. A UK Parliament White Paper (the Companies Bill – Cm 5553-11) that was issued in July 2002, does not include this provision although it provides that in taking action to promote the success of the company the directors are to take into account, *inter alia*, the company's need to foster its relationships with its employees (Schedule 2, Note (2)(a) to para 2).

12 W. Leung, "The Inadequacy of Shareholder Primacy : A Proposed Corporate Regime that Recognizes Non-Shareholder Interests" (1997) 30 Columbia Journal of Law and Social Problems 589; D Gordon Smith, "The Shareholder Primacy Norm" (1998) 23 Journal of Corporate Law 277; T. Smith, "The Efficient Norm for Corporate Law : A Neotraditional Interpretation of Fiduciary Duty" (1999) 98 Michigan Law Review 214; G. Crespi, "Rethinking Corporate Fiduciary Duties : The Inefficiency of the Shareholder Primacy Norm" (2002) 55 SMU Law Rev 141; J. Armour, S. Deakin, and S. Konzelmann, "Shareholder Primacy and the Trajectory of UK Corporate Governance" (2003) 41 British Journal of Industrial Relations 531.

13 The view was made more (in)famous by the comments of the Noble laureate economist, Milton Friedman, in "The Social Responsibility of Business is to Increase its Profits" New York Times, September 13, 1970, Section 6 (Magazine). See, for instance, M. van der Weide, "Against Fiduciary Duties to Corporate Stakeholders" (1996) 21 Delaware Journal of Corporate Law 27; L. Stout, "Bad and Not-so-Bad Arguments for shareholder Primacy" (2002) 75 Southern California Law Review 1189, 1190-1191.

While in a dictum in *Winkworth v Edward Baron Development Ltd*,[14] Lord Templeman appeared to state that the duty owed by directors was a direct duty owed to the creditors, and one or two courts have adopted this approach,[15] the predominance of authority in England and elsewhere, does not support that view.[16] Rather, the courts have said that directors do not owe any duty to creditors, but they owe a duty to the company and it involves taking into account creditor interests in the process of discharging their duty. In other words, the duty is mediated through the company. Sometimes it is said that the directors owe an indirect duty to creditors. The upshot is that as the duty is not owed to the creditors, they cannot enforce any breach of the duty. The company can, obviously, but it is unlikely that a company will seek to take action against its own directors on the basis that they have breached their duty to take into account the interests of creditors, especially if the company is closely-held, that is, where the directors are also the controlling shareholders. Consequently, the creditors must wait until a liquidator or an administrator is appointed in relation to the company, when action can be taken to enforce the rights of the company. While on the present law it would seem that directors do not owe a duty to creditors, strictly speaking, for ease of exposition the article will talk in these terms from time to time.

## III. IN WHAT WAY ARE DIRECTORS TO FUNCTION?

### *A. The Issues*

The central question in this article is : how are directors to discharge their duty when circumstances are such that they are required to take into account creditor interests? Or, as Chris Riley has put it, “Are the interests of the creditors merely one competing interest to be borne in mind by directors in their running of the company, and if so, how much prominence are they to be given?”[17] The question might be put in more economic terms as : how do directors fairly allocate company resources?

The simple fact is that the case law gives little indication as to what directors are to do. One of the main drawbacks with the case law as it presently stands is that it fails to address how the obligation imposed on directors to take into account creditor interests fits in with the traditional duties that directors have in relation to shareholders.[18] For the most part, the cases have merely said that directors must take into account the creditors’ interests in making their decisions. In the recent decision

14 [1986] 1 W.L.R. 1512, 1516; [1987] 1 All E.R. 114, 118.

15 For instance, see *Jeffree v NCSC* (1989) 7 A.C.L.C. 556 (Full Court, Supreme Court of Western Australia); *Hilton International Ltd v Hilton* (1988) 4 N.Z.C.L.C. 64,721 (High Court, New Zealand).

16 For example, see *Yukong Lines Ltd of Korea v Rendsburg Investments Corporation* [1998] B.C.C. 870; *Spies v The Queen* (2000) 201 C.L.R. 603; (2000) 173 A.L.R. 529 (Australian High Court); *Peoples’ Department Stores v Wise* [2004] SCC 68 (Supreme Court of Canada) (the case can be accessed through the Canadian Legal Information Institute. See < www.canlii.org/ca >). See D.D. Prentice, “Creditors’ Interests and Directors’ Duties” (1990) 10 O.J.L.S. 265, 275-276, for an explanation of the reasons why the duty is not a direct one.

17 C. Riley, “Directors’ duties and the interests of creditors” (1989) 10 Co Law 87 at 89.

18 This is also the case in the United States, where the position is still uncertain and developing : R. Cieri, P. Sullivan, and H. Lennox, “The Fiduciary Duties of Directors of Financially Troubled Companies” (1994) 3 Journal of Bankruptcy Law and Practice 405, 405.

of *Gwyer v London Wharf (Limehouse) Ltd*,[19] the court was a little more forthcoming when it said that in considering the interests of creditors, directors are to take into account the impact of their decision on the ability of the creditors to recover the sums due to them from the company,[20] but this is as far as any court has really gone.

The problem facing us is not unique. For instance, s.214 of the Insolvency Act 1986, which proscribes what is known as "wrongful trading," merely prescribes the conditions for wrongful trading; it fails to set out how directors are to act to avoid it, save stating that they are to take every step with a view to minimising losses to the creditors at a time when they knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation.

The duty, being owed to the company, and not to the creditors, means that it does not simply entail directors refraining from disposing of assets improperly or diverting property to insiders in the company, but it extends to all of the duties that are owed by directors to companies, including duties of loyalty.

*B. The Financial State of the Company*

Whether or not directors are obliged to consider creditor interests all depends on the financial state of their company.[21]

*1. Solvency*

Where companies are solvent and suffering no financial difficulty, it is often regarded as being axiomatic that directors must seek the maximisation of shareholder value,[22] the so-called "shareholder primacy principle," referred to earlier. The directors of companies that are solvent have no responsibility to take into account creditor interests.[23]

*2. Insolvency*

In contrast, the courts have held unequivocally that where a company is insolvent, its directors must consider the interests of creditors.[24] In perhaps the leading English case on this topic, *Liquidator of West Mercia Safetywear Ltd v Dodd,*[25] the Court of Appeal stated what seems to be an accepted view in England and elsewhere as far as the role of directors is concerned when their companies are insolvent. The Court said that where a company is insolvent, the creditors' interests overrode the interests of the shareholders.[26] More recently, *Re Pantone 485 Ltd*[27] and *Gwyer v London Wharf*

19 [2003] 2 B.C.L.C. 153; [2002] EWHC 2748.
20 *Ibid* at p181; [81].
21 See above, n.3.
22 Above n.18, 406.
23 For example, see *Brady v Brady* (1987) 3 B.C.C. 535 (C.A.).
24 For instance, see *Liquidator of West Mercia Safetywear Ltd v Dodd* (1988) 4 B.C.C. 30.
25 *Ibid* at p33.
26 Also, see the earlier Court of Appeal case of *Brady v Brady* (1987) 3 B.C.C. 535, 552.
27 [2002] 1 B.C.L.C. 266 at [69].

*(Limehouse) Ltd*,[28] have indicated that when a company is insolvent then the creditors' interests are paramount.[29]

This approach was also advocated by Street C.J. in the New South Wales Court of Appeal in *Kinsela v Russell Kinsela Pty Ltd (in liq)*.[30] His Honour said that:

> But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanisms of liquidation, to displace the power of the shareholders and directors to deal with the company's assets.[31]

Likewise, the Irish Supreme Court in *Re Frederick Inns Ltd*[32] said that, "[b]ecause of the insolvency of the companies the shareholders no longer had any interest. The only parties with an interest were the creditors. The payments made could not have been lawful because they were made in total disregard of their interests."[33] In the United States the Bankruptcy Court in the Massachusetts case of *In re Healthco International Inc*[34] held, in common with a number of US cases,[35] that when a company is insolvent the creditors' interests are pre-eminent.[36]

The Government appears to accept that this approach is correct as it stated in the explanatory notes to the draft clauses in the latest Company Law Reform White Paper[37] (published in March 2005) that the interests of the members should be replaced by those of the creditors when a company is insolvent.[38]

So, if creditors' interests are paramount, directors have to put aside the shareholder primacy principle and rather than seeking to maximise shareholder wealth, the

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28 [2003] 2 B.C.L.C. 153, 178; [2002] EWHC 2748 at [74].

29 Professors LoPucki and Whitford, ("Corporate Governance in the Bankruptcy Reorganization of Large Publicly Held Companies" (1993) 141 U. Pa. L. Rev. 669, 709) disagree, taking the view that management owes duties to both creditors and shareholders of an insolvent company until a bankruptcy reorganization occurs. But from their empirical research LoPucki and Whitford found that the managers of large public companies that are insolvent aligned with creditors more frequently than shareholders (at 745).

30 (1986) 4 A.C.L.C. 215; 10 A.C.L.R. 395.

31 *Ibid* at p221; p401.

32 [1993] I.E.S.C. 1 at [47] per Blayney J. (giving the judgment of the Court).

33 There is a divergence of opinion in the courts in the United States as to whether duties are still owed to shareholders. See R. Millner, "What Does it Mean for Directors of Financially Troubled Corporations to Have Fiduciary Duties to Creditors?" (2000) 9 Journal of Bankruptcy Law and Practice 201, 217.

34 208 B.R. 288 (1997) (Delaware).

35 See, for example, *Snyder Electric Co v Fleming* 305 N.W. 2d 863 (1981) (Minnesota); *Hixson v Pride of Texas Distribution Co Inc* 683 S.W. 2d 173 (1985) (Texas); *Geyer v Ingersoll Publications Co* 621 A. 2d 784 (1992) (Delaware).

36 The Court in *In re Healthco International Inc* ((1997) 208 B.R. 288, 300) cited a number of American cases for the proposition. Some are : *Pepper v. Litton*, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939); *McCandless v. Furlaud*, 296 U.S. 140, 56 S.Ct. 41, 80 L.Ed. 121 (1935); *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506 (2d Cir.1981); *Automatic Canteen Co. of Am. v. Wharton*, 358 F.2d 587, 590 (2d Cir.1966); *New York Credit Men's Adjustment Bureau, Inc. v. Weiss*, 305 N.Y. 1, 110 N.E.2d 397 (1953); *The Official Comm. of Unsecured Creditors of Buckhead America Corp. v. Reliance Capital Group, Inc. (In re Buckhead Am. Corp.),* 178 B.R. 956, 968 (Delaware, 1994).

37 Cm. 6456.

38 Note to clause B19 of the Company Law Reform Bill.

directors should maximise creditor wealth. Directors will do so by eliminating the high risk policies that they might have followed when implementing shareholder primacy. The company's affairs are to be administered in such a way as to ensure that actions will enhance the wealth of creditors, that is the creditors will be repaid more of the funds that are owed to them.

It has been said that if directors must engage in creditor maximisation, then that produces an inefficient result in that directors will ignore potentially lucrative but risky investments.[39] But, of course, if one limits creditor maximisation to the time when the company is insolvent, then arguably the company should not be indulging in risky activities in any event. What will creditor maximisation involve? Directors know that the primary interest of creditors is to get repaid in full, or as far as possible. So, essentially, directors can keep this at the backs of their minds. Anything that makes repayment less likely, harms creditor interests and should be eschewed as a valid action.

Therefore, once a company is insolvent the task of the directors is, relatively speaking, a little easier in that they must focus on the creditors' interests. Consequently, it is the period of time before insolvency occurs, but when the directors are obliged to take into account the interests of creditors, that is more of a concern as far as ascertaining how directors are to function.

It would seem that the predominance of case law supports the view that while directors must consider creditor interests, they are not obliged to focus solely on those interests. But what are they are to do?

*C. The Balancing of Interests*

One approach that could be invoked when directors are bound to consider creditor interests, is to say that the directors, in determining what to do, must balance the interests of creditors and shareholders. The latter's interests are not to be forgotten, certainly outside of insolvency, as the traditional view is that their interests must be taken into account by directors. In *Re MDA Investment Management Ltd*[40] Park J. indicated that when a company is in financial difficulties, although not insolvent, "the duties which the directors owe to the company are extended so as to encompass the interests of the company's creditors as a whole, *as well as those of the shareholders"* (my emphasis). Reginald Barrett assumes that there must be a balancing between the interests of shareholders and creditors if creditors' interests are to intrude. He said that : "there will be insoluble problems of reconciling conflicting interests" of shareholders and creditors if a duty to creditors applied other than where insolvency exists.[41] The conflict between the interests of shareholders and creditors is likely to be more manifest when it comes to the issue of risk. As Riley puts it : "How are directors to balance such competing interests when deciding whether to embark upon some speculative venture?" The comment of Lord Templeman in *Winkworth v Edward Baron Development Ltd*, that:

39 J. Lipson, "Directors' Duties to Creditors : Volition, Cognition, Exit and the Financially Distressed Corporation" (2003) 50 U.C.L.A. L. Rev. 1189, 1225.
40 [2004] 1 B.C.L.C. 217, 245; [2004] B.P.I.R. 75, 102.
41 "Directors' Duties to Creditors" (1977) 40 M.L.R. 226, 231.

> The company is not bound to pay off every debt as soon as it is incurred, and the company is not obliged to avoid all ventures which involve an element of risk – but it owes a duty to its creditors to keep its property inviolable and available for the repayment of its debts.[42]

sounds sensible, yet what does it actually mean as far as a director is concerned when he or she is trying to run the company's business? As one American court put it in relation to the law as it applied in the State of Delaware, at least: "the extent to which directors of putatively insolvent corporations can continue to advance the interests of stockholders without violating their fiduciary duty to the corporate entity or to creditors remains hazy…"[43]

The next section of the article identifies and then considers the issues that arise if directors are to balance the interests of shareholders and creditors in making appropriate decisions.

*1. Shareholders v Creditors*

Shareholders and creditors alike supply capital to companies, with each contributing "funds in exchange for claims on cash flows generated by the entity's [company's] operations."[44] While in a wide range of issues the interests of shareholders and creditors will be aligned,[45] it cannot be doubted that there is likely to be some conflict between the interests of the two groups at some point,[46] with the conflict increasing as "the financial condition of the firm deteriorates and its debt-equity ratio increases."[47]

It is likely, particularly when a company is in financial difficulty, that it is in the shareholders' interests to embrace greater risks,[48] for they have little to lose if a venture is not successful, while if it is successful the company "could be made," and not only will creditors be paid, but the shareholders will make a substantial amount. Of course, if the venture is unsuccessful the shareholders, because of the concept of limited liability, will not lose any more than they would if the company took no action. By way of illustration, let us say that there are two projects, both costing

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42 [1986] 1 W.L.R. 1512, 1516; [1987] 1 All E.R. 114, 118.

43 *Jewel Recovery L.P. v Gordon* 196 B.R. 348, 355 (1996).

44 L. Lin, "Shift of Fiduciary Duty Upon Corporate Insolvency : Proper Scope of Directors' Duty to Creditors" (1993) 46 Vanderbilt Law Review 1485, 1488.

45 Leung, above n.12, 590 n.8; J. Macey and G. Miller, "Corporate Stakeholders : A Contractual Perspective" (1993) 43 University of Toronto Law Review 401, 415.

46 J. Coffee and A. Schwartz, "The Survival of the Derivative Suit : An Evaluation and a Proposal for Legislative Reform" (1981) 21 Colum L Rev 261, 313; D. Harvey, "Bondholders' Rights and the Case for a Fiduciary Duty" (1991) 65 St John's L. Rev. 1023, 1040, n86; M. Whincop, "Taking the Corporate Contract More Seriously : The Economic Cases against, and a Transaction Cost Rationale for, the Insolvent Trading Provisions" (1996) 5 Griffith Law Review 1, 10-11; above n.18, 414.

47 Above n.44.

48 R. Scott, "A Relational Theory of Default Rules for Commercial Contracts" (1990) 19 Journal of Legal Studies 597, 624; above n.29, 768; B. Adler, "A Re-Examination of Near-Bankruptcy Investment Incentives' (1995) 62 U. Chic. L. Rev. 575, 590-598; R. de R Barondes, "Fiduciary Duties of Officers and Directors of Distressed Corporations" (1998) 7 George Mason Law Review 45, 46 and 49.

£100,000. Project A offers a safe return of £110,000 (the initial outlay together with a clear profit). Project B offers a 50:50 chance of success, whereby if it does not succeed the company will only have returned to it the sum of £50,000, but if it succeeds the company will get £150,000. The shareholders will generally prefer B to A and the creditors, if the sum total owed to them exceeds £50,000, will favour A over B. If B succeeds then the shareholders will gain most from it. If, however, B fails, the creditors will absorb most of the loss.

While it is axiomatic that shareholders and creditors have divergent views about risk and returns, so that conflict between the two constituencies is unavoidable in some cases, there are a number of substantial points that have been made for advocating a balancing exercise. First, it has been argued that resolving conflicts is part and parcel of being a director. Some management specialists have even said that managing competing interests is a primary function of management.[49] The fact that the balancing of diverse interests is within directors' abilities and skills is something that has been recognised as far back as 1973 by a UK Department of Trade and Industry Report,[50] and by some American courts.[51] For example, in the American decision of *In re Healthco International Inc*, the court played down the conflict between shareholders and creditors, saying that there were not irreconcilable conflicts and the action of looking out for creditors and shareholders' interests was merely an incident of a director's fiduciary obligations.[52] It has been contended that it is not unmanageable or unreasonable for persons occupying positions like directors, to make allocative decisions. Directors have been classified as fiduciaries and society regularly requires those who are fiduciaries to make balanced decisions that can be quite difficult.[53] Proponents of the view might point to another kind of fiduciary, the trustee. Trustees have to make investment decisions sometimes with various categories of beneficiaries in mind. This can involve weighing up risk in a similar manner that is required by a director under a duty to consider creditor interests. It usually involves the steering of a middle course.

Second, while it is argued that it is easier to police how directors are acting when directors are to act only for shareholders and no one else,[54] it must not be forgotten that once all is said and done, that it is not always easy to perceive what is in the best interests of the shareholders, and directors have to balance various elements. For example, a particular action might boost the share prices of a company, but it will also

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49 H. Ansoff, Implanting *Strategic Management* (Englewood Cliffs, 1984) and referred to in J. Harrison and R. Freeman, "Stakeholders, Social Responsibility and Performance : Empirical Evidence and Theoretical Perspectives" (1999) 42 Academy of Management Journal 479, 479. Management commentators have asserted that directors are in effect to act as referees between two stakeholder groups (M. Aoki, *The Co-operative Game Theory of the Firm* (Oxford, 1984) and referred to in T. Donaldson and L. Preston, "The Stakeholder Theory of the Corporation Concepts, Evidence, and Implications" (1995) 20 The Academy of Management Review 65, 86).

50 *Company Law Reform*, Cmnd. 5391 at [55-59].

51 For example, *Unocal Corporation v Mesa Petroleum Corporation* 493 A. 2d 946 (1985).

52 208 B.R. 288, 301 (1997) (Delaware).

53 Rutheford B. Campbell Jr, "Corporate Fiduciary Principles for the Post-Contractarian Era" (1996) 23 Florida State University Law Review 561, 593.

54 For example, R. Clark, *Corporate Law* (1986) at 20 and referred to in "Other Constituency Statutes :Potential for Confusion" (1990) 45 Bus. Law. 2253, 2270.

reduce the likelihood of dividends for a year or so, and directors have to decide whether this is appropriate.

Third, there is evidence that directors are often seeking to balance interests in the decisions which they make.[55] A corporate reputation survey of Fortune 500 companies (the largest listed companies in the United States) found that satisfying the interests of one stakeholder does not automatically mean that this is at the expense of other stakeholders.[56] It might be concluded that if the interests of creditors are considered then it does not necessarily mean that shareholders' interests will be prejudiced. It has been found empirically, in a study of UK private water companies, that the requirement that directors must consider customer interests as well as that of shareholders, can result in "mutual benefits for different stakeholder groups with apparently conflicting economic interests."[57] For instance, in taking into account creditor interests by reviewing all available material information relating to the financial standing of the company before embarking on any actions, shareholders might well benefit in that the company might be spared from pursuing an inappropriate strategy. Further, in undertaking the necessary monitoring to protect creditors, directors might identify improvements that could be made in the company's procedures and profit-making processes that could lower costs and increase profits, thereby promoting overall benefits for the company. Other empirical evidence, obtained in a study by the Financial Times of Europe's most respected companies, found that chief executive officers were of the view that one of the features of a good company was the ability to balance the interests of stakeholder groups.[58]

Fourth, shares come in different shapes and sizes and companies often have different kinds of shares, such as ordinary and preference, and it is incumbent on directors to balance the interests of different kinds of shareholders, so that they act fairly between them[59] as, on occasions, these different classes of shareholders have opposing interests.[60] Professors Jonathan Macey and Geoffrey Miller point out[61] that some preferred shareholders may have interests that resemble those of fixed claimants, such as creditors, more than those associated with common shareholders. Some shareholders intend only to retain shares for a short term, while others are in for the long haul. Other shareholders hold a diversified portfolio, with their investment

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55 It has been noted that directors do already consider the interests of various constituents : *Report of the Committee on Corporate Governance* (chair, Sir Ronald Hampel) (1998) and referred to by J. Dine, "Implementation of European Initiatives in the UK : The Role of Fiduciary Duties" (1999) 3 Cfi L.R. 218, 223.

56 L. Preston and H. Sapienza, "Stakeholder Management and Corporate Performance" (1990) 19 Journal of Behavioral Economics 361.

57 S. Ogden and R. Watson, "Corporate Performance and Stakeholder Management : Balancing Shareholder and Customer Interests in the UK Privatized Water Industry" (1999) 42 Academy of Management Journal 526, 536.

58 E. Scholes and D. Clutterbuck, "Communication with Stakeholders : An Integrated Approach" (1998) 31 Long Range Planning 227, 230.

59 *Mills v Mills* (1938) 60 C.L.R. 150, 164; *Re BSB Holdings Ltd (No2)* [1996] 1 B.C.L.C. 155, 246-249.

60 M. McDaniel,"Bondholders and Stockholders" (1988) 13 Journal of Corporation Law 205, 273; above n.53, 593; de R Barondes, above n.48, 78.

61 "Corporate Stakeholders : A Contractual Perspective" (1993) 43 University of Toronto Law Review 401, 433.

spread around a number of companies, and still others might have all their investment concentrated in the one company. In companies that are closely-held, one has the problem of the conflicting interests of controlling and minority shareholders. Notwithstanding this, no concerns are voiced about the stresses of decision-making for directors in undertaking a balancing of the interests of the various types of shareholders, nor is it argued that directors, in balancing interests, are too burdened.

Furthermore, as indicated earlier, it has been held in English law that directors are obliged to conduct the affairs of their company for the benefit of the company as a whole, and that has been interpreted to mean the interests of both the present and future shareholders of the company.[62] So, in some of their decision-making, it is likely that directors will have to balance the interests of present shareholders as against the interests of future shareholders. In other words, directors will have to balance short-term considerations as against long-term considerations, so that they are not unfair to either present shareholders or future shareholders.

So, there are significant points that favour the idea that directors should balance the interests of creditors and shareholders when directors are subject to a responsibility to take into account creditor interests. However, it is submitted that they are outweighed by the many problems that are caused by endeavouring to strike a balance between interests. Clearly, most commentators, whatever view they take, accept that the balancing of shareholder and creditors interests is a tricky issue. It means that directors have to solve what some commentators see as impossible conflicts of interests.[63] Specifically, directors have to cope with the following.

First, it might be difficult for directors to take into account creditor interests as they are so accustomed to focusing on the interests of shareholders alone. It has been argued that directors will not understand the interests of creditors as they are usually involved in exercising entrepreneurial skills.[64] With respect, directors are not just pure entrepreneurs, they have responsibilities in relation to the finances of the company and they have to be financial managers. But, notwithstanding this, it must be acknowledged that directors will rarely align themselves with creditor interests. This is demonstrated by an empirical study conducted by Professors Lyn Lo Pucki and William Whitford of large companies in the United States that have entered bankruptcy under Chapter 11 of the Bankruptcy Reform Act 1978.[65] The learned

62 See *Re Smith & Fawcett Ltd* [1942] Ch. 304; *Ganmain v National Association for Mental Health* [1971] Ch. 317.

63 There are many American commentators who take this view. For example, J.R. Macey, “An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties” (1991) 21 Stetson Law Review 23, 31; V. Jelisavcic, “A Safe Harbour Proposal to Define the Limits of Directors’ Fiduciary Duty to Creditors in the ‘Vicinity of Insolvency” (1992) 17 Journal of Corporation Law 145, 148; N. Beveridge, “Does a Corporation’s Board of Directors Owe a Fiduciary Duty to its Creditors?” (1994) 25 St Mary’s Law Journal 589, 621. This view gains some support from the Ontario High Court of Justice in *Royal Bank of Canada v First Pioneer Investments Ltd* (1980) 20 O.R. (2d) 352.

64 M. van der Weide, “Against Fiduciary Duties to Corporate Stakeholders” (1996) 21 Delaware Journal of Corporate Law 27, 60.

65 Above n.29, 751.

writers found that directors of solvent companies never aligned with creditors.[66] Hence, for directors to take into account creditors' interests will necessitate something of a culture change.

Second, it has been argued that requiring the balancing of interests, means that directors have to serve two masters.[67] Many commentators argue against the idea of directors being required to have regard for a number of constituencies on the basis that directors cannot manage companies properly in such circumstances. An example of the predicament in which directors could find themselves, according to Professor Dale Tauke, is where the company has excess funds and has to decide whether to pay a dividend to shareholders or retain the funds.[68] In this situation, the learned commentator asserts, the shareholders will prefer the former decision and the creditors the latter. Which constituency do the directors favour?

Third, the agency theory,[69] the theory that directors act as the agents of shareholders (although not agents in the strict legal sense), has, as one of its elements the notion that directors will be opportunistic and engage in self-serving activity, known as shirking. Consistent with that, it might well be that directors will use the requirement to balance between conflicting interests as an opportunity to foster their own self-interest.[70] In their empirical study Lo Pucki and Whitford found that this occurs with respect to companies that are subject to Chapter 11 bankruptcy.[71] Directors might consider that if they favour the shareholders, their position might be enhanced, especially if they own shares in the company, or if their compensation packages are tied to share prices.[72] On the other hand, executive directors who are concerned about their reputation and the need to find posts elsewhere in the future, might, under the guise of effecting a balance, favour creditor interests in an effort to keep a company operating and being able to satisfy creditors so that they are not, personally, tainted by a financial collapse of the company.

Fourth, and allied to the previous point, in any balancing exercise the danger is that the director whose actions are likely to be reviewed will simply pay lip-service to the need to consider the interests of both shareholders and creditors, and then make the decision that he or she wants, possibly based on self-interest. Of course, there is lip-service and there is lip-service, and while the activity of some directors might be sufficient to cause an adequate doubt in the mind of a judge that they had considered

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66 *Ibid*.

67 T. Hurst and L. McGuiness, "The Corporation, The Bondholder and Fiduciary Duties" (1991) 10 Journal of Law and Commerce 187, 205

68 D. Tauke, 'Should Bondholders Have More Fun? A Reexamination of the Debate Over Corporate Bondholder's Rights' (1989) Colum. Bus. L. Rev. 1 at 60.

69 This is based on a large number of works, but the most influential are : Michael Jensen and William Meckling, "Theory of the Firm : Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 Journal of Financial Economics 305; Eugene Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J Pol Econ 288; Eugene Fama and Michael Jensen, "Separation of Ownership and Control" (1983) 26 Journal of Law and Economics 301; Frank Easterbrook and Daniel Fischel, *The Economic Structure of the Corporate Law* (Cambridge, Mass, 1991).

70 M. Roe, "The Shareholder Wealth Maximization Norm and Industrial Organization" (2001) 149 U. Pa. L. Rev. 2063 at 2065.

71 Above n.29, 710

72 Above n.68, 65

creditor interests, on other occasions it will be reasonably clear that directors have really only sought to appear to be taking the interests of creditors into account, and they have failed to do their duty.

Fifth, as Professor Victor Brudney has stated : "the conflict between the interests of stockholders and bondholders does not permit management to be agent of both in a manner consistent with fiduciary principles."[73] Consequently, it might be argued that requiring directors to effect a balance is unfair to directors[74] as it places them in invidious, no win situations.

Sixth, it might be argued that there is the danger that the natural tendency of directors is to favour shareholders as they are the ones who can decline to re-elect them, or even dismiss them, pursuant to s.303 of the Companies Act 1985. While directors might realise that whatever they do when their company is in financial distress could be the subject of close scrutiny at some later date by a court, the present reality of the possibility of dismissal could well lead to directors following a line that shareholders find palatable.[75] LoPucki and Whitford have maintained that if the elections of directors are permitted in relation to companies that are subject to Chapter 11 bankruptcy in the United States, then shareholders will use the threat of elections to induce the directors to follow policies that favour shareholder interests.[76]

Besides the issue of control and election, it needs to be noted that only shareholders are able to bring actions to challenge breaches of directors' duties[77] or even actions that are short of breaches of duty, provided that they can use s.459 of the Companies Act 1985 or bring a derivative action by successfully making out an exception to the rule in Foss v Harbottle. Apart from those creditors who have extended credit pursuant to an agreement that included covenants allowing some form of control, creditors, prima facie, cannot, unlike the shareholders who can vote at meetings, have any real input into management. There is evidence from the United States that bank creditors have been successful in having some effect on how companies are controlled by orchestrating the dismissal of directors,[78] but often banks have the standing of secured creditors and they do not have the same interest in monitoring and taking action if they are well secured, only being concerned that their security is safe,[79] so this will rarely provide any benefits for creditors in general. The upshot is that, effectively, the shareholders are the only ones whom directors must fear.

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[73] "Corporate Bondholders and Debtor Opportunism : In Bad Times and Good" (1992) 105 Harv L. R. 1821, 1837 n49.

[74] Above n.39, 1222.

[75] The formulation of strategies to obtain a dismissal of directors does occur. For instance, a group of shareholders in Morgan Stanley are endeavouring to oust the chief executive officer of the company on the basis, *inter alia*, that he is destroying the value of the bank See J. Doran and C. Merrell, "Morgan Stanley rebel presses shareholders to support putsch" *The Times*, April 7, 2005.

[76] Above n.29, 770.

[77] Compare the position in Canada, where creditors may instigate derivative actions. See the Canadian Business Corporations Act 1985, s.241(2)(c).

[78] Stuart Gilson and Michael Vetsuypens, "Credit Control in Financially Distressed Firms : Empirical Evidence" (1994) Wash. U. L. Q. 1005, 1011-1015.

[79] T. Jackson and A. Kronman, "Secured Financing and Priorities Among Creditors" (1979) 88 Yale L. J. 1143, 1154.

Seventh, as was mentioned earlier, there are often different kinds of shareholders in companies, and while directors might be accustomed to having to balance the interests of such persons, the fact that there are multiple types of shares is likely to make the balancing exercise more complicated as the directors' task is not merely to consider shareholders' interests on one side, and creditors' on the other.

*2. Creditors v Creditors*

So much for the balancing of shareholder and creditor interests; but that is not the whole story. Just as there are different kinds of shareholders in some companies, any company is likely to owe money to several groups of creditors who have different agenda, and who are dealt with in different ways by the law. Companies might have all or any of the following creditors : secured creditors, suppliers with a retention of title clause in supply contracts, trade creditors, suppliers under long-term contracts, lessors, holders of unexpired intellectual property licences, employees, Inland Revenue Commissioners and HM Customs, tort victims with claims, and customers who have paid deposits for goods or services to be supplied by the company. There is, for instance, likely to be a significant difference between the interests of a bank creditor with a charge over company assets compared with an unsecured trade creditor. In considering creditor interests what does a director do if the interests of different groups do not accord?[80] There is going to be conflict, and this internecine conflict can be as difficult to resolve as the shareholder-creditor conflict.

As one might expect there will be different risks assumed by different creditors. For instance, short term creditors, such as suppliers,[81] often do not assume as high a risk as long-term creditors. The former will often enter into repeat transactions with companies and they can more easily respond to indications that companies are in a financial malaise. Long term creditors bear a greater risk that the company with which they are dealing engages in some activity post-contract that heightens the chance of non-payment. An example is a creditor who is tied to the company in some way, such as a creditor who, in installing in its factory special machinery, did so solely to enable it to supply the company. Given all of this, it is more likely that long-term creditors will require the insertion of restrictive covenants in the credit contract, and such creditors are more exposed to improper directorial behaviour that will cause them prejudice.

Before considering the various groups of creditors, it is worth noting that even creditors in the same group might not have the same interests. For instance, let us take the broad grouping of trade creditors. These creditors are generally treated in the same way by the law, and certainly they are when it comes to a liquidation of an insolvent company. This group might include, at one extreme, large companies that supply significant quantities of goods to the company, and, at the other end of the spectrum, self-employed tradespersons, like plumbers. The former type of creditors

80 This is assuming that all creditors are owed a duty. This is something which Professor Jonathan Lipson has questioned : above n.39.

81 Some suppliers might be more easily placed in the category of long term creditors, when they invest in specific equipment or other capital items in order to service the company's business.

might have a turnover of many millions of pounds per annum and are likely to be more willing to accept the directors embracing ventures and actions that involve a greater amount of risk, as large company suppliers are probably not so reliant as the tradespersons, whose turnover is likely to be only in the region of thousands of pounds, on being paid the debt owed. While the large company can gamble with its debt, tradespersons probably cannot. The latter would prefer to be assured of receiving, say half of what is owed, rather than seeing company funds used in such a way that *might* lead to full payment of the debt, but could just as likely lead to nothing being left to pay creditors. In contrast, the large company might be ready to approve of a gamble because if it does not get paid, it can still survive.

The main groups of creditors that are recognised by the law, as far as the rights to which they are entitled, particularly if the company enters some form of insolvency administration, are secured creditors, preferential creditors and unsecured creditors. In Anglo-American law secured creditors generally retain their pre-insolvency right to recover what they are owed from the assets of the company over which they have security, in priority to any other creditors.[82] Absent significant devaluation of the secured assets or the fraudulent disposal of such assets, secured creditors are generally in a strong position to recover their debt, and the actions of the directors might have little effect on them.[83] Provided that company action does not, or is not likely to, place a secured creditor's security in some jeopardy, secured creditors will not be too concerned about what the directors decide to do. In any event, those with fixed charges overwhelmingly include covenants in their loan agreement that provide that the value of the security is not to fall below a set multiple of the amount of the debt secured.[84]

Preferential creditors are those unsecured creditors who are entitled, if the company enters some form of insolvency regime, such as administration or liquidation, to be paid before other creditors. Most jurisdictions provide for a preferential creditor grouping, although there are jurisdictional differences as to the kinds of creditors that fall into the category. The most prevalent kind of preferential creditors are employees of the company. In the UK employees are effectively the only major type of preferential creditor since the corporate insolvency provisions of the Enterprise Act 2002 came into operation on 15 September 2003. Before then, and in common with many jurisdictions around the world, such as France, Spain, Ireland, South Africa and Italy, tax authorities also were accorded preferential status.

82 However, where a creditor holds a floating charge created on or after 15 September 2003, a certain part of the net proceeds (net property) from the realisation of the property covered by the floating charge must be set aside for the unsecured creditors : Insolvency Act 1986, s.176A. This does not apply where, *inter alia*, the company's net property is less than the sum, at present, of £10,000 (Insolvency Act 1986 (Prescribed Part) Order 2003, S.I. 2003/2097), para 2)) and the relevant office-holder thinks that the cost of making a distribution to the unsecured creditors would be disproportionate to the benefits received by the unsecured creditors (s.176A(3)(a)(b)).

83 D. Citron, "The Incidence of Accounting-Based Covenants in UK Public Debt Contracts : An Empirical Analysis" (1995) 25 *Accounting and Business Research* 139 and referred to in R. Mokal, "The Floating Charge – An Elegy" in Sarah Worthington (ed), *Commercial Law and Commercial Practice* (Oxford, 2003), p487.

84 The debenture deed will permit the secured creditor to invoke a process to safeguard their position, such as the appointment of a receiver, if their security was in danger.

The group that is at the bottom of the priority ladder are the ordinary unsecured creditors, who are merely given the right to an equal and proportional claim to any company funds that remain after the secured and preferential creditors have been satisfied. They are the ones who usually lose out when companies fall into insolvency.

The preferential creditors would undoubtedly see it as being in their best interests for a company's business to be terminated where there was just sufficient company funds to satisfy what they are owed. While, in such a situation, the unsecured creditors would be in a similar position to the shareholders of an insolvent company, in that they would be content to see the company business continue, and maybe new ventures taken on, in the hope that there will be more funds produced over and above that owed to the preferential creditors, so that there is something for them. Of course, the preferential creditors would be opposed to this as further activity might mean that the company's funds are diminished and that would imperil their return.

Is it also necessary for directors to have to balance the rights and interests of existing creditors as against those of future creditors? The main debate in this regard has been over whether a duty is actually owed to future creditors. While there are dicta in cases, such as *Winkworth v Edward Baron Development Ltd*,[85] that indicate that directors do owe a duty to future creditors, the suggestion has been the subject of a significant amount of robust criticism.[86] It seems to be the law that the interests of future creditors do not have to feature in the concerns of directors.

If a company has different kinds of creditors, should directors in discharging their duties take into account the position that various creditors occupy as far as priority to payment is concerned? Against requiring this are three factors. First, directors would have to take legal advice as to what the priority order would be and that would hinder directors in some cases in fulfilling their duties in a timely way. Second, directors might be somewhat hamstrung in trying to maximise benefits for the company if they were to consider creditor priority. Third, priority issues are only relevant if and when the company enters administration or liquidation as a result of being insolvent. Priorities established by the Insolvency Act 1986 have no application outside of these regimes, although secured creditors will enjoy the same rights whether or not a company enters a formal insolvency regime.

Although it does not resolve the problem that we are investigating, the decision in *Re Pantone 485 Ltd*,[87] is noteworthy, for it implicitly indicates that directors must effect a balance between the interests of all creditors. In this case the liquidator of a company failed in a claim that the directors of the company in liquidation had disposed of company property without taking into account the interests of one of the

85 [1986] 1 W.L.R. 1512, 1516; [1987] 1 All E.R. 114, 118.

86 For example, see L. Sealy, "Directors' Duties – An Unnecessary Gloss" [1988] C.L.J. 175; J. Farrar, "The Responsibility of Directors and Shareholders for a Company's Debts" (1989) 4 Canta L.R. 12; B. Cheffins, *Company Law : Theory, Structure and Operation* (Oxford, 1997), p338.

87 [2002] 1 B.C.L.C. 266.

creditors, an unsecured creditor entitled to priority in a distribution of the company's assets. The Court acknowledged that when a company was insolvent the directors had to have regard for the creditors' interests.[88] The claim failed because, according to the Court, the directors had a duty to make decisions, when their company was insolvent, while having regard for all of the general creditors, and not one, or a section, of the creditors. Thus, if directors are found, in balancing the interests of creditors, that they have favoured one or more groups, they will have failed to discharge their responsibility.

Of course, the more creditor groups to whom money is owed by a company, the more difficult it is, potentially, for directors to take all creditors' interests into account in what they propose to do. The danger is that in some circumstances the directors are in a "no win situation" and might feel that the preferable thing to do, is nothing. Ultimately this could prejudice all creditors.

### *3. Summary*

The idea of balancing the interests of the shareholder and creditor constituencies seems meritorious, but in practice it would be very difficult for a director, in many situations, to know what to do. The same could be said in relation to deciding what to do when an action discriminates between individual creditors. The main problem is that balancing is a fairly nebulous idea unless there is a goal that has been set for the balancing exercise. To what end is the balancing to be directed? To be effective any balancing must be done in the context of achieving an aim. Consequently, in the next section of the article I propose a framework that provides an objective to which directors should be working in making their decisions.

## IV. A PROPOSED FRAMEWORK

It is simply not possible to formulate a single overarching principle or test to guide directors for the times when they subject to a responsibility to consider creditor interests, as circumstances will be so varied and the issues that directors encounter are often complex and multifaceted. It is necessary to have flexibility. We have, therefore, to formulate a framework that embraces broad principles rather than specific rules, but something that has a prophylactic effect. The aim of arriving at a framework is to provide greater certainty for directors and to act in such a way so as to discourage directors from damaging creditors' interests.[89] Below I seek to develop a framework that has built into it flexibility and accountability.

### *A. Entity Maximisation*

When directors are not subject to an obligation to consider creditor interests we can assume, certainly for the purposes of this article, that directors will seek to maximise shareholder wealth,[90] a principle generally accepted as operating in Anglo-American

88 *Ibid* at pp286-287.
89 L. Mitchell, "The Fairness Rights of Bondholders" (1990) 65 N.Y.U.L.R. 1165, 1226.
90 It is submitted that there is significant authority in both the UK and the US that suggests that this approach is not completely established in law. The issue, though, is outside the ambit of this article.

corporate law.[91] But when directors have to take into account creditors' interests, it is submitted that directors should be seeking to implement a broader approach and the one that is advocated here is an entity maximisation approach.[92] This involves, in a nutshell, the directors making decisions that will maximise the general wealth of the company and enhance its sustainability. In other words, directors should do that which value maximises the corporate entity so that the net present value to the company as a whole is enhanced (maximising the total financial value of the firm and taking into account the sum of the various financial claims that are made on the company[93]) and not just its equity.[94] Directors will endeavour to increase the "total long-run market value of the firm,"[95] by making the pie larger.[96] In doing this directors should have concern for "the community of interest,"[97] which would include the creditors. This means that the common interest of all who have a stake in the company is to be fostered, but it does not mean that at some point one group will not benefit at the expense of another.[98] It might be argued, on the basis of hypothetical bargain theory,[99] that as entity maximisation endeavours to increase the value of all parties' interests *ex post*, creditors and shareholders would bargain for it *ex ante* if they could have done so.[100]

The approach discussed here is similar to saying that politicians are under a duty to do that which will make society better off, with "society" meaning the sum of the interests of the people who constitute society.[101] It is to be remembered that the duty

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91 See above n.11.

92 Referred to as the "financial value maximization" in A. Chaver and J. Fried, "Managers' Fiduciary Duty Upon the Firm's Insolvency : Accounting for Performance Creditors" (2002) 55 Vanderbilt Law Review 1813, 1815, the "corporate value maximization" approach in Campbell, above n.54, 580 and "the maximization of firm value" approach in McDaniel, above n.60, 309.

93 T. Smith, 'The Efficient Norm for Corporate Law : A Neotraditional Interpretation of Fiduciary Duty,' (1999) 98 Michigan Law Review 214, 246

94 Some scholars have taken this view even where companies are not in financial difficulties. See, for example, *ibid* at 223; G. Crespi, "Rethinking Corporate Fiduciary Duties : The Inefficiency of the Shareholder Primacy Norm" (2002) 55 SMU Law Rev, 141, 143, 152-153. This approach is criticised in Chaver, above n.92, on the basis that it might lead to inefficiency.

95 M. Jensen, "Value Maximisation, Stakeholder Theory, and the Corporate Objective Function" (2001) 7 European Financial Management 297, 299. Professor Jensen refers to this as "value maximisation."

96 M. McDaniel, "Bondholders and Corporate Governance" (1986) 41 Bus Law 413, 448.

97 In *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp* 1991 WL 277613; 1991 Del Ch LEXIS 215; LEXIS 215; reprinted in (1992) 17 *Delaware Journal of Corporate Law* 1099 (Delaware Chancery Court), at [34] per Chancellor Allen. This might be said to overlap with the argument posited by some, namely that directors act as stewards who identify with their company and its corporate aspirations : J. Davis, F.D. Schoorman and L. Donaldson, "Toward a Stewardship Theory of Management" (1997) 22 The Academy of Management Review 20.

98 This is accepted even by some advocates of stakeholder theory in relation to companies :W. Evan and R. Freeman, "A Stakeholder Theory for Modern Corporation : Kantian Capitalism" in T. Beauchamp and N.Bowie (eds), *Ethical Theory and Business* (Englewood Cliffs, 1988), p103.

99 Sometimes referred to as "hypothetical perfect contract." See C. Rose, "Stakeholder Orientation v.s Shareholder Value – A Matter of Contractual failures" (2004) 18 European Journal of Law and Economics 77, 79.

100 Above n.93, 244; above n.92, 1825.

101 Above n.93, 244.

of directors is to the company, and, therefore, being concerned about entity maximisation is consistent with fulfilling that overall duty, more so, arguably, than shareholder primacy.

The entity maximisation approach takes into account the interests of those who have claims on the company, including the creditors, so that the most efficient outcome can be achieved for the benefit of the entity.[102] The decision in the American case of *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp*[103] endorsed the approach formulated here. In this case the court said that when a company is in the vicinity of insolvency, the directors owed their duty to the corporate enterprise, which is "an obligation to the community of interest that sustained the corporation... to exercise judgment in an informed, good faith effort to maximize the corporation's long term wealth-creating capacity."[104] Implicitly, this means that creditor interests are taken into account. Very recently, the Supreme Court of Canada in *Peoples' Department Stores v Wise*[105] seemed to accept this approach. The Court said that when a company's financial position has deteriorated significantly, directors should seek to act in such a way as to create a "better' corporation," which involves not favouring any one group of stakeholders.[106] Arguably the notion of a "better company" is encompassed by the concept of maximisation of entity wealth.

One of the concerns that we identified with the approach whereby directors simply seek to balance the interests of shareholders and creditors, was that it was difficult to implement. Is entity maximisation approach any different? First, directors do not have to engage in active balancing between interests as their aim is to maximise entity wealth. Therefore, they do not have to feel that they must explain how they engaged in balancing the relevant interests. To be sure, the directors will inevitably have to undertake some balancing, as they do if applying the principle of shareholder primacy. For example, they have decide what portion of profits to use to pay dividends and what portion should be used to purchase new equipment or stock etc. Second, according to empirical evidence derived in relation to a study of negotiated mergers, directors, when left alone, tend to maximise firm value rather than shareholder wealth,[107] which suggests that it can be, and is being, done.

So, how will directors have to act in order to achieve maximisation of entity wealth? They will have to evaluate the fairness of all investment opportunities when they are subject to the responsibility to consider creditor interests. Wild risk-taking must be eliminated, so that, for instance, directors will not be able to engage in "bet the firm" enterprises, or go "for double or nothing." As Morey McDaniel has stated : "A project is risky if it has a low probability of success but a big payoff if it succeeds, that is, a long shot. If such a project succeeds, stockholders reap most of the gain.

102 Leung, above n.12, 605; L.Mitchell, "A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes" (1992) 70 Texas L. Rev. 579, 633.

103 1991 WL 277613; 1991 Del Ch LEXIS 215; reprinted in (1992) 17 *Delaware Journal of Corporate Law* 1099 (Delaware Chancery Court), n.55.

104 At 109 (Lexis) and quoted in above n.18, 418.

105 [2004] SCC 68. The case can be accessed through the Canadian Legal Information Institute. See < www.canlii.org/ca >

106 *Ibid* at [47].

107 Dennis and McConnell, "Corporate Mergers and Security Returns" (1986) 16 Journal of Financial Economics 143. While this study is not recent, it accords with empirical evidence discussed in Stout, above n.13, 1201-1207.

The market value of the firm will increase, but most of the increases will accrue to stockholders."[108] McDaniel's statement is apposite when one takes into account the fact that, according to empirical evidence,[109] when a company is near to insolvency the managers engage in greater risks,[110] and it has become axiomatic that this risk-taking will take place,[111] particularly where the directors are also the owners[112] in the context of closed corporations. If, because the directors have little to lose where their company is in financial distress, they engage in excessive risk-taking,[113] then the creditors will be the ones to lose out if the risk does not bear fruit. Professor Robert Scott puts it this way:

> As long as the debtor's business prospects remain good, a strong reputational incentive deters misbehaviour. But once the business environment deteriorates, the [company's manager] is increasingly influenced by a 'high-roller' strategy. The poorer the prospects for a profitable conclusion to the venture, the less the entrepreneur has to risk and the more he stands to gain from imprudent or wrongful conduct.[114]

A hypothetical case study may be helpful in order to illustrate what entity maximisation involves.[115] A company has a £22m judgment and this is its only asset. The company's only liability is a sum of £5m owed to unsecured creditors. The judgment is to be appealed. On appeal, there are three possible outcomes. First, the judgment has a 25% chance of being upheld, giving an expected value of the judgment of £5.5m (i.e. 25% of £22m). Second, there is a 70% chance that the judgment will be reduced to £2m, thus giving an expected value of £1.4m (i.e. 70% of £2m). Finally, there is a five per cent chance that the judgment will be overturned, giving an expected value of £0. Say that there are offers of settlement of £5m and £7m. The expected value of the judgment on appeal is £6.9m (the total of the values of the possible outcomes – 5.5m + 1.4m). The creditors would be happy with either offer as that would satisfy all of them fully, whereas in the appeal court there is a 75% chance of them receiving nothing or a much-reduced return on their debt. Neither of the offers is all that attractive to the shareholders, for pursuant to the former offer their wealth is not increased, and with the latter it is not anything like the original judgment

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108 Above n.100, 419.

109 Ronald J. Daniels, "Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance" in Jacob S. Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law*, (Oxford, 1994), p549. However, Royce de R Barondes, above n.48, 62 challenges this view.

110 This is known as the "overinvestment theory" in finance theory : above n.48, 46.

111 Adler, above n.48, 590-598; de R Barondes, above n.48, 46 and 49.

112 Rizwaan J. Mokal, "An Agency Cost Analysis of the Wrongful Trading Provisions : Redistribution, Perverse Incentives and the Creditors' Bargain" (2000) 59 C.L.J. 335, 353-354.

113 See, Easterbrook and Fischel, above n.69, 60; Jelisavcic, above n.63, 148; Adler, above n. 48, 590-598.

114 Above n.48, 624.

115 This example is based substantially on that given by Chancellor Allen in *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp* 1991 WL 277613; 1991 Del Ch LEXIS 215; reprinted in (1992) 17 Delaware Journal of Corporate Law 1099 (Delaware Chancery Court), n.55.

of £22m. The shareholders would probably prefer to reject the offers and take their chances in the appeal court, on the basis that they have the least to lose and the most to gain from such a course of action. But, the directors, if applying entity maximisation would, in seeking the best for the corporate entity, accept any offer over £6.9m (the total of the values of the possible outcomes) and reject anything below that amount.

Let us take another example.[116] Say X Ltd has assets of £10m and debts of £8m, but has some financial concerns over projects that are ongoing. The directors are presented with two ventures. The first is quite conservative, involving a £5m outlay of funds with a 90% chance of reaping £6m and a 10% chance of being worth £4m. This effectively means that the company has a 90% chance of making a gain of £1m and a 10% chance of losing £1m. The full amount of any gain would go to the shareholders, so the creditors might not be particularly supportive of the venture, especially as there is a 10% chance that some or all of them will not receive full payment of their debts. The second venture is more risky. It requires an outlay of £10m. There is a 10% chance of a £100m return (making a gain of £90m), but it has a 90% chance of producing a £10m loss. The shareholders are likely to support this as they will be entitled to all of the gain, and even if the venture fails they will only lose their equity in X, something which is, in total, likely to be in the region of £2m before the venture is taken on. The creditors would the ones who would bear most of the risk with the second venture. If the venture succeeds the creditors will be no better off and if it fails then they will get nothing. Directors following an entity maximisation framework would dismiss the second venture, but might reason that the former is worthwhile, despite the fact that some creditors might oppose it, given the high probability of a gain.

An entity maximisation approach is attractive as it provides a happy medium between excessive risk and excessive caution.[117] If the directors were only concerned for shareholder wealth maximisation they would, potentially, be inclined to indulge in excessive risk, while if they were focusing on creditor wealth maximisation, then directors would engage in excessively cautious activity, thereby perhaps leaving potential value unrealised. This should mean that when directors are under an obligation to consider creditor interests, they are not to react by acting too cautiously, causing the company to miss out on good deals, and, conversely, they must ensure that they re-consider such things as their operating strategy in light of creditor interests. In other words, the directors must effect a balance so that creditors are protected and at the same time the company's ability to innovate and take some appropriate risks is not totally or unreasonably proscribed.[118]

An entity maximisation approach is not new. As indicated above, Chancellor Allen in *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp*[119] advocated it,

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116 Loosely based on that provided in above n.93, 221-222.

117 Above n.39, 1221.

118 S. Schwarcz, "Rethinking a Corporation's Obligations to Creditors" (1996) 17 Cardozo Law Review 647, 673

119 1991 WL 277613; 1991 Del Ch LEXIS 215; reprinted in (1992) 17 Delaware Journal of Corporate Law 1099 (Delaware Chancery Court), n.55.

and empirical evidence seems to suggest that many directors choose that approach even when companies are not in financial difficulty.[120] Interestingly, Chancellor Allen is not alone in Delaware, reputed to be the most hard line jurisdiction when it comes to supporting the ruling out of any interests other than shareholders, for there are many cases where entity maximisation has been followed.[121]

In the framework suggested, it is critical that directors remember that they are not to act as advocates of any constituency or part of one, but rather "as a neutral mediator and, when necessary, as a referee between divergent interests,"[122] so that the most efficient outcome can be achieved for the benefit of the entity.[123] The directors take on the role of a mediating body,[124] in that they mediate between the sometimes competing interests of the shareholders and the creditors, and the creditors inter se. But the mediating is done indirectly in that this occurs as they seek to maximise the entity's wealth. There is provision for director discretion, but they must always have in their mind that they might be accountable for their actions and that this will be tested pursuant to the entity maximisation principle.

*B. The Mechanics of the Framework*

This section of the article seeks to articulate the mechanics of the entity maximisation approach in the context of a responsibility to consider creditor interests. We specifically examine here, how directors are actually to operate properly in undertaking entity maximisation. Initially, we must acknowledge that there has to be an element of discretion allowed to directors because no two cases are going to be the same. Directors will be confronted with different situations and with different shareholder and creditor constituencies. Having said that, it is proposed that there are four broad elements that directors must address in implementing entity maximisation. These are prescribed in order to foster accountability of directors as well as providing them with some guidance, without being overly prescriptive, thus leaving room for some flexibility.

First, directors would have to have, given the company's position, a real legitimate purpose of business in mind in taking any action. This excludes doing something for an improper objective, such as transferring property for less than market value. In the United States it was stated in the Massachusetts case of *Re Healthco Int'l Inc*[125] by Judge Queenan that:

> A distribution to stockholders which renders the corporation insolvent, or leaves it with unreasonably small capital,

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120 Stout, above n.13, 1201-1207.

121 L. Strine, "The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions Is There any 'There' There?" (2002) 75 Southern California Law Review 1169, 1176.

122 Leung, above n.12, 590.

123 *Ibid* at.605; Mitchell, above n.102, 633.

124 See M. Blair and L. Stout, "A Team Production Theory of Corporate Law" (1999) 85 Va L. R. 247.

125 208 B.R. 288 (1997).

> threatens the very existence of the corporation. This is prejudicial to all its constituencies, including creditors, employees, and stockholders retaining an ownership interest. Surely it is not asking too much of directors that they honor their obligations of loyalty and care to avoid the corporation's destruction.[126]

Likewise, some actions that are very risky would not be legitimate, but this would not exclude the taking of all risks, save perhaps where a company is teetering on the edge of insolvency.

Second, directors must ensure that they are adequately informed when deciding on a particular action, and this includes taking the company's financial position into account before embarking on it. This is likely to include being completely aware of the financial position of the company, and, in accordance with what the law now requires of directors, they must be able to understand company accounts.[127] If they are not able to do so, then they must employ someone who can advise them appropriately.[128] Actions of directors should include calling for cash flow projections and re-assessing financial exposure at regular intervals, with the intervals between assessments becoming shorter the greater the severity of the company's financial woes. One thing that directors must be careful about doing is taking on additional debt, thereby worsening the prospects for the existing creditors. It is to be remembered that they must consider the impact of their decision on the creditors' ability to recover what they are owed.[129] Directors should take into account the position of the company, the reasons for its financial difficulty and the future of the business.

Third, directors must take the action being proposed in the good faith belief that it is reasonably likely to foster the long-term wealth of the company.[130] Fourth, a director must be persuaded in his or her mind that a reasonable director in the position of the director armed with the relevant information, and with entity maximisation in mind, would agree to the proposal.

The second and third elements are derived from the American business judgment rule,[131] which pervades every aspect of corporate law in the United States.[132] This rule is designed to preserve directors' discretion and to protect the directors from courts using hindsight to find them liable. The rule provides, in a nutshell, that courts will not substitute their business judgment for that of the informed, reasonable director

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126 *Ibid*.

127 See the comments in *Re DKG Contractors Ltd* [1990] B.C.C. 903 and referred to in D. Milman, "Strategies for Regulating Managerial Performance in the 'Twilight Zone' – Familiar Dilemmas : New Considerations" [2004] J.B.L. 493, 497.

128 *Re Hitco 2000 Ltd* [1995] 2 B.C.L.C. 63.

129 *Gwyer v London Wharf (Limehouse) Ltd* [2003] 2 B.C.L.C. 153, 181; [2002] EWHC 2748 at [81].

130 This element is consistent with what the Supreme Court of Canada in *Peoples' Department Stores v Wise* (2004) SCC 68.

131 For example, see *In re Healthco International Inc* (1997) 208 B.R. 288, 306 (Massachusetts).

132 S. Bainbridge, "Director Primacy : The Means and Ends of Corporate Governance" (2003) 97 Northwestern University Law Review 547, 601.

who acts bona fide in the best interests of the company.[133] Directors cannot be second-guessed by a court concerning their actions, provided that the directors made informed, reasonable decisions in good faith, and which were based on the details that were available to them when making the decisions. Incorporating elements that are derived from the business judgment rule serves to provide some protection for directors in an area where concern has been voiced that directors have to endure uncertainty.[134] It is worth noting that British courts have tended not to second-guess the decisions that directors have made. They have tended to place a generous interpretation on what directors have done at times when they are alleged to have breached their duties to creditors. More will be said in this respect shortly under the heading of "Review by the Courts."

The approach advocated in the above elements is similar to that implemented by the constituency statute applicable in the State of Indiana (a type of statute which provides that directors may consider the interests of constituencies, and specifically including creditors, as well as shareholders, when they make corporate decisions), which states that "if a determination is made with respect to the interests of constituencies by a majority of disinterested directors in good faith after reasonable investigation, then that determination shall be presumed to be valid."[135]

The last of the four elements introduces an objective aspect, necessary to achieve a fair result, and something that the courts have included when evaluating whether a director has acted bona fide in the best interests of his or her company. The objective aspect of the test applied in relation to evaluating whether directors have breached their fiduciary duties was set out in *Charterbridge Corp Ltd v Lloyds Bank Ltd*[136] and asks whether an intelligent and honest man in the position of a director of the company involved, could, in the whole of the circumstances, have reasonably believed that the transaction was for the benefit of the company.[137]

Professor Jonathan Lipson has said that the entity maximisation approach "has a certain appeal, on both efficiency and fairness grounds. If one distils business reality down to certain understandings of rational economic behaviour" the entity maximisation approach is the most efficient as it brings risk and reward together.[138] However, Professor Lipson went on to criticise the entity maximisation approach on the basis, *inter alia*, that decisions that directors make will often benefit one constituency at the expense of another.[139] In response one might say that the

133 For instance, see *Moran v Household International Inc* (1983) 500 A. 2d 1346, 1356 (Delaware); *Spiegel v Buntrock* 571 A. 2d 767, 774 (1990) (Delaware); above n.18, 408. The review of a director's action by a court, applying the business judgment rule, will involve a review of the objective financial interests of the directors, a review of the director's motivation and an objective review of the process by which a decision was reached by the director : *Re RJR Nabisco Inc. Shareholders' Litigation* (unreported, Delaware Chancery Court, 31 January 1989), referred to by A. Tompkins, "Directors' Duties to Creditors : Delaware and the Insolvency Exception" (1993) 47 SMU L. Rev. 165, 188.

134 Above n.18, 422

135 Committee on Corporate Laws of the Section of Business Law of the American Bar Association, "Other Constituency Statutes :Potential for Confusion" (1990) 45 Bus Law 2253, 2262.

136 [1970] Ch. 62; [1969] 2 All E.R. 1185.

137 *Ibid* at 74; 1194.

138 Above n.39, 1221.

139 *Ibid* at p1223.

framework articulated here attempts to provide a defence for directors in relation to any complaint brought against them, assuming that the directors have sought to entity maximise and followed the steps referred to above. It is submitted that the problem of balancing is in fact solved by employing the entity maximisation principle as directors are not forced to weigh up the benefits and harm accruing to different shareholders or creditors as a result of a particular action. Their remit is to act to enhance the wealth of the entity, and any balancing must seek to achieve this.

*C. Review by the Courts*

What is clear, and by way of safeguard for directors, courts, in reviewing the actions of directors, would, in applying the framework discussed above, have to dump the traditional approach used. This has involved merely stating that the directors owe a duty and then deciding whether directors have breached it or not. Rather the courts would have "to articulate more clearly the true reasons for their rulings,"[140] instead of "trotting out" the usual dicta from earlier cases.[141] But, given the framework articulated above, can the courts assess what directors have done? Professor Len Sealy, who, in a significant contribution to the literature on this topic, asserts that in a commercial context this is not a justiciable issue. But, the courts have been judging the actions of fiduciaries for many years and, it is submitted, they are now more adept at doing so than ever before. It is contended that British courts (and courts in other jurisdictions where the duty has been applied[142]) have increasingly become more competent at assessing the actions of directors. Moreover, the courts have not second-guessed the decisions that directors have made. They have generally been careful not to employ hindsight to find directors liable and have extended to directors reasonably wide latitude in interpreting how they have acted. Perhaps one example might suffice. In *Re Welfab Engineers Ltd*[143] the action involved a claim that directors had breached their duty to the company, in that they failed to take into account the interests of creditors, because they accepted one bid for the company's property, while rejecting what appeared to be more substantial bids at a time when the company was in desperate financial straits. The court, in coming to a decision that the directors were not liable for breach of their duties, took into account the commercial environment at the time of the making of the transaction alleged to constitute the breach, even though it occurred some seven years before the hearing. At the time of the alleged breach the geographical region in which the company's business operated was suffering a harsh recession and this impacted markedly on the decision made.

Cases where directors have been found liable involve situations where the directors have clearly acted against creditor interests. An example is to be found in *Liquidator of West Mercia Safetywear Ltd v Dodd*[144] where Dodd was a director of two companies, X and Y. X was a wholly owned subsidiary of Y. Y had an overdraft, the payment of which had been personally guaranteed by Dodd. X owed Y money and Dodd transferred some money from X's account to Y before both companies entered liquidation. The liquidator of X issued proceedings against Dodd and the latter was held to be in breach of his duty to X's creditors in making the payment. Clearly he

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[140] Above n.7, 180

[141] *Ibid*.

[142] For instance, Australia. See the decision in *Linton v Telnet Pty Ltd* (1999) 30 A.C.S.R. 465.

[143] [1990] B.C.C. 600.

[144] (1988) 4 B.C.C. 30.

did so in order to reduce his liability on the guarantee, therefore he was acting in his own interests rather than those of the creditors, or even the shareholders.

## V. DISSENSION AT BOARD LEVEL

One practical issue warrants a brief discussion before the close of this article. It is quite possible that one can have the situation where there is dissent amongst the directors as to what action should be taken. What are those who want to adopt a cautious approach, which they felt would enhance entity value or, if the company is insolvent, the best interests of the creditors (creditor maximisation), to do? What is the fate of these directors? This is a similar problem to the one facing a director who believes that his or her company has no reasonable prospect of avoiding insolvent liquidation. Unless something is done the director could be found liable, in such circumstances (where there is no prospect of avoiding insolvent liquidation), under s.214 of the Insolvency Act 1986 for wrongful trading. A director has a defence to wrongful trading if he or she can establish that after the point when he or she first knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, the director took *every step* with a view to minimising the potential loss to the company's creditors as ought to have been taken (my emphasis).[145] Perhaps some of the actions that have been suggested as constituting "every step" in the context of s.214 are relevant in determining what a director should do where there is dissension.[146] To what lengths must directors go to protect themselves? One possible action to take is to insist that the minutes of the relevant board meeting indicated that they dissented from the proposed course of action that is believed to be in breach of the obligation to consider creditor interests. Would resignation protect directors? If resignation occurred prior to the taking of actions that turn out to prejudice creditors' interests, it might be argued that the directors who resigned were not parties to the actions that caused loss to creditors. However, that might be a too glib approach. It might be contended that because the directors were under a duty at the time that the proposed action(s) was discussed, they should do more than merely resign.

## VI. CONCLUSION

This article has examined what directors are to do when obliged to consider the interests of creditors. Undoubtedly, the first thing that has to be said is that there are difficulties in defining under what governance norms directors are to operate when they are subject to a responsibility to take creditor interests into account. While the exact circumstances that will precipitate the advent of the duty are not precise, how directors are to fulfil their responsibilities to creditors is even less clear. Much has been made of the fact that determining what is meant by taking into account the interests of creditors is difficult, and close to meaningless. Unfortunately the problem is that legal doctrine has not caught up with the economic reality where financially distressed companies are involved.[147] Without doubt, "it is unsatisfactory that there should be no precise indication of the nature of the duty and the conduct that it

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145 Section 214(3).

146 For instance, see those elements mentioned in R. Goode, *Principles of Corporate Insolvency Law*, 2nd ed, (London, 1997), pp472-473.

147 Above n.18, 415.

demands from directors"[148] when they are subject to a duty to consider creditor interests.

It has been submitted that if a company is insolvent, because the interests of creditors are paramount, the task of directors is not so difficult. In all that they do, directors should have in mind the payment of creditors, and be implementing policies that maximise creditor wealth. The problem occurs where the company is in a position that is short of insolvency. In such a situation, the article considered the problems that exist if we simply require directors, when under an obligation to consider creditor interests, to balance the interests of creditors as against shareholders, as well as balancing the interests of creditors *inter se*. It was demonstrated that the task confronting directors in doing this is sometimes complex, primarily because of the existence of conflicting interests, and it is an invidious assignment for directors, with little in the way of a guide being given to directors as to how they should carry out the company's business.

The prime difficulty in devising resolutions to the problem is that there are no hard and fast rules concerning how directors are to act when creditor interests are to be taken into account. What is clear is that one cannot apply across the board prophylactic rules to govern directors in the kinds of situations raised in this article. It is not possible to resort to something akin to mathematical formulae. The issues that face directors are often complex and difficult to predict so it would not be feasible to lay down in advance how directors are to act in the light of future contingencies. The circumstances and conflicts of each case must be considered separately. We cannot escape having to rely on directors' discretion to some extent. But this does not exactly help directors to know what they are to do. While accepting all of this, it has been submitted in the article that we can provide, at least, a framework within which directors should operate when subject to a responsibility to creditors. The framework advocated here is the entity maximisation approach which makes it incumbent on directors to make decisions that will maximise the general wealth of the company so that the net present value to the company as a whole is enhanced. The article has also sought to explain how directors should act in endeavouring to maximise entity wealth.

One critical advantage of adopting the entity maximisation approach is that it avoids a total dependence on directors having to engage in a balancing exercise, weighing up the interests of the shareholder and creditor constituencies, which is extremely difficult to do. Some balancing will have to be undertaken, but at least the directors have an aim in what they doing, when they engage in the balancing, namely to ensure that entity value is maximised.

The framework proposed is an attempt to provide some guidance and a degree of certainty for directors, as well as providing some principles upon which courts could evaluate the actions of directors. Rather than having little on which to judge directors, courts would be able to assess whether directors sought to maximise entity wealth, and before finding them liable they would need to point to some aspect of the directors' mode of operation that constituted a neglect of the interests of creditors.

148 Above n.17, 90.

# WORKING PAPER

# SHAREHOLDER PRIMACY AND THE ADVENT OF ENLIGHTENED SHAREHOLDER VALUE IN THE REFORM OF DIRECTORS' DUTIES.


## Andrew Keay

Professor of Corporate and Commercial Law, Centre for Business Law and Practice

E-mail – a.r.keay@leeds.ac.uk


## I Introduction

The role and work of directors in managing their companies is a critical aspect of corporate law. One element of this role, and which has been the subject of robust debate for many years, is : for whom are they to manage the company? While this debate has been at its hottest in the United States, spawning a voluminous amount of impressive scholarly pieces, in recent years there has been greater consideration of the issue in the United Kingdom.

It is trite law that a director owes a duty to act bona fide in the best interests of the company in which he or she is involved.[1] But it has been a vexed question as to what is meant by "the interests of the company." The conventional view is that this means that the director must act in the best interests of the company's shareholders, present and future.[2] This view has been taken-for-granted[3] and is articulated by most texts and commentaries[4] as well as being endorsed by the Takeover Code.[5] The following exemplifies the position stated in much of the literature : "The modern conceptualisation of the corporation states that the shareholders…are entitled to assume that the company will be run in their

1 If authority is needed, see *Percival v Wright* [1902] 2 Ch 421; *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] Ch 258. In the United States of America, see, for example, *United States v Byrum* (1972) 408 US 125 (US Supreme Court), in New Zealand, see *Nicholson v Permakraft (NZ) Ltd* ((1985) 3 ACLC 453 (Court of Appeal), and in Australia, see *Grove v Flavel* (1986) 11 ACLR 161 (Full Court of the Supreme Court of South Australia).

2 The case that is often cited is *Hutton v West Cork Railway Co* (1883) 23 Ch D 654, but it is arguable whether it does in fact stand for this approach. The case is discussed later.

3 P. Ireland, "Property and contract in contemporary corporate theory" (2003) 23 LS 453 at 456.

4 Lord Wedderburn, 'The Legal Development of Corporate Responsibility' in K. Hopt and G. Teubner (eds), *Corporate Governance and Directors' Liabilities* Berlin, Walter de Gruyter, 1985, 1 at 5; L S Sealy, "Director's Wider Responsibilities – Problems Conceptual Practical and Procedural" (1987) 13 *Monash University Law Review* 164 at 173, B. Hannigan, *Company Law*, London, LexisNexis, 2003 at 203; P. Davies, *Gower and Davies' Principles of Modern Company Law*, 7th ed, London, Sweet and Maxwell, 2003 at 372; H. Hirt, "The Company's Decision to Litigate Against its Directors : Legal Strategies to Deal with the Board of Directors' Conflict of Interest" [2005] JBL 159 at 164-165. The view was made more (in)famous by the comments of the Noble laureate economist, Milton Friedman, in "The Social Responsibility of Business is to Increase its Profits" New York Times, September 13, 1970, Section 6 (Magazine).

5 S. Deakin and G. Slinger, "Hostile Takeovers, Corporate Law and the Theory of the Firm" (1997) 24 *Journal of Law and Society* 124.

interests."[6] The approach to which the quotation refers is often known variously as the shareholder primacy principle (or paradigm), shareholder value principle or the shareholder wealth maximisation norm.[7] It requires, inter alia, a company to be run in such a way as to maximise the interests of the shareholders ahead of any other interested parties who might have claims against the company.[8] The objective of the company is, under this principle, to maximise market value of the company "through allocative, productive and dynamic efficiency."[9] Generally the principle is said to be embraced by most scholars[10] and applies in the United Kingdom, the United States and in many common law jurisdictions, such as Australia and Canada.

The approach that should be adopted in the UK was considered in recent years by the Company Law Review Steering Group (CLRSG), appointed in 1998 by the Department of Trade and Industry to undertake a comprehensive review of company law. It finally came to the conclusion that what it termed, "an enlightened shareholder value approach," should prevail. This recommendation was accepted by the Government in two White Papers, in July 2002 and March 2005, that followed the final report from the CLRSG.

The purpose of this article is to examine the theoretical basis of the shareholder primacy principle, its position in UK law and to assess the enlightened shareholder value concept as proposed by the CSRLG and encapsulated in the March 2005 White Paper. The article also aims to consider the application of the enlightened shareholder value concept in future legislation.

The article begins with an examination of the rationale for the shareholder primacy principle and the debate that has raged, principally in the United States, concerning the normative quality of the principle. Following this there is an examination of the positive law and then a particular focus on the UK case law that has considered the meaning of "the interests of the company." Next, the article considers the enlightened shareholder value approach sanctioned by the CLRSG in its reports, and by the Government in its White Papers. Finally, before some concluding remarks, the article first examines the CLRSG proposals and the provisions in the White Papers that implement the enlightened shareholder value approach and then moves on to assess the application of this approach in future legislation.

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6 L. Roach, "The Paradox of the Traditional Justifications for Exclusive Shareholder Governance Protection : Expanding the Pluralist Approach" (2001) 22 Co Law 9 at 9.

7 S. Bainbridge, "In Defense of the Shareholder Wealth Maximization Norm : A Reply to Professor Green" (1993) 50 *Washington and Lee Law Review* 1423; M. Roe, "The Shareholder Wealth Maximization Norm and Industrial Organization" (2001) U Pa L Rev 2063; W. Allen, J. Jacobs and L Strine, "The Great Takeover Debate : A Mediation on Bridging the Conceptual Divide" (2002) 69 U Chi L Rev 1067 at 1075; S. Bainbridge, "Director Primacy : The Means and Ends of Corporate Governance" (2003) 97 *Northwestern University Law Review* 547 at 549, 552, 565. The Company Law Review Steering Group in the UK did in fact refer to the principle simply as "shareholder value" (Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at paras 5.1.12ff.

8 Some would also see the principle as representing the idea that the shareholders are the ones who have ultimate control of a company.

9 Colin Mayer, "Corporate Governance, Competition and Performance" (1997) 24 *Journal of Law and Society* 152 at 155.

10 H. Hansmann and R. Kraakman, "The End of History for Corporate Law" (2001) 89 *Georgetown Law Journal* 439 at 440-441.

## II The Theoretical Foundations of Shareholder Primacy

### A. The Background

Shareholder primacy has been largely fostered as a leading principle of corporate law by the contractarian school in the US.[11] It was in the US in the early 1930s that we find the genesis of the debate concerning the objective of a company. It all really started in earnest with the debates between Professors Adolf Berle and E Merrick Dodd, and carried out in the literature published at the time.[12] Without going into great detail, Berle maintained, inter alia, that directors should not, as managers of companies, have any responsibilities other than to the shareholders of their companies, for whom money was to be made.[13] On the other hand, Dodd held that the public saw companies as economic institutions that have a social service role to play as well as making profits, and that companies had responsibilities to the company's shareholders, employees, customers, and to the general public.[14] While the former conceded defeat eventually, the last half of the twentieth century has arguably been characterised as a time when many of Berle's views held sway, especially in the US. It might be said that this position has been attenuated somewhat by the introduction of constituency statutes in over half of the American states, an issue that is discussed later. These statutes permit directors to take into account the interests of constituencies, other than shareholders, in the actions that they take. If there has been a weakening, and many would argue against that, it has been minimal, as the number of learned articles arguing for a shareholder maximisation approach attest.

### A. The Arguments in Favour

The contractarian theorists, many of whom advocate a law and economics approach to law, focus on the contractual relationships that exist between persons involved in the

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11 This is not to say that those who do not see themselves as contractarians do not agree with shareholder primacy. For some of the leading works on the principle, see J. Macey, "An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties" (1991) 21 *Stetson Law Review* 23; S. Bainbridge, "In Defense of the Shareholder Maximization Norm : A Reply to Professor Green" (1993) 50 *Washington and Lee Law Review* 1423; Bernard Black and Reiner Kraakman, "A Self-Enforcing Model of Corporate Law" (1996) 109 *Harvard Law Review* 1911; D Gordon Smith, "The Shareholder Primacy Norm" (1998) 23 *Journal of Corporate Law* 277. It must be noted that some contractarians do not accept shareholder primacy : D.D. Prentice, "The Contractual Theory of the Company and the Protection of Non-Shareholder Interests" in D. Feldman and F. Meisel, *Corporate and Commercial Law : Modern Developments* (London, Lloyds of London Press, 1996) at 121.

12 See A. A. Berle, "Corporate Powers as Powers in Trust" (1931) 44 Harv L R 1049; E. M. Dodd, "For Whom are Corporate Managers Trustees?" (1932) 45 Harv L R 1145; A. A. Berle, "For Whom Managers are Trustees : A Note" (1932) 45 Harv L R 1365. Also, see A.A. Berle and G. Means, *The Modern Corporation and Private Property* MacMillan, New York, 1932; E.M. Dodd, "Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?" (1935) 2 *University of Chicago Law Review* 194.

13 A. A. Berle, "Corporate Powers as Powers in Trust" (1931) 44 Harv L R 1049 at 1049. The view was put forward, in effect, in the earlier decision of *Dodge v Ford Motor Co* (1919) 170 NW 668 (Michigan).

14 E. M. Dodd, "For Whom are Corporate Managers Trustees?" (1932) 45 Harv L R 1145 at 1148.

affairs of the company, and, accordingly, hold to the principle of the sanctity of contract. Many contractarians[15] regard the company as nothing more than a number of complex, private consensual contract-based relations,[16] either express or implied, and they consist of many different kinds of relations that are worked out by those voluntarily associating in a company.[17] The parties involved in these contracts are regarded as rational economic actors, and includes shareholders, managers, creditors and employees, and it is accepted that each of these constituencies endeavour in their contracting to maximise their own positions, with the intention of producing concomitant benefits for themselves.[18] This scheme is usually known by the shorthand expression of "a nexus of contracts."[19] The nexus of contracts theory in relation to the firm was devised by economists[20] and embraced by economically inclined law academics.[21] The contractarians generally[22] regard shareholder primacy as the focal point of their view of the public company.[23] The principle fills gaps in the corporate contract;[24] it establishes "the substance of the corporate fiduciary duty."[25]

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15 For example, Eugene Fama, 'Agency Problems and the Theory of the Firm (1990) 99 *Journal of Political Economics* 288, 290.

16 Referring to the relations as contracts is probably incorrect. Some authors refer to the relations as bargains as some of the relations do not constitute contracts in a technical sense. See, Michael Klausner, 'Corporations, Corporate Law and Networks of Contracts' (1995) 81 *Virginia Law Review* 757, 759.

17 Frank H. Easterbrook and Daniel R. Fischel, 'The Corporate Contract' (1989) 89 Colum L Rev 1416, 1426. At p1428 the learned commentators give examples of some of the arrangements.

18 See, Henry N. Butler, 'The Contractual Theory of the Corporation' (1989) 11 *George Mason University Law Review* 99; Christopher A. Riley, 'Understanding and Regulating the Corporation' (1995) 58 MLR 595, 598.

19 The literature considering the nexus of contracts is too voluminous to cite. But see, for example, Eugene E. Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economy* 228, 290; Frank H. Easterbrook and Daniel R. Fischel, 'The Corporate Contract' (1989) 89 Colum L Rev 1416, 1426-1427. Professor Stephen Bainbridge has said that the nexus of contracts provides us with "an educated guess" about the rule that most parties would embrace if they could bargain *ex ante*. The nexus of contracts approach is critiqued by William W. Bratton Jr in 'The "Nexus of Contracts Corporation" : A Critical Appraisal' (1989) 74 Cornell L Rev 407, 412, 446-465. The scheme has been referred to as 'a nexus of incomplete contracts.' For recent comments, see, for example, Simon Deakin and Alan Hughes, 'Economic Efficiency and the Proceduralisation of Company Law'(1999) 3 CfiLR 169, 176-180; Iain McNeil, 'Company Law Rules : An Assessment from the Perspective of Incomplete Contract Theory' (2001) 1 JCLS 107 .

20 See R Coase, "the Nature of the Firm" (1937) 4 *Economica* 386 at 390-392; A Alchian and H Demsetz, "Production, Information Costs, and Economic Organization" (1972) 62 Am Econ Rev 777 at 794; M. Jensen and W. Meckling, "Theory of the Firm : Managerial Behaviour, Agency Costs, and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305.

21 See F Easterbrook and D Fischel 'The Corporate Contract' (1989) 89 Colum L Rev 1416; Easterbrook and Fischel *The Economic Structure of Company Law* (Cambridge, Mass, Harvard University Press, 1991) at 37-39; W Bratton Jr "The 'Nexus of Contracts' Corporation : A Critical Appraisal" (1989) 74 Cornell L Rev 407.

22 Professor Stephen Bainbridge would appear to be an exception as he emphasises director primacy : "The Board of Directors as Nexus of Contracts" (2002) 88 *Iowa Law Review* 1; "Director Primacy : The Means and Ends of Corporate Governance" (2003) 97 *Northwestern University Law Review* 547.

23 M. Bradley, C. Schipani, A. Sundaram and J. Walsh, "The Purposes and Accountability of the Corporation in Contemporary Society : Corporate Governance at a Crossroads" (1999) 62 *Law and Contemporary Problems* 9 at 38.

24 Frank Easterbrook and Daniel Fischel *The Economic Structure of Company Law* (Cambridge, Mass, Harvard University Press, 1991) at 90-93; J. Macey, and G. Miller, "Corporate

The preference for shareholder primacy is not a consequence of a "philosophical predilection"[26] towards shareholders, but a concern that the business should be run for the benefit of the residual claimants, namely, the shareholders, while the company is solvent.[27] This is probably regarded as the primary argument in favour of the shareholder value approach. The residual claimants have the greatest stake in the outcome of the company,[28] as they will benefit if the company's fortunes increase, but they will lose out if the company hits hard times (with their claims being last in line if the company is dissolved), and they will value the right to control above any other stakeholders,[29] as they have an interest in every decision that is taken by a solvent firm.[30] It has been said that as shareholders are the owners of the company,[31] those who manage the company should do so for the benefit of the shareholders.[32] Of course, this does not mean that the shareholders are the only ones who value the right to be owed fiduciary duties. But it has been argued that fiduciary duties are not public goods and the enjoyment by one group of stakeholders reduces the ability of other

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Stakeholders : A Contractual Perspective" (1993) 43 *University of Toronto Law Review* 401 at 404.

25 T. Smith, "The Efficient Norm for Corporate Law : A Neotraditional Interpretation of Fiduciary Duty" (1999) 98 *Michigan Law Review* 214 at 217. A view with which Professor Smith disagrees (ibid).

26 M. Bradley, C. Schipani, A. Sundaram and J. Walsh, "The Purposes and Accountability of the Corporation in Contemporary Society : Corporate Governance at a Crossroads" (1999) 62 *Law and Contemporary Problems* 9 at 37.

27 F. Easterbrook and D. Fischel, *The Economic Structure of Company Law* (Cambridge, Mass, Harvard University Press, 1991) at 36-39. Professors Margaret Blair and Lynn Stout take issue with this : "Director Accountability and the Mediating Role of the Corporate Board" (2001) 79 Wash U L Q 403 at 404. Also, see L. Stout, "Bad and Not-so-Bad Arguments for shareholder Primacy" (2002) 75 *Southern California Law Review* 1189 at 1192-1193. The view is sometimes espoused that the shareholders own the company : M. Friedman, "The Social Responsibility of Business is to Increase its Profits" New York Times, September 13, 1970, Section 6 (Magazine) at 32, 33; R. Hessen, "A New concept of Corporations : A Contractual and Private Property Model" (1979) 30 *Hastings Law Journal* 1327 at 1330.

28 J. Macey, "Fiduciary Duties as Residual Claims : Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective" (1999) 84 *Cornell Law Review* 1266 at 1267. This has been queried by several commentators, such as Professor Margaret Blair (*Ownership and Control* (Washington DC, The Brookings Institute, 1995) at 229).

29 Mark E.Van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27 at 57; M. Bradley, C. Schipani, A. Sundaram and J. Walsh, "The Purposes and Accountability of the Corporation in Contemporary Society : Corporate Governance at a Crossroads" (1999) 62 *Law and Contemporary Problems* 9 at 38.

30 J. Macey, and G. Miller, "Corporate Stakeholders : A Contractual Perspective" (1993) 43 *University of Toronto Law Review* 401 at 408.

31 For example, see Committee on the Financial Aspects of Corporate Governance (Cadbury Report), London, Gee, 1992, at para 6.1; Confederation of British Industries, *Boards Without Tiers : A CBI Contribution to the Debate*, London, CBI, 1996 at 8.

32 This view has been criticised by many. For example, Martin Lipton and Steven Rosenblum, "A New System of Corporate Governance : The Quinquenial Election of Directors" (1991) 58 U Chi L Rev 187 at 195; Paddy Ireland, "Capitalism without the capitalist : The joint stock company share and the emergence of the modern doctrine of separate corporate personality" (1996) 17 *Legal History* 40; S. Worthington, "Shares and shareholders : property, power and entitlement (Part 1) (2001) 22 Co Law 258 and Part 2 (2001) 22 Co Law 307. Also see, *Short v Treasury Commissioners* [1948] 1 KB 116 at 122 where Evershed LJ denied the fact that shareholders were the owners of a company.

groups to enjoy the benefits that the duties produce.[33] The bottom line is that contractarians have a shareholder-centric concept of the company.

There are other arguments that are propounded in favour of shareholder primacy. First, according to the prevailing agency theory,[34] directors are the agents of the shareholders and are employed to run the company's business for the shareholders who do not have the time or ability to do so, and it is the shareholders who are best suited to guide and discipline directors in the carrying out of their powers and duties.[35] It is said that if there is no shareholder primacy, the directors are able to engage in opportunistic behaviour, known as "shirking." Costs, known as "agency costs,"[36] will be incurred in monitoring the work of the directors, so as to reduce the incidence of shirking, and the existence of duties owed to shareholders reduces those costs and at the same time protects the shareholders. The bottom line is that shareholder primacy means that directors are fully accountable for what they do in running the company's business.

Second, it is argued that the principle is based on efficiency. Shareholders have incentives to maximise profits and so they are likely to foster economic efficiency. It is more efficient if directors operate on the basis of maximising shareholder wealth, because the least cost is expended in doing this;[37] the directors can work more efficiently if they are focused only on one objective.

Third, and allied to the previous argument, if directors owe duties to various constituencies, then it would be impossible for directors to balance all of the divergent interests, with the result that directors will make poor decisions.[38] It is said that the principle is certain and easy to administer, especially when compared with the stakeholder theory,[39] under which directors are to act with all stakeholder interests in view. Shareholder primacy allows, so the argument goes, courts to review managerial conduct with some rationality.[40]

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33 J. Macey, and G. Miller, "Corporate Stakeholders : A Contractual Perspective" (1993) 43 *University of Toronto Law Review* 401 at 410.

34 This is based on a large number of works, but arguably the most influential are : Michael Jensen and William Meckling, "Theory of the Firm : Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305; Eugene Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J Pol Econ 288; Eugene Fama and Michael Jensen, "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301; Frank Easterbrook and Daniel Fischel, *The Economic Structure of the Corporate Law*, 1991.

35 J. Matheson and B. Olson, "Corporate Law and the Longterm Shareholder Model of Corporate Governance" (1992) 76 *Minnesota Law Review* 1313 at 1328.

36 These costs are those resulting from managers failing to act appropriately and the costs expended in monitoring and disciplining the managers in order to prevent them abusing their positions.

37 M.Van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27 at 56-57.

38 The Committee on Corporate Law, "Other Constituency Statutes : Potential for Confusion" (1990) 45 *Business Lawyer* 2253 at 2269. It is generally felt that life would be made somewhat easier for directors if shareholder primacy did not exist as they could more easily justify decisions that they make.

39 Mark E.Van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27 at 68.

40 Mark E.Van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27 at 69.

Fourth, it is argued that constituencies other than the shareholders are able to protect themselves by the terms of the contracts that they make, while shareholders do not have this kind of protection. The assertion is made that the shareholders are vulnerable[41] in that they are not, unlike say creditors, able to negotiate special terms by way of contract, and they are, in many ways, at the mercy of the directors, for they have difficulty in monitoring the work of directors. Fifth, unlike some groups, such as creditors, shareholders are not always able to diversify their exposure to losses sustained by their investments. Finally, shareholders are not, except in listed companies, always able to exit easily a company with which they are not happy.

**A. The Critics**

It has been asserted in recent times that corporate governance debates have now been resolved in favour of the shareholder primacy model. [42] However, the shareholder primacy principle has long had its critics and some theorists have questioned its normative value, [43] and others, principally those adopting a communitarian or pluralist approach to corporate law,[44] have argued that directors should be required to consider the interests of others besides shareholders, namely those whom we can call stakeholders. While shareholder primacy appears to hold sway in legal, accounting and finance circles, this is not the case in relation to other disciplines, such as management and business ethics, which have embraced a wider perspective than shareholder primacy. Clarkson illustrates this when he states that : "Managers are now accountable for fulfilling the firm's responsibility to its primary stakeholder

41 See Luigi Zingales, "Corporate Governance" in *The New Palgrave Dictionary of Economics and Law*, Basingstoke, MacMillan, 1997 at 501.

42 H. Hansmann and R. Kraakman, "The End of History for Corporate Law" (2001) 89 *Georgetown Law Journal* 439.

43 For example, see David Millon, "New Game Plan or Business as Usual? A Critique of the Team Production Model of the Corporate Board" (2000) 86 *Virginia Law Review* 1001 at 1001-1004; Lynn Stout, "Bad and Not-So-Bad Arguments for Shareholder Primacy" (2002) 75 *South California Law Review* 1189 at 1191.

44 For discussions of this approach to corporate law, see, for example, Lawrence E. Mitchell (ed), *Progressive Corporate Law* (1995); William Bratton Jr, "The 'Nexus of Contracts Corporation' : A Critical Appraisal" (1989) 74 Cornell L Rev 407Lawrence Mitchell, "The Fairness Rights of Bondholders" (1990) 65 *New York University Law Review* 1165; David Millon, "Theories of the Corporation" [1990] Duke LJ 201; Lyman Johnson, "The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law" (1990) 68 *Texas Law Review* 865. Works in the UK that have advocated this approach are : Janet Dine, "Companies and Regulations : Theories, Justifications and Policing" in D Milman (ed), *Regulating Enterprise : Law and Business Organisations in the UK* (Hart Publishing, Oxford, 1999) at 295-296; Janet Dine, *Company Law* (Sweet and Maxwell, London, 2001), 27-30; John Parkinson, *Corporate Power and Responsibility* (Clarendon Press, Oxford, 1993); Gavin Kelly and John Parkinson, "The Conceptual Foundations of the Company : A Pluralist Approach" (1998) 2 CfiLR 174. Also, see W. Leung, The Inadequacy of Shareholder Primacy : A Proposed Corporate Regime that Recognizes Non-Shareholder Interests" (1997) 30 *Columbia Journal of Law and Social Problems* 589; G. Crespi, "Rethinking Corporate Fiduciary Duties : The Inefficiency of the Shareholder Primacy Norm" (2002) 55 SMU Law Rev 141.

groups."[45] Some leading writers have even proclaimed boldly that stakeholder theory is generally so pre-eminent that shareholder primacy is dead.[46]

Those holding to a communitarian[47] view of the company object to the shareholder primacy principle on normative grounds,[48] arguing that directors should be obliged to run companies for the benefit of all potential stakeholders in companies, such as creditors, employees, suppliers, customers and the communities in which the company operates. This aligns with the view of communitarians that companies should serve broader social purposes than simply making money for shareholders.

Communitarians theorists seek to focus on the fact that those involved in, and dealing with, companies are humans and corporate law should not be de-personalised.[49] In the communitarian assessment a greater array of social and political values are considered, and communitarians opine that whether the company is useful is measured by evaluating how it assists society gain a richer understanding of community by respecting human dignity and overall welfare.[50] Communitarians embrace a normative world view that emphasises the fact that people are part of a shared community who inherit the benefits, values and goals of the community, thus the cultural milieu in which people find themselves cannot be ignored,[51] and the company is regarded as "a community of interdependence, mutual trust and reciprocal benefit."[52] It has been argued, inter alia, in the communitarian corporate law literature[53] that companies are public institutions with public obligations and it is necessary to have mandatory rules to control what they and their managers do.[54] A consequence of this view is that it is asserted that the interests of shareholders are not the only interests to be considered by directors when carrying out their functions, for

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45 M. Clarkson, "A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance" (1995) 20 *Academy Management Review* 92 at 112.

46 For example, Professor R Edward Freeman : "The Politics of Stakeholder Theory : Some Future Directions" (1994) 4 *Business Ethics Quarterly* 409 at 413.

47 Those arguing for a "team production" approach to corporate law (the main scholars adopting this view are Professors Margaret Blair and Lynn Stout in Stout, L., 'A Team Production Theory of Corporate Law' (1999) 85 Va L R 247; "Director Accountability and the Mediating Role of the Corporate Board" (2001) 79 Wash U L Q 403) also take issue with the shareholder primacy principle.

48 For instance, see David Millon, "Redefining Corporate Law" (1991) 24 *Indiana Law Review* 223 at 227ff.

49 For example, see Lawrence Mitchell, "Groundwork of the Metaphysics of Corporate Law" (1993) 50 *Washington and Lee Law Review* 1477 at 1479-1481. In another work ("The Death of Fiduciary Duty in Close Corporations" (1990) 138 U Pa LR 1675 at 1675), the learned commentator states that "The corporation is a human enterprise."

50 D. Sullivan and D. Conlon, "Crisis and Transition in Corporate Governance Paradigms : The Role of the Chancery Court of Delaware" [1997] *Law and Society Review* 713 and referred to by Janet Dine, "Companies and Regulations : Theories, Justifications and Policing" in D. Milman (ed), *Regulating Enterprise : Law and Business Organisations in the UK* (Hart Publishing, Oxford, 1999) at 295.

51 D. Millon, 'New Directions in Corporate Law : Communitarians, Contractarians and Crisis in Corporate Law' (1993) 50 *Washington and Lee Law Review* 1373 at 1382.

52 D. Millon, 'Communitarianism in Corporate Law : Foundations and Law Reform Strategies' in Lawrence E. Mitchell (ed), *Progressive Corporate Law* (Boulder, Colorado, Westview Press, 1995) at 10.

53 Of course, not all progressives adhere to the same view on all matters.

54 For example, see Douglas M Branson, "The Death of Contractariansim and the Vindication of Structure and Authority in Corporate Governance and Corporate Law" in Lawrence E. Mitchell (ed), *Progressive Corporate Law* (1995) at 93.

there are other important constituencies that warrant consideration from directors.[55] The effect of invoking a shareholder primacy approach is, arguably, to damage the incentives of non-shareholder stakeholders to make firm-specific investments in companies as they are aware that their investments will be subordinated to shareholder interests at all times,[56] therefore, communitarians have criticised it, with Professor Lyman Johnson saying that "a radically proshareholder vision of corporate endeavour [is] substantially out of line with prevailing social norms,"[57] and that courts must acknowledge this and define "the meaning of corporate endeavour"[58] by embracing norms "wider than the thin thread of shareholder primacy."[59]

Another commentator has argued that the shareholder primacy principle is not relevant to business decisions today and that it was introduced originally to resolve disputes among majority and minority shareholders in closely-held companies, and courts tended not to distinguish between closely-held and public companies until the middle of the last century.[60] Others have said that shareholder primacy produces a short-term focus and short term earnings performance overshadows all else,[61] and this fails to maximise social wealth.[62]

As far as public companies are concerned it has been asserted that they are of such broad public concern, and affect the lives and interests of so many, that they can no longer be managed solely for the benefit of shareholders.[63]

## III Shareholder Primacy and the Law

### A. Support for Shareholder Primacy?

55 For example, Professor Lawrence Mitchell criticises the whole notion of shareholder maximisation in corporate law ("A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes (1992) 70 *Texas Law Review* 579 at 640). See Millon, above n 67 at 7-9. Progressives differ among themselves concerning the strength of the claims of various non-shareholder constituencies to warrant legal intervention.

56 G.Kelly and J.Parkinson, "The Conceptual Foundations of the Company : A Pluralist Approach" in J.Parkinson, A.Gamble and G.Kelly (eds), *The Political Economy of the Company*, Oxford : Hart Publishing, 2000 at 131.

57 "The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law" (1990) 68 *Texas Law Review* 865 at 934.

58 Ibid.

59 Ibid.

60 D Gordon Smith, "The Shareholder Primacy Norm" (1998) 23 *Journal of Corporate Law* 277 at 279.

61 S. Wallman, "The Proper Interpretation of Corporate Constituency Statues and Formulation of Director Duties" (1991) 21 *Stetson Law Review* 163 at 176-177; M. Lipson and S. Rosenblum, "A New System of Corporate Governance : The Quinquennial Election of Directors (1991) 58 *University of Chicago Law Review* 187 at 205-215; Mark E.Van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27 at 61.

62 S. Wallman, "The Proper Interpretation of Corporate Constituency Statues and Formulation of Director Duties" (1991) 21 *Stetson Law Review* 163 at 176-177; M. Lipson and S. Rosenblum, "A New System of Corporate Governance : The Quinquennial Election of Directors (1991) 58 *University of Chicago Law Review* 187 at 203.

63 R. Karmel, "Implications of the Stakeholder Model" (1993) 61 *George Washington Law Review* 1156 at 1171-1175; L. Johnson and D. Millon, "Corporate Takeovers and Corporate Law : Who's in Control?" (1993) 61 *George Washington Law Review* 1177 at 1197-1207.

Clearly there are strong arguments that favour shareholder primacy as a normative principle, notwithstanding the communitarian critique. But is it descriptive of the law as it stands? In the US the Principles of Corporate Governance seem to provide for shareholder primacy.[64] In the UK there is some evidence of directors following a shareholder primacy approach. The 1999 survey of directors conducted by the Institute of Directors found that many directors believed that they were obliged to maximise short term shareholder benefits at the expense of long-term interests.[65] More pertinently, the UK's Company Law Review Steering Group ("CLRSG") stated that the directors are to manage the company's business for the benefit of the company, and this normally means that it is managed for the benefit of the shareholders as a whole.[66] Earlier the CLRSG had said that the legal framework essentially supported a shareholder primacy system.[67] Certainly there are aspects of corporate law that appear to support shareholder primacy. Three examples suffice. First, shareholders have voting rights which can determine who will be the directors and also the shareholders have the power to dismiss directors under s 303 of the Companies Act 1985. These rights give the shareholders, in limited situations, the right to decide on fundamental changes to the corporate constitution, such as alterations to the articles of association. But, when it comes to electing and possibly dismissing directors, we have to note that in public companies with a widely dispersed share ownership there are legal and practical hurdles that mean that voting rights will often make little or no difference.[68] The chairman of the board will often be empowered by absent shareholders to vote on their behalf through the use of proxies, and this frequently sees the incumbent directors retaining control. In closely-held companies it is usually the case that a shareholder or group of shareholders will control the voting at meetings and so the voting rights of individual shareholders are rendered close to otiose. As far as voting on changes to the life of the company are concerned, shareholders usually only get to vote on such issues when the board convenes the appropriate meeting. When they the opportunity does arise then the points that have been made above apply just as they do with respect to voting for the election and/or removal of directors. It has been said that shareholder voting is "a fraud or a mere ceremony designed to give a veneer of legitimacy to managerial power."[69] Generally, shareholders do not have the power to tell the directors how to run the company. That is something that is usually bestowed on the directors by the articles.[70] Consequently, describing the directors as the agents of the shareholders, as is often done, is arguably, debatable.

Second, s.459 of the Companies Act 1985 permits shareholders to file a petition against a company where the company is being run in a way that is unfairly

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64 *Principles of Corporate Governance : Analysis and Recommendations*, 1994, s.2.01(a) and referred to in Mark Roe, "The Shareholder Wealth Maximization Norm and Industrial Organization" (2001) 149 U Pa L Rev 2063 at 2072.

65 *Good Boardroom*, London, Institute of Directors and referred to in Lee Roach, "The legal model of the company the Company Law Review" (2005) 26 Co Law 98 at 101.

66 Company Law Review, *Modernising Company Law :* The Strategic Framework, London, DTI, 1999, at para 5.1.5.

67 Company Law Review, *Modernising Company Law :* The Strategic Framework, London, DTI, 1999, at para 5.1.4.

68 See, L. Bebchuk, "The Case for Increasing Shareholder Power" (2005) 118 Harv L R 833.

69 R. Clark, *Corporate Law*, (Aspen Publishers, New York, 1986) at 781-782 and quoted by Margaret Blair and Lynn Stout in 'A Team Production Theory of Corporate Law' (1999) 85 Va L R 247 at 312.

70 For example, see Art 70 of Table A of the Companies (Tables A-F) Regulations 1985.

prejudicial to his or her interests. However, s.459 has been used overwhelmingly in relation to private companies where a member can establish that he or she had, when joining the company, certain legitimate expectations that have not been adhered to. With public companies, where people tend to become involved without being given any expectations by directors or managers, this sort of approach is generally not going to work.[71]

Third, in certain restricted cases, shareholders may take derivative proceedings against the directors on behalf of the company. This is permitted primarily where directors have committed a fraud on the minority, that is, their actions perhaps constitute a breach of duty and this prejudices the interests of the minority shareholders.[72] Certainly shareholders are exclusively granted special rights, but this is simply instrumental. As Professors Margaret Blair and Lynn Stout have said:

> "Shareholders enjoy special legal rights not because they have some unique claim on directors, but because they often are in the best position to represent the interests of the coalition that comprises the firm."[73]

So, if shareholders initiate derivative proceedings against errant directors, any benefits that result from that action will usually inure to the company as a whole, and not just to shareholders. In like manner, if shareholders use their voting rights to oust a director who has acted incompetently and/or improperly, that will benefit the company as a whole.[74]

Yet, notwithstanding the points that seem to favour shareholder primacy, it is possible to identify a number of aspects of the law that do not appear to support shareholder primacy.

**B. The United States Position**

Even in the US, where shareholder primacy has been advocated with the greatest force,[75] it was not until we were well into the last century that some American judges accepted the view that directors had to run the company for the benefit of shareholders and not the company itself.[76] Also, there are indications that while there is today significant support for it in the courts and law journals, it is not a universally accepted principle, particularly amongst the judges.[77] In the most influential state, as

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71 See *Re Astec (BSR) plc* [1998] 2 BCLC 556.

72 A classic case is *Cook v Deeks* [1916] 1 AC 554.

73 Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 Va L R 247 at 289.

74 Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 Va L R 247 at 289

75 The best known case might well be, *Dodge v Ford Motor Co* (1919) 170 NW 668 (Michigan). For a more recent decision that advocates it, see the Delaware case of *Simons v Cogan* (1988) 549 A 2d 300 at 304.

76 T. Smith, "The Efficient Norm for Corporate Law : A Neotraditional Interpretation of Fiduciary Duty" (1999) 98 *Michigan Law Review* 214 at 243; G. Crespi, "Rethinking Corporate Fiduciary Duties : The Inefficiency of the Shareholder Primacy Norm" (2002) 55 SMU Law Rev 141 at 155.

77 A point acknowledged in R. Booth, "Who Owns a Corporation and Who Cares?" (2001) 77 *Chicago-Kent Law Review* 147 at 147.

far as corporate law goes, Delaware, the Court of Chancery has stated that directors owe duties to the corporate enterprise and have "an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the long-term wealth creating capacity."[78] In *Revlon Inc v MacAndrews & Forbes Holdings Ltd*[79] it was said that duties are owed to the corporation and the shareholders, indicating that reference to the corporation does not automatically mean the shareholders,[80] a point made more recently in the Massachusetts case of *In re Healthco International Inc*.[81] It has been said that corporate law in Delaware remains ambivalent on whether shareholder primacy is the determining force.[82] More recently a federal court in the US has clearly stated that duties are owed by directors to the corporate entity and not to any person.[83] In another case, *Green v Hamilton International*,[84] duties were held to be owed to the community of interests in the corporation, and not solely to shareholders.[85] Chancellor Allen of the Delaware Chancery Court took a very similar approach in *Credit Lyonnais Bank Nederland N.V. v Pathe Communications Corp.*,[86] when he said that when a company is in the vicinity of insolvency directors owe duties not simply to shareholders, but to the community of interests that the company represents. It is interesting that Chancellor Allen, when writing in an extra-curial context at close to the time of his judgment in *Credit Lyonnais*, took the view that essentially what can be seen as the shareholder primacy held sway in the nineteenth century and co-existed with what the judge called, "the social entity view," namely directors have to consider stakeholders besides shareholders, but now the social entity view prevails.[87] The result is that in the US Professors Blair and Stout have queried whether courts in fact generally accept the shareholder primacy principle.[88]

While a significant number of jurisdictions require directors to act in the best interests of the corporation and the shareholders,[89] a majority of state legislatures,[90] the first

78 *Geyer v Ingersoll Publications Co* 621 A 2d 784 at 787-788 (1992).

79 (1986) 506 A 2d 173 at 176-182 (Delaware). Also, see *Simons v Cogan* (1988) 549 A 2d 300 at 302-304 (Delaware).

80 Although some scholars interpret this to mean shareholder primacy : A. Chaver and J. Fried, "Managers' Fiduciary Duty Upon the Firm's Insolvency : Accounting for Performance Creditors" (2002) 55 *Vanderbilt Law Review* 1813 at 1814. It might be because the proviso laid down in Revlon was that action that is taken must ultimately provide some benefit for the shareholders (at 176).

81 208 BR 288 at 301 (1997).

82 W. Allen, J. Jacobs and L Strine, "The Great Takeover Debate : A Mediation on Bridging the Conceptual Divide" (2002) 69 U Chi L Rev 1067 at 1067.

83 *Official Committee of Unsecured Creditors v R F Lafferty & Co* (2001) 267 F 3d 340 at 348 (3rd Circuit).

84 (1977) 437 F Supp 723 (New York).

85 Ibid at 729, n4.

86 1991 Del Ch WL 277613; LEXIS 215; (1992) 17 *Delaware Journal of Corporate Law* 1099.

87 (1992) 14 *Cardozo Law Review* 261 at 276.

88 "Director Accountability and the Mediating Role of the Corporate Board" (2001) 78 Wash U L Q 403. This view has been echoed by Professor Richard Booth in "Who Owns A Corporation and Who Cares?" (2001) 77 *Chicago-Kent Law Review* 147 at 147, but Professor Stephen Bainbridge implicitly disagrees ("Director Primacy : The Means and Ends of Corporate Governance" (2003) 97 *Northwestern University Law Review* 547 at 575-576).

89 For example, California (Corporations Code, s.309).

90 For a list of the States and the statutes, see L. Mitchell, "A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes" (1992) 70 *Texas Law Review* 579 at n.1; R. Karmel, "Implications of the Stakeholder Model" (1993) 61 *George Washington Law Review* 1156 at n.42.

being Pennsylvania (in 1983), have sought by way of legislation to ensure that shareholder primacy does not prevail, certainly to the point of promoting short-termism. These states have enacted what are referred to as "constituency statutes." While the respective statutes differ from one another in some respects each of them authorises the directors to consider the interests of other corporate stakeholders, such as employees, suppliers, customers, creditors and the communities in which companies establish themselves, when discharging their duties. The statutes enacted in Indiana and Pennsylvania expressly provide that directors are not required to give primacy to any constituency or interest.[91] Connecticut, Arizona and Idaho[92] went even further and required directors to consider the long term interests of the company. The Pennsylvania and Indiana legislatures provided in their respective Codes that directors are not required to give dominant effect to any constituency, thereby ruling out shareholder primacy.[93] During the campaign instigated to have the legislation passed in Pennsylvania, the co-sponsor of the Bill stated that the Bill would : "reaffirm and make more explicit the time-honoured (and current) principle that directors owe their duties to the corporation rather than to any specific group such as shareholders."[94] But too much cannot be made of these statutes as they only operate, for the most part, in the context of takeovers, and therefore they have a limited effect. By the end of the last century, only three of the statutes had been cited in court and only on one occasion, in *Georgia Pacific Corp v Great Northern Nakoosa Corp*,[95] had a statute been referred to in finding in favour of a decision by the managers.[96] Nevertheless, the statutes have had an effect on US corporate law and they can be added to the divergent case law to suggest that shareholder primacy is not as dominant in the US as we are often led to believe.

## IV "In the Interests of the Company"

As explained at the beginning of this article, the UK courts have said that directors' powers are to be exercised in the interests of the company.[97] But more often than not, the courts have not explained what they mean by the phrase, "the interests of the company." As pointed out by Nourse LJ in *Brady v Brady*,[98] this is an expression that is often used, but is rarely defined, and it is probably one of the most problematical expressions in company law. His Lordship opined that it was sometimes

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91 Indiana, s.23-1-35-1(d)(f) and Pennsylvania, ss.515(a)-(b), 516(a).

92 Connecticut Corporations Code, s.33-313; Arizona Corporations Code, s.10-1202; Idaho Corporations Code, s.30-1602.

93 This is even acknowledged by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association ("Other Constituency Statutes :Potential for Confusion" (1990) 45 Bus Law 2253 at 2262), which was essentially in favour of shareholder primacy.

94 Outrage of the Month, Issue Alert, Dec 1989 at 6 and quoted in N. Minow, "Shareholders, Stakeholders and Boards of Directors" (1991) 21 *Stetson Law Review* 197 at 220.

95 727 F Supp 31 (1989) (Maine).

96 Richard Marens and Andrew Wicks, "Getting Real : Stakeholder Theory, Managerial Practice, and the General Irrelevance of Fiduciary Duties Owed to Shareholders." (1999) 9 *Business Ethics Quarterly* 273 at 284.

97 For instance, see *Re Smith and Fawcett Ltd [1942] Ch 304 at 308; Mutual Life Insurance Co of New York v The Rank Organisation Ltd* [1985] BCLC 11 at 21; *Fulham Football Club Ltd v Cabra Estates plc* [1994] 1 BCLC 363 at 378; *Brunninghausen v Glavanics* [1999] NSWCA 199; (1999) 17 ACLC 1247 at para 40.

98 (1987) 3 BCC 535 at 552.

misunderstood. Professor Dan Prentice has referred to the phrase as being "indeterminate"[99] and another commentator has said that it was "unclear."[100]

The phrase has been employed by judges in several corporate law areas, besides when hearing cases that involve the exercise of directors' duties.[101] For instance, it is used when assessing whether an alteration to the articles of a company is permissible,[102] and some of those cases will be referred to below.

One of the first indications that shareholder primacy held sway in English law was the comments of Jessel MR in *In re Wincham Shipbuilding*[103] in 1878. His Lordship (with the concurrence of James and Bramwell LJJ) said, after asking the question, for whom are the directors trustee, that "the directors are trustees for the shareholders, that is, for the company."[104] Shortly after that case, *Hutton v West Cork Railway Co*[105] was decided (by a differently constituted Court of Appeal) and it is often cited as supporting shareholder primacy. It is also well known for the classic statement by Bowen LJ that : "The law does not say that there shall be no cake and ale, but there are to be no cakes and ale except such as are required for the benefit of the company."[106] The fact is that the Court did not make a specific statement concerning who are to be the beneficiaries of the directors' management efforts. The Court was concerned that any action was taken for the benefit of the company, and it did not, it appears, notwithstanding the assertions of a number of writers,[107] state that this meant benefiting the shareholders' interests.

As mentioned above, there are many cases that have considered the meaning of the expression in the context of dealing with whether an alteration of articles of association was in the best interests of the company as a whole.[108] In one of the strongest cases supporting a shareholder primacy interpretation, *Greenhalgh v Arderne Cinemas,*[109] Evershed MR, in whose judgment the other members of the Court of Appeal agreed, said that the phrase "interests of the company as a whole" did not mean the company as a commercial entity, but rather it meant the corporators as a general body.[110] This approach might be said to be consistent with what Dixon J said

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99 D.D. Prentice, "Creditor's Interests and Director's Duties" (1990) 10 OJLS 265 at 273

100 J. Heydon, "Directors' Duties and the Company's Interests" in P. Finn (ed), *Equity and Commercial Relationships* (Law Book Co, Sydney, 1987) at 122.

101 For instance, see *In re Smith & Fawcett Ltd* [1942] Ch 304 at 306, 308 (CA).

102 For instance, see *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 at 671.

103 (1878) LR 9 Ch D 322.

104 Ibid at 328. Such a view was posited in New Zealand in *Re H Linney & Co Ltd* [1925] NZLR 907 at 922. In more recent times the idea that directors are trustees has been exploded. For instance, see L S Sealy, "The Director as Trustee" [1967] CLJ 83. However, even more recently reference has still been made to directors acting as trustees. For instance, see Lord Cullen in *Dawson International plc v Coats Paton plc (No1)* 1988 SLT 854 at 858; [1989] BCLC 233 at 237.

105 (1883) 23 Ch D 654.

106 Ibid at 673.

107 For instance, Jeffery MacIntosh, "Designing an Efficient Fiduciary Law" (1993) 43 *University of Toronto Law Journal* 425 at 452.

108 For example, see *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656; *Sidebottom v Kershaw Leese and Co Ltd* [1921] 1 Ch 154; *Shuttleworth v Cox Bros and Co (Maidenhead) Ltd* [1927] 2 KB 9.

109 [1951] Ch 286.

110 Ibid at 291.

in the Australian High Court case of *Peters American Delicacy v Heath*,[111] where it was said that the company as a whole is a corporate entity consisting of all of the shareholders.[112] Yet, it must not be forgotten that these cases, and all the cases dealing with an alteration of the articles are referring to how the members of the company are to act, and not the directors. Only the latter group is encumbered by acting subject to certain fiduciary duties. Furthermore, the cases dealing with the articles are not addressing the issue of for whose benefit is the company to be managed. But, there is recent authority involving consideration of directors' duties, such as *Parke v Daily News Ltd*[113] where Plowman J said that the benefit of the company meant the benefit of the shareholders as a general body.[114] Later, iIn *Gainman v National Association for Mental Health,*[115] Megarry J said that "it is not very easy to determine what is in the best interests of the [company] without paying due regard to the members of the [company]. His Lordship went on to say that he regarded the expression to mean the interests of present and future shareholders as a whole.

Perhaps one of the clearest statements to favour shareholder primacy was emitted by Nourse LJ in *Brady v Brady*.[116] His Lordship said :

> "The interests of a company, an artificial person, cannot be distinguished from the interests of the persons who are interested in it. Who are those persons? Where a company is both going and solvent, *first and foremost* come the shareholders, present and no doubt future as well."[117](my emphasis)

However, the case was essentially dealing with whether there had been a breach of s.151 of the Companies Act 1985, the provision that prohibits the giving of financial assistance, and not directors' duties.

Notwithstanding the comments supporting shareholder primacy, there are cases in which judges have played down the shareholders' interests. The paradigm was indirectly questioned by Lord Diplock in *Lonrho Ltd v Shell Petroleum Co Ltd,*[118] where he stated, by way of obiter, that :

> "[I]t is the duty of the board to consider whether to accede to the request [for inspection of documents] would be in the best

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111 (1939) 61 CLR 457. The case can be accessed at http://www.austlii.edu.au/cases/cth/HCA/1939/2.html

112 The difficulties with the "benefit of the company as a whole" test caused the Australian High Court in *Gambotto v WCP Ltd* (19995) 182 CLR 432, to say that it was time that the test was dispensed with. But the Company Law Review Steering Group felt that that the test was too well-established in English law, and should be retained (*Modern Company Law for a Competitive Economy : Completing the Structure*, London, DTI, 2000 at paras 5.94-5.99; Company Law Review, *Modern Company Law for a Competitive Economy :*Final Report, vol 1, London, DTI, 2001, at paras 7.52-7.62).

113 [1962] Ch 927.

114 Ibid at 963.

115 [1971] Ch 317 at 330

116 (1987) 3 BCC 535

117 Ibid at 552

118 [1980] 1 WLR 627.

> interests of the company. These are not exclusively those of its shareholders but may include those of its creditors."[119]

The other four Law Lords concurred with his Lordship's judgment. There was no indication here that Lord Diplock had insolvency or near insolvency in view when he referred to consideration of the creditors' interests.

More recently the Court of Appeal in *Fulham Football Club Ltd v Cabra Estates plc*[120] stated that "the duties owed by the directors are to the company and the company is more than just the sum total of its members."

Many of the cases[121] that have been regarded as holding that directors must act for shareholders, do not in fact support that position. The courts in these cases have said that directors may owe fiduciary duties to the shareholders where special circumstances exist, such as when the company is the subject of a takeover offer.[122] Absent special circumstances, directors clearly do not owe such duties. Take the judgment in *Dawson International plc v Coats Paton plc (No1)*[123] for example. It was stated in that case that the directors were, in conducting the affairs of the company and discharging their duties, to consider the interests of the company.[124] The directors owed no general fiduciary duty to shareholders, although directors might become subject to a duty to shareholders if they were to make recommendations to the shareholders in light of a takeover offer, for if directors took the decision to recommend the acceptance of that offer they had a duty (which might he called a secondary fiduciary duty) to the shareholders.[125] This case suggests that the directors are to run the business of the company for the benefit of the company, and this involves considering the interests of stakeholders, such as shareholders. This is supported by the fact that the Court said that "the directors are under a fiduciary duty to the company to have regard to *inter alia* the interests of members and employees"[126] (my emphasis). The use of "inter alia" appears to indicate that the Court is saying that members and employees are only two of a number of interests to which the directors are to consider. Members are mentioned because the action involved a claim by members that the directors breached their duties to members. Employees are adverted to because the Court had referred specifically to s.309 of the Companies Act 1985, a provision requiring directors to consider the interests of employees, earlier in its judgment.

The equivocal position that appears to exist in the UK, seems to reflect the experience in other parts of the Commonwealth. In the New Zealand Court of Appeal in

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119 Ibid at 634.

120 [1994] 1 BCLC 363 at 379.

121 For instance, see *Heron International Ltd v Lord Grade* [1983] BCLC 244; *Peskin v Anderson* [2000] BCC 1110; [2000] 2 BCLC 1(and affirmed on appeal by the Court of Appeal [2001] BCC 874).

122 For instance, see *Gething v Kilner* [1972] 1 WLR 337; [1972] 1 All ER 1166; *Re a Company* [1986] BCLC 382; *Brunninghausen v Glavanics* [1999] NSWCA 199; (1999) 17 ACLC 1247.

123 1988 SLT 854; [1989] BCLC 233.

124 Ibid at 860; 241.

125 Ibid at 859; 240. This was acknowledged in *Prudential Assurance Co Ltd v Newman Industries Ltd* (*No 2*) [1982] Ch 204; *Gething v Kilner* [1972] 1 WLR 337; [1972] 1 All ER 1166.

126 Ibid.

*Nicholson v Permakraft (NZ) Ltd*[127] Cooke J indicated that the duties of creditors are owed to the company, and he went on to say unequivocally that directors had to act in the best interests of company as a whole.[128] His Lordship did not go on to say that this meant that consideration had to be given specifically to the interests of the shareholders. There are comments by Latham CJ and Dixon J in the Australian High Court case of *Richard Brady Franks Ltd v Price*[129] that support the notion that we are talking more about the shareholders when we say that directors are to act in the best interests of the company. In *Kinsela v Russell Kinsela Pty Ltd,*[130]Street CJ of the New South Wales Court of Appeal stated that when a company is solvent, "the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise."[131] According to his Honour this is why shareholders are able to authorise actions of directors such that the latter's actions cannot be challenged. But, in a later New South Wales Court of Appeal case, *Brunninghausen v Glavanics,*[132] Handley JA said that : "The general principle that a director's fiduciary duties are owed to the company and not to shareholders is undoubtedly correct…" More recently, in *Peoples' Department Stores v Wise*[133] Canada's highest court, the Supreme Court of Canada, said that directors had a duty to act in the best interests of the corporation and that "the best interests of the corporation" meant acting to maximise the value of the corporation. Major and Deschamps JJ, in delivering the judgment of the Court, specifically stated that the expression acting in the "best interests of the corporation" does not mean acting in the best interests of the shareholders or any one stakeholder's interests.[134] The judges went on to say that :

> "But if they [the directors] observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not…leave directors open to the charge that they have failed in their fiduciary duty to the company…We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, *inter alia*, the interests of the shareholders, employees, suppliers, creditors, consumers, governments and the environment…At all time, directors and officers owe their fiduciary duties to the corporation. The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholders."[135]

In sum, there is not a clear strain of authority running through UK case law supporting shareholder primacy, and, as the article has already mentioned, this is similar to the

127 (1985) 3 ACLC 453 at 459.
128 Ibid at 462.
129 [1937] HCA 42; (1937) 58 CLR 112.
130 (1986) 4 ACLC 215; (1986) 10 ACLR 395.
131 Ibid at 221; 395
132 [1999] NSWCA 199; (1999) 17 ACLC 1247 at para 43.
133 [2004] SCC 68. The case can be accessed through the Canadian Legal Information Institute. See < www.canlii.org/ca >
134 Ibid at para 42.
135 Ibid at paras 42-43.

US where the position of the courts on the subject is equivocal. Undoubtedly some cases suggest that the focus should be on shareholders, while others either merely blandly state that the directors are to act in the interests of the company, or indicate that more than the interests of shareholders make up the interests of the company.

This accords with the view propounded recently by John Armour, Simon Deakin, and Suzanne Konzelmann that corporate governance has not stabilised around a norm of shareholder primacy, but is in "a state of flux."[136] There are clear instances where a strict shareholder primacy approach has not been adhered to. A good example is the transfer by BMW to the Phoenix consortium of the Rover factory and operation at Longbridge in the West Midlands in 2000. The concerns and interests of the workforce and the local community were key factors in the decision to transfer to Phoenix.[137]

It is respectfully submitted that John Lowry and Alan Dignam are correct when they assert that in dealing with the question of what is meant by acting in the company's interests, "The courts have cleverly fudged the answer."[138] This conclusion is consistent with Professor Simon Deakin's recent statement that "It is surprisingly difficult to find support within company law for the notion of shareholder primacy."[139] Nevertheless, as we will soon see, the Company Law Review Steering Group (CLRSG) found little difficulty in asserting that the positive law favoured shareholder primacy.

## V Policy Developments

### A The Company Law Review

In March 1998 the Department of Trade and Industry commissioned a review that was to include proposals for the reform of UK company law in order to address a modern world.[140] This review was to be the most wide-ranging since the middle of the nineteenth century and was established to formulate a framework of company law which "facilitates enterprise and promotes transparency and fair-dealing;"[141] it was to be overseen by a Steering Group that has become known as the Company Law Review Steering Group (CLRSG). The CLRSG clearly saw the issue of in whose interests company law should be formulated as a critical one in its deliberations.[142] The CLRSG proceeded to identify two possible approaches to addressing the issue, namely either a shareholder value approach or a pluralist approach, and it did this in connection with its recommendations to have the duties of directors, which presently

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136 "Shareholder Primacy and the Trajectory of UK Corporate Governance" (2003) 41 *British Journal of Industrial Relations* 531 at 531.

137 For a detailed discussion of the transfer, see ibid (Armour, Deakin and Konzelmann). Of course, with the wonders of hindsight, the subsequent collapse of Rover in April 2005 causes one to question the wisdom of the rescue of the company in 2000, or at least the strategy employed to engineer the rescue. But that is another issue.

138 *Company Law*, 2nd ed, (LexisNexis, London, 2003) at 292.

139 "The Coming Transformation of Shareholder Value" (2005) 13 *Corporate Governance* 11.

140 Company Law Review, *Modern Company Law For a Competitive Economy*, DTI, 1998, at 1.

141 Company Law Review, *Modern Company Law for a Competitive Economy*, London, DTI, 1998, Foreword.

142 See, Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.1

are based on common law, codified. The CLRSG pointed up, in its discussion, many of the arguments that have been tossed to and fro by law and economics scholars on the one side and communitarian and pluralist scholars on the other. As mentioned earlier, the CLRSG stated[143] that the present law reflects the fact that companies are managed for the benefit of the shareholders, and it confers on the shareholders ultimate control of the undertaking, such that "[t]he directors are required to manage the business on their behalf…"[144] It went on to say that the ultimate objective of companies is to generate maximum wealth for shareholders.[145]

In considering the objective of companies carrying on business, the CLRSG advocated an approach which it referred to as, "enlightened shareholder value,"[146] and which it was felt would better achieve wealth generation and competitiveness for the benefit of all. This approach involves directors having to act in the collective best interests of shareholders,[147] but it eschews "exclusive focus on the short-term financial bottom line" and seeks a more inclusive approach that values the building of long-term relationships.[148] It involves "striking a balance between the competing interests of different stakeholders in order to benefit the shareholders in the long run."[149] The CLRSG emphasised in one of its consultation papers, that this did not mean disregarding the short term interests of shareholders, but it in fact envisaged directors taking a balanced approach and that the long term view should not be paramount over the short-term or vice versa.[150] The concept of the enlightened shareholder value approach found its way into the Government's White Papers of July 2002 and March 2005,[151] to which we will refer shortly.

In the process of embracing the enlightened shareholder value approach, the CLRSG rejected the pluralist theory which involves the law being :

> "modified to include other objectives [besides maximising shareholder value] so that a company is required to serve a wider range of interests, not subordinate to, or as a means of achieving shareholder value (as envisaged in the enlightened shareholder value view), but as valid in their own right."[152]

The CLRSG said that adopting the pluralist approach would necessitate substantial reform of the law on directors' duties,[153] and later in another consultation paper, the CLRSG regarded the pluralist approach as neither workable nor desirable in the

143 Ibid at para 5.1.4.
144 Ibid at para 5.1.5.
145 Ibid at para 5.1.12.
146 Ibid
147 Company Law Review, *Modern Company Law for a Competitive Economy*, : Developing the Framework, 2000, London, DTI at para 2.22
148 Ibid.
149 John Armour, Simon Deakin, and Suzanne Konzelmann, "Shareholder Primacy and the Trajectory of UK Corporate Governance" (2003) 41 *British Journal of Industrial Relations* 531 at 537.
150 Company Law Review, *Modern Company Law for a Competitive Economy*, : Developing the Framework, 2000, London, DTI at para 3.54.
151 Cm 6456, B3(3)(a).
152 Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.13.
153 Ibid at para 5.1.30

UK.[154] In later consultation paper, the CLRSG explained its approach further, stating that under the enlightened shareholder value directors were obliged to "achieve the success of the company for the benefit of the shareholders by taking proper account of all the relevant considerations for that purpose" and this involved taking "a proper balanced view of the short and long term; the need to sustain effective ongoing relationships with employees, customers, suppliers and others" as well as to "consider the impact of its operations on the community and the environment."[155] In addition, the CLRSG recommended that listed companies and certain other large companies with significant economic power should publish an operating and financial review (OFR) as part of the company's annual report.[156] This review is

> "designed to address the need in a modern economy to account for and demonstrating stewardship of a wide range of relationships and resources, which are of vital significance to the success of modern business, but often do not register effectively, or at all, in traditional financial accounts."[157]

The CLRSG viewed s.309 of the Companies Act 1985 as providing a statutory declaration of enlightened shareholder value, because it requires directors to consider the interests of employees in determining what is in the best interests of the company.[158]

The concept of enlightened shareholder value is similar to enlightened value maximisation that is advocated by Professor Michael Jensen, who states that :

> "it is obvious that we cannot maximise the long-term market value of an organisation if we ignore or mistreat any important constituency. We cannot create value without good relations with customers, employees, financial backers, suppliers, regulators, communities, and so on."[159]

The sentiments expressed by the learned commentator were effectively acknowledged by the CLRSG in its various reports.

### B Company Law Reform : the First Government White Paper

154 Company Law Review, *Modern Company Law for a Competitive Economy*, : Completing the Structure, 2000, London, DTI at para 3.5.

155 Company Law Review, *Modern Company Law for a Competitive Economy*, : Developing the Framework, 2000, London, DTI at para 2.19

156 Company Law Review, *Modern Company Law for a Competitive Economy* : The Final Report, vol 1, 2001, DTI, London, at paras 3.33-3.45.

157 Company Law Review, *Modern Company Law for a Competitive Economy*, : Completing the Structure, 2000, London, DTI at para 3.4.

158 Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.21.

159 Michael Jensen, "Value Maximisation, Stakeholder Theory and the Corporate Objective Function" (2001) 7(3) *European Financial Management* 297 at 309.

The Government published a White Paper in July 2002,[160] a year after the CLRSG delivered its final report. It was to be the first of a number of such documents.[161] Amongst its proposals was an acceptance of the general approach to the issue of the objective of the company proposed by the CLRSG, as well as expressly endorsing many of the statements of the CLRSG.[162] Furthermore, the Government accepted the need for an operating and financial review in order to require companies to address concerns that are broader than shareholder issues.[163]

The Companies Bill that was drafted as part of the White Paper provided for the codification of the duties of directors. Clause 19 stated that Schedule 2 to the Bill set out the general principles by which directors were to be bound. Paragraph 2 of the Schedule state that:

> "A director of a company must in a given case –
> (a) act in the way he decides, in good faith, would be the most likely to promote the success of the company for the benefit of its members as a whole; and
> (b) in deciding what would be most likely to promote that success, take account in good faith of all the *material factors* that it is practicable in the circumstances for him to identify" (my emphasis)

The paragraph then went on to enumerate what were the "material factors." We will come back to this in the next section of the article, when considering the second White Paper.

Importantly, the draft clauses in the Bill included provision for the operating and financial review (OFR) that had been proposed by the CLRSG. Preparation of one is limited to certain companies, namely those with economic power and referred to as major companies.[164] Clause 73(2) states that directors are obliged to ensure that the information contained in the OFR is such as to achieve the review objective, and the review objective is explained in clause 73(3), namely to allow shareholders to make an informed assessment of the company's operations, financial position and its future business strategies and prospects. The material that directors must consider including in the review is relevant to the interests of stakeholders other than shareholders, such as the company's policies in relation to : employment; environmental issues relevant to the company's business; and the company's policies on social and community issues relevant to the company's business.[165] But there is no requirement that the directors must actually include such material in the review and there is no indication as to what weight they are to give to it, if they do include it. Furthermore, the OFR is presented to the shareholders and it is not likely that they will be concerned that the directors have failed to take into account the interests of other constituencies.

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160 *Modernising Company Law*, Cm 5553, DTI. For a discussion of the White Paper, see R. Goddard, 'Modernising Company Law : The Government's White Paper' (2003) 66 MLR 402 at 407.
161 To date there have been subsequent White Papers in March and October 2005.
162 For example, ibid at para 3.6.
163 Ibid at para 4.28. See, B. Hannigan, *Company Law*, (LexisNexis, London, 2003) at 214.
164 Clauses 77 and 78 set out the criteria for companies that fall into this category.
165 Clause 75(2).

## C Company Law Reform : the Second Government White Paper

Nothing further was published until March 2005 when a second White Paper titled "Company Law Reform"[166] appeared. This second White Paper encompassed many of the points raised in the earlier White Paper, but there were some interesting changes in how the approaches advocated in the CLRSG's Final Report and the first White Paper would be implemented.

Importantly, for the purposes of this article, the second White Paper is said by the explanatory notes to :

> "embed in statute the concept of Enlightened Shareholder Value by making clear that shareholders must promote the success of the company for the benefit of its shareholders, and this can only be achieved by taking due account of both the long-term and short-term, and wider factors such as employees, effects on the environment, suppliers and customers."[167]

The White Paper provides, as with the earlier one, that there are two elements to the way in which directors are to run the company.[168] First, they are to do that which they consider, in good faith, is most likely to promote the success of the company for the benefit of the members as a whole. Second, in carrying out the first element, the directors are to take into account, where relevant, and as far as is reasonably practicable, several factors (in order to reflect wider consideration of responsible business behaviour) that are listed, but not intended to be exhaustive. The factors enumerated in the draft provision, clause B3, and very similar to the notes relating to paragraph 2 of Schedule 2 of the first White Paper are set out in clause B3(3) and are:

> "(a)The likely consequences of any decision in both the long and the short term
>
> (b) any need of the company –
>
> (i)to have regard to the interests of its employees
> (ii)to foster its business relationships with suppliers, customers and others
> (iii)to consider the impact of its operations on the community and the environment, and
> (iv)to maintain a reputation for high standards of business conduct."

The directors also have to consider the need to act fairly as between members of the company who have different interests. In addition, the Company Law Reform Bill, included with the White Paper, recognises that the directors have to take into account creditors' interests in certain

166 Cm 6456, DTI.
167 Ibid at 5.
168 *Company Law Reform*, DTI, 2005, Explanatory notes, para B17.

circumstances. These circumstances are, according to the explanatory notes, when the company is insolvent or near to insolvent.[169]

Clause B3 encompasses two ideas. First, the long term performance of the company has to be considered by directors. It has been a frequent criticism of directors that they overly focus on the short term benefits for companies as this pleases shareholders. The inclusion of the idea of a long term benefit replicates what is found in most US constituency statutes.[170] Second, the approach takes into account an array of interests of those who might be categorised loosely as stakeholders. So, while the clause ensures the maintaining of the shareholder-centred paradigm, at the same time it permits, in appropriate circumstances, consideration being given to a wider range of interests. However, although not overtly stated, it is likely that the duty to foster the success of the company for the benefit of the members and the duty to take into account other interests can be seen in a hierarchal way, with the former being regarded more highly than the latter. This is because the CLRSG advocated a hierarchy of obligations when it proposed a similar approach,[171] and this involved the promotion of the benefit of the members' interests above those of the broader matters set out in B3(3) of the White Paper. A director only has an obligation to take account of B3(3) matters where he or she believes that it is relevant and reasonably practicable to do so. But once he or she has reached the view that it is relevant and reasonably practicable to consider wider interests, it is not permissible for them to be disregarded. There is, however, no indication as to the extent to which directors are to have regard for wider interests, an issue that is discussed later.

Prima facie, B3(3) might be regarded as embedding a form of shareholder value in company law when it had not previously been so embedded. This article has already suggested that UK law has not unequivocally adopted shareholder value as the main concern for directors in managing the company. But B3(3), if implemented, will make it clear that the focus is to be on shareholder interests, and for that reason alone it constitutes a critical development.

## VI An Assessment of the Proposed Reforms

The main issue that emanates from the aspect of the company law reform process that we have been focusing on is, with whose interests directors are to be concerned in the process of running the business of the company. This Part of the article explores how the provisions considered in the last Part might work and what issues they appear to raise.

### A. Balancing Constituent Interests in the Modern Company

169 Ibid at B19. For a discussion of this issue, see, for example, A. Keay, "The Director's Duty to Take into Account the Interests of Company Creditors : When is it Triggered?" (2001) 25 *Melbourne University Law Review* 315.

170 Of the 29 States that have such statutes, all but five allow directors to consider long-term interests. These states are Louisiana, Maine, Missouri, Tennessee and Wisconsin. It is noted that the CLRSG did criticise such statutes (Company Law Review, *Modern Company Law for a Competitive Economy,* : Developing the Framework, 2000, London, DTI at para 3.33).

171 Company Law Review, *Modern Company Law for a Competitive Economy* : *Completing the Structure*, 2000, London, DTI at para 3.19.

The first point to note is that the draft provision, clause B3, appears to give the directors a completely unfettered discretion in what they do provided that they are acting in a way that they consider would most likely promote the success of the company for the benefit of the members. Yet the CLRSG, whose basic recommendations are implemented in the White Papers, stated that the pluralist position was to be rejected primarily because it would grant an unpoliced discretion to directors.[172] Second, the Company Law Reform Bill does not explain, and nor do the explanatory notes, how directors are to consider interests other than those of the members, in the decisions that they are making. This is particularly pertinent where there are competing interests, that is, where a course of action would benefit one constituency and prejudice another. Are directors to engage in a balancing exercise in such circumstances? Clearly, the balancing of stakeholder interests is, of itself, a tricky issue, and it means that directors have to solve what some commentators see as impossible conflicts of interests.[173] According to Jay Lorsch and Elizabeth MacIver, who studied director behaviour, only a minority of directors refused to acknowledge that there was a conflict between holding strictly to shareholder primacy and the interests of other stakeholders. The learned commentators found that the majority of directors regarded themselves as accountable to more than one constituency and this led to a complicated decision-making process.[174] The problem that really exists with balancing in a stakeholder context is that there is no object stated for the balancing exercise, that is, to what end is the balancing to be conducted. Hence, balancing involves an "inherently subjective process."[175] It has been the subject of significant criticism over the years,[176] particularly on the basis that directors are unable to balance the interests of constituencies. For instance, in its response to the second White Paper, the Law Society for England and Wales indicated significant concern in relation to directors having to weigh up the list of factors contained in clause B3(3) when making decisions, fearing that it will lead to practical problems, and that the issue of balancing was one of their concerns.[177] It might be argued that directors will not understand the interests of non-shareholder groups as directors are usually involved in exercising entrepreneurial skills.[178] Allied to this is the fact that directors'

172 Company Law Review, *Modern Company Law for a Competitive Economy*, : *Developing the Framework*, 2000, London, DTI at para 3.24.

173 There are many American commentators who take this view. For example, J. Macey, 'An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties' (1991) 21 *Stetson Law Review* 23 at 31; V. Jelisavcic, 'A Safe Harbour Proposal to Define the Limits of Directors' Fiduciary Duty to Creditors in the 'Vicinity of Insolvency' [1992] *Journal of Corporation Law* 145 at 148; N. Beveridge, 'Does a Corporation's Board of Directors Owe a Fiduciary Duty to its Creditors?' (1994) 25 *St Mary's Law Journal* 589 at 621. This view gains some support from the Ontario High Court of Justice in *Royal Bank of Canada v First Pioneer Investments Ltd* (1980) 20 OR (2d) 352.

174 *Pawns or Potentates : The Reality of America's Corporate Boards*, 1989 at 50 and referred to in D Gordon Smith, "The Shareholder Primacy Norm" (1998) 23 *Journal of Corporate Law* 277 at 291.

175 J. Parkinson, "Models of the Company and the Employment Relationship" (2003) 41 *British Journal of Industrial Relations* 481 at 498.

176 For instance, see T Hurst and L McGuiness, 'The Corporation, The Bondholder and Fiduciary Duties' (1991) 10 *Journal of Law and Commerce* 187 at 205; M. Siems, "Shareholders, Stakeholders and the 'Ordoliberalism"(2002) 13 EBLR 139 at 141.

177 June 2005 at p35. The reply can be accessed at the Society's Website – www.lawsociety.org.uk

178 Mark E.Van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27 at 60.

thinking is, generally, too centred on shareholder benefits to be able to focus on what are the interests of others. This is accentuated by the existence of shareholder power. Are directors going to take into account other interests in light of the power that shareholders have? It might be argued that the directors will only practise shareholder maximisation because it is the shareholders who have power over the directors, as mentioned in brief earlier in the article. The shareholders have voting rights which can determine whether directors are re-elected. Furthermore, the shareholders have the right under s.303 of the Companies Act 1985 to set in motion a process which can lead to a vote to have directors dismissed. As far as legal proceedings are concerned shareholders might be able to initiate either action against directors under s.459 of the Companies Act or derivative proceedings where directors have breached their duties.

The agency theory,[179] a popular way of explaining the relationship between directors and shareholders, has, has as one of its elements the notion that directors will be opportunistic and engage in self-serving activity, known as shirking. Consistent with that, it might well be that directors will use the requirement to balance between conflicting interests, and their apparent freedom in doing this, as an opportunity to foster their own self-interest.[180] Certainly Professors Lyn Lo Pucki and William Whitford found in an empirical study that this occurs with respect to US companies that are subject to Chapter 11 bankruptcy.[181] With directors having greater discretion in deciding what interests to take into account, it might be thought that shareholders will have more difficulty in monitoring the performance of directors, and directors might resist claims of breach of duty on the basis that what they did was based on a consideration of the interests of one or more parties mentioned in clause B3(3)(b). This might, for instance, enable them to thwart hostile takeovers on the basis that it would not benefit one or more constituencies.[182]

Some adherents of stakeholder theory, although not accepting the agency theory would also question whether the company managers are in a position to carry out a fair and efficient balancing of the interests on the basis that they will take into account their own interests, often at odds with those of many constituencies.[183] For instance, the directors might consider that if they favour the shareholders, their position might be enhanced, especially if they own shares in the company, or if their compensation packages are tied to share prices.[184]

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179 This is based on a large number of works, but the most influential are : Michael Jensen and William Meckling, "Theory of the Firm : Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305; Eugene Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J Pol Econ 288; Eugene Fama and Michael Jensen, "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301; Frank Easterbrook and Daniel Fischel, *The Economic Structure of the Corporate Law*, 1991

180 M. Roe, "The Shareholder Wealth Maximization Norm and Industrial Organization" (2001) 149 U Pa L Rev 2063 at 2065.

181 See, L. LoPucki and W. Whitford, "Corporate Governance in the Bankruptcy Reorganization of Large Publicly Held Companies" (1993) 141 U Pa L Rev 669 at 710.

182 This issue was a concern of the CLRSG in Company Law Review, *Modern Company Law for a Competitive Economy,* : *Developing the Framework*, 2000, London, DTI at para 3.24.

183 J. Parkinson, "Models of the Company and the Employment Relationship" (2003) 41 *British Journal of Industrial Relations* 481 at 495.

184 D. Tauke, 'Should Bondholders Have More Fun? A Reexamination of the Debate Over Corporate Bondholder's Rights' (1989) Colum Bus L Rev 1 at 65.

It is likely that in large companies that often have different kinds of shareholders, the balancing exercise will be made more complicated, for while directors might be accustomed to having to balance the interests of such persons, the fact that there are multiple types of shares is likely to exacerbate the difficulty of the directors' task of balancing when the interests of other constituencies are also taken into account.

Notwithstanding all of this, there are points that favour directors being able to balance. First, it has been argued that resolving conflicts is part and parcel of being a director. Some management specialists have even said that managing competing interests is a primary function of management.[185] The fact that the balancing of diverse interests is within directors' abilities and skills is something that has been recognised as far back as 1973 by a UK Department of Trade and Industry Report,[186] and by some American courts.[187] Directors have been classified as fiduciaries and society regularly requires those who are fiduciaries to make balanced decisions that can be quite difficult.[188] Proponents of the view might point to another kind of fiduciary, the trustee. Trustees have to make investment decisions sometimes with various categories of beneficiaries in mind. Second, while it is argued that it is easier to police how directors are acting when directors are only to act for shareholders and no one else,[189] it must not be forgotten that once all is said and done, that it is not always easy to perceive what is in the best interests of the shareholders, and directors have to balance various elements when deciding what is the best for shareholders. For example, directors might have to consider whether to take a particular action which, although it might boost the share prices of a company, it will also reduce the likelihood of dividends for a year or so.

Third, as adverted to above, shares come in different shapes and sizes and it is incumbent on directors to balance the interests of different kinds of shareholders, so that they act fairly between them[190] for, on occasions, these different classes of shareholders have opposing interests.[191] Some shareholders intend only to retain

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185 H. Ansoff, *Strategic Management* (Englewood Cliffs, Prentice-Hall, 1984) and referred to in J. Harrison and R. Freeman, "Stakeholders, Social Responsibility and Performance : Empirical Evidence and Theoretical Perspectives" (1999) 42 *Academy of Management Journal* 479 at 479. Management commentators have asserted that directors are in effect to act as referees between two stakeholder groups (M. Aoki, The co-operative game theory of the firm (Oxford, Clarendon Press, 1984) and referred to in T. Donaldson and L. Preston, "The Stakeholder Theory of the Corporation Concepts, Evidence, and Implications" (1995) 20 *The Academy of Management Review* 65 at 86).

186 *Company Law Reform*, Cmnd 5391 at paras 55-59.

187 For example, *Unocal Corporation v Mesa Petroleum Corporation* (1985) 493 A 2d 946.

188 R. Campbell Jr, 'Corporate Fiduciary Principles for the Post-Contractarian Era' (1996) 23 *Florida State University Law Review* 561 at 593.

189 For example, R. Clark, *Corporate Law* (1986) at 20 and referred to in Committee on Corporate Laws, "Other Constituency Statutes :Potential for Confusion" (1990) 45 Bus Law 2253 at 2270.

190 *Mills v Mills* (1938) 60 CLR 150, 164; *Re BSB Holdings Ltd (No2)* [1996] 1 BCLC 155, 246-249.

191 M. McDaniel, 'Bondholders and Stockholders' (1988) 13 *Journal of Corporation Law* 205 at 273; R. Campbell Jr, 'Corporate Fiduciary Principles for the Post-Contractarian Era' (1996) 23 *Florida State University Law Review* 561 at 593; R de R Barondes, 'Fiduciary Duties of

shares for a short term, while others are in for the long haul. Other shareholders hold a diversified portfolio, with their investment spread around a number of companies, and still others might have all their investment concentrated in the one company. In companies that are closely-held, one might have the problem of the conflicting interests of controlling and minority shareholders. Notwithstanding this, no concerns are voiced about the stresses of decision-making for directors in this latter respect, nor is it argued that directors, in balancing interests, are too burdened.

Finally, it has been found empirically, in a study of UK private water companies, that the requirement that directors must consider customer interests as well as that of shareholders, can result in "mutual benefits for different stakeholder groups with apparently conflicting economic interests."[192] Therefore, this suggests that balancing can be achieved, and can be beneficial.

How have directors conducted themselves in the past? Have they engaged in balancing? There is evidence that directors are often seeking to balance interests in the decisions which they make.[193] The chairman of the US company, Standard Oil, stated, as far back as 1946, that the business of companies should be carried on "in such a way as to maintain an equitable and working balance among the claims of the various directly interested groups – stockholders, employees, customers and the public at large."[194] More recently, a corporate reputation survey of Fortune 500 companies (the largest listed companies in the United States) found that satisfying the interests of one stakeholder does not automatically mean that this is at the expense of other stakeholders.[195] This is supported by empirical evidence, obtained in a study by the Financial Times of Europe's most respected companies, which found that chief executive officers were of the view that one of the features of a good company was the ability to ensure that there was a balancing of the interests of stakeholder groups.[196] Lorsch and MacIver, in their empirical study found that "directors usually don't share a consensus about their accountability to various constituencies and, therefore, about their purposes in serving. Further, the norm in most boardrooms is to

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Officers and Directors of Distressed Corporations' (1998) 7 *George Mason Law Review* 45 at 78.

192 S. Ogden and R. Watson, "Corporate Performance and Stakeholder Management : Balancing Shareholder and Customer Interests in the UK Privatized Water Industry" (1999) 42 *Academy of Management Journal* 526 at 536.

193 It has been noted that directors do already consider the interests of various constituents : *Report of the Committee on Corporate Governance* (chair, Sir Ronald Hampel) (1998) and referred to by J. Dine, 'Implementation of European Initiatives in the UK : The Role of Fiduciary Duties' (1999) 3 *Company Financial and Insolvency Law Review* 218 at 223.

194 Quoted in M. Blair, *Ownership and Control* (Washington DC, The Brookings Institute, 1995) at 212. It is also quoted in N. Craig Smith, *Morality and the Market*, London, Routledge, 1990, at 65 and referred to in J. Parkinson, "Models of the Company and the Employment Relationship" (2003) 41 *British Journal of Industrial Relations* 481 at 494, although the date given in the latter is 1950.

195 L. Preston and H. Sapienza, "Stakeholder Management and Corporate Performance" (1990) 19 *Journal of Behavioral Economics* 361.

196 Referred to in Eileen Scholes and David Clutterbuck, "Communication with Stakeholders : An Integrated Approach" (1998) 31 *Long Range Planning* 227 at 230.

avoid discussing such matters."[197] Yet, the learned authors found that while shareholders are regarded as the most important constituencies, directors do take into account the other constituencies in their decision-making.[198] However, in very recent times Tom Watson, the chief executive of Hermes, a British fund manager, said that British directors were managing for the short-term and this seemed to suggest that boards were focusing solely on shareholder interests and not balancing interests.[199] In a recent paper, it has been asserted that shareholder interests are in a paramount position in the attitudes of directors due to :

> "the rise of the hostile takeover and increased institutional activism, which have the effect of putting managers under greater pressure to maximize 'shareholder value,' plus remuneration schemes that link management pay to shareholder returns and heightened competition resulting from the trend towards globalization."[200]

The Confederation of British Industries has emitted mixed message. In 1973 it opined that boards should take note of obligations "arising from the company's relationships with creditors, suppliers, customers, suppliers and society at large" and to balance them and their responsibilities to shareholders.[201] But in 1996, in its submission to the Hampel Committee, it rejected the idea that directors should be responsible to non-shareholder stakeholders.[202] This latter view accords with the fact that Deakin has asserted that "[m]anagers are encouraged to pursue strategies for share price maximisation which depend upon the externalisation of costs on to other stakeholder groups."[203] So, in sum the evidence on what directors do is somewhat equivocal.

Clearly an issue that has come out of the above discussion is that it is difficult to assess whether directors have undertaken appropriate balancing. It has been argued that an independent process of review is needed,[204] and Professor John Parkinson suggested a supervisory board or an independent and diversified set of non-executive

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197 *Pawns or Potentates : The Reality of America's Corporate Boards*, 1989 at 38 and referred to in D Gordon Smith, "The Shareholder Primacy Norm" (1998) 23 *Journal of Corporate Law* 277 at 290.

198 Ibid

199 P. Hosking, "Blue-chip bosses 'are too focused on short-termism" *The Times*, June 29, 2005.

200 J. Parkinson, "Models of the Company and the Employment Relationship" (2003) 41 *British Journal of Industrial Relations* 481 at 494 and referring to John Armour, Simon Deakin, and Suzanne Konzelmann, "Shareholder Primacy and the Trajectory of UK Corporate Governance" (2003) 41 *British Journal of Industrial Relations* 531.

201 *Responsibilities of the British Public Company*, London, CBI, 1973 at para 61 and referred to in J. Parkinson, "Models of the Company and the Employment Relationship" (2003) 41 *British Journal of Industrial Relations* 481 at 494.

202 Confederation of British Industries, *Boards Without Tiers : A CBI Contribution to the Debate*, London, CBI, 1996 at 8.

203 "The Coming Transformation of Shareholder Value" (2005) 13 *Corporate Governance* 11 at 16.

204 J. Kay and A. Silberston, "Corporate Governance" [1995] *National Institute Economic Review*, August, 84 at 93-95.

directors in a single board set up.[205] But, neither the CLRSG nor the White Papers have advocated such an approach, although the Higgs Report did advocate the greater use of independent non-executive directors.

The clear benefit of the Bills is that there is an object to the balancing in which directors might have to engage, namely the promotion of the success of the company for the benefit of the members. But, arguably certainty could be achieved by simply providing that the interests are to be taken into account so as to ensure the success of the company. In adding the proviso that the success must be for the benefit of the members, with the members' interests therefore being the primary focus, "it will never be clear whether the directors ought to favour members' short or long-term interests, or their interests in income or capital generation,"[206] and it is questionable whether we have an approach that is far different from shareholder primacy.

## B. Enforcement

If directors fail to take into account the interests enumerated in clause B3(3) in circumstances where the company needed to do so, it causes one to ask, what penalty will ensue for the directors who would be in breach of duty? The answer appears to be : none. The reason is that no one, other than the board itself or shareholders (under a derivative action), has the right to initiate proceedings against the directors. Even if action against directors is taken later, perhaps following the company's entering into administration or liquidation, it is likely to be difficult to establish that the directors should not have done what they did. First, any administrator or liquidator would have to impugn successfully any claim on the part of the directors that they had acted in good faith in a way that was most likely to promote the success of the company for the benefit of members. Second, the courts have made it plain that they will not use hindsight in making their decision when assessing the actions of directors,[207] and it might be argued, certainly when one studies the wrongful trading cases, that courts have tended to place a benevolent interpretation on what directors have done, and they have not found them liable save where they have acted in a completely irresponsible manner.[208]

The CLRSG has stated that it sees s.309 as a declaration of an enlightened shareholder value approach,[209] in that directors must have regard for the interests of the employees of the company while deciding what in the best interests of the company. However, most, if not all, are agreed that the provision is something of a lame duck,[210] and, therefore, not a particularly good example. The provision has not

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205 J. Parkinson, "Models of the Company and the Employment Relationship" (2003) 41 *British Journal of Industrial Relations* 481 at 499.

206 Sarah Worthington, Reforming Directors' Duties (2001) 64 MLR 439 at 447.

207 For instance, see *Re Welfab Engineers Ltd* [1990] BCC 600; *Re Sherborne Associates Ltd* [1995] BCC 40.

208 For example, see *Re Continental Assurance Co Ltd* ([2001] BPIR 733); *The Liquidator of Marini Ltd v Dickensen* ([2003] EWHC 334 (Ch); [2004] BCC 172).

209 Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.21

210 See criticism of it in L. Sealy, "Director's Wider Responsibilities – Problems Conceptual Practical and Procedural" (1987) 13 Mon U LR 164 at 177.

been used and there is very little case law on the section.[211] No one has known what to do with the provision and it is likely that that will be the case with clause B3(3) of the 2005 White Paper. One of the primary problems with s.309 is that the constituent group affected, in this case the employees, had no right to bring an action against the directors if they contravened the section, a point acknowledged by the CLRSG.[212] The same thing can be said for clause B3 as far as the constituencies mentioned there are concerned. The CLRSG says that the benefit of a provision like s.309 is that it will "confer an immunity on the directors, who would be able to resist legal actions by the shareholders based on the ground that the directors had neglected their normal fiduciary duty to them…"[213] That might be true, but the problem is not usually that directors considered the interests of non-shareholder interests and need protection; rather it is that the directors in fact failed to consider non-shareholder interests.

One avenue available to disenchanted shareholders is to initiate derivative proceedings, but these proceedings are not available to non-shareholder stakeholders. It is highly unlikely that the UK would introduce derivative actions for non-shareholders. The only possible action might be to allow proceedings for injunctive relief, stopping directors from doing something that manifests a lack of regard for the interests of stakeholders. Even here there is danger for the courts as they would have to consider evidence in order to make a decision as to whether directors did intend to act appropriately. This is not an easy issue even for a judge hearing the actual trial dealing with alleged breaches of duty, let alone on an application for an injunction, and while judges have shown themselves in the past couple of decades to be more ready to make judgments concerning what directors do, it is probable that they would not wish to make these sorts of decisions. Yet if we accept that the Bill grants directors greater power and discretion there must be some framework in place to ensure that they are held accountable. As it is there is likely to be few occasions, if any, where a director is going to have to justify what he or she did. Of course, very often, and especially with what might be regarded as the day-to-day affairs of the company, constituencies will not know what the directors have done. In many situations they might know what has been done for some appreciable time, and by then it might be too late.

The CLRSG rejected the pluralist position, inter alia, because it would involve directors having to consider the interests of all constituencies, and it would give no formal remedy for abuse by the directors[214] But, that is exactly what we have with the draft provision in the latest White Paper. The framework proposed by the CLRSG, and adopted by the Government, seems to have the same failings that the CLRSG identified with the pluralist theory – how to choose between a number of competing and inconsistent constituent interests? We could end up with what has

211 Cases that refer to it, do so in passing. For instance, see *Dawson International plc v Coats Paton plc (No1)* 1988 SLT 854 at 860.

212 Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.21.

213 Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.21.

214 Company Law Review, *Modern Company Law for a Competitive Economy* : "The Strategic Framework" 1999, London, DTI, at para 5.1.21 at 5.1.30.

been said to be wrong with stakeholder theory, namely directors are left in a position of not being accountable for their stewardship of their company's resources.[215]

It has been suggested, with some significant justification, it is respectfully submitted, that while the enlightened shareholder approach is traditional[216] in substance, its objective is pluralist, with the OFR helping this objective.[217] Yet there is simply no meaningful mechanism by which directors can be called to book, and any breach remedied. Perhaps the real problem is that unlike in the past where the law has sought to require directors to meet acceptable standards of behaviour, such as not acting in self-interest, it is now seeking to compel directors to act in a particular manner.[218]

Of course, it might be argued that some, if not all stakeholders, are protected by legislation outside of company law, so they are not relying on the directors' discretion to provide them with protection, and the CLRSG certainly thought that non-Companies Act legislation could be used to provide safeguards for stakeholders.[219] As far as creditors of the company are concerned, they are protected if directors engage in wrongful trading in breach of s.214 of the Insolvency Act. The environment is safeguarded by the provisions of the Environment Protection Act 1990. Employees are protected by the Health and Safety Executive and employment statutes. But, these give partial and imperfect cover to stakeholders and only allow for some sort of remedy or relief ex post, while protection ex ante is often needed in order for it to be truly effective.

The fact of the matter is that protection of the interests of stakeholders is left not to any specific rights, such as the right to be heard or represented, but to the discretion of the directors.

**C. Good Faith**

The 2005 Bill provides that directors must act in good faith in a way that is most likely to promote the success of the company for the benefit of members. This seems to be a significant departure from the terms of the 2002 draft Bill, which contained a clause, clause 2(b) of Schedule 2, that said that "in deciding what would be most likely to promote that success [of the company], [a director must] take account in good faith of all the material factors that it is practicable in the circumstances for him to identify." "Material factors" were defined as :

> "(a)The likely consequences (short and long term) of the actions open to the director, so far as a person of care and skill would consider them relevant; and

215 Michael Jensen, "Value Maximisation, Stakeholder Theory and the Corporate Objective Function" (2001) 7(3) *European Financial Management* 297 at 305.

216 That is in the mould of shareholder primacy. This is regarded as the traditional approach : Jeffery MacIntosh, "Designing an Efficient Fiduciary Law" (1993) 43 *University of Toronto Law Journal* 425 at 451.

217 Sarah Worthington, Reforming Directors' Duties (2001) 64 MLR 439 at 440. See Company Law Review, *Modern Company Law for a Competitive Economy* : Completing the Structure, 2000, London, DTI at para 2.21.

218 Ibid at 448.

219 Company Law Review, *Modern Company Law for a Competitive Economy* : Developing the Framework, 2000, London, DTI at para 2.12.

> (b)All such factors as a person of care and skill would consider them relevant…"

The later Bill omitted any reference to the fact that the directors are to consider the factors that a person of care and skill would consider relevant. It would appear that the later Bill indicates that the Government does not want to see directors' actions being assessed on the basis of an objective test, as the 2002 wording seemed to require. All that directors have to do, under the 2005 provision, in carrying out their decision-making, is to act in good faith. For example, according to the CLRSG directors do not have to consider long term interests if they believe, in good faith, that they are not material.[220] The difficulty with this is that there are no definite standards against which the actions of directors can be assessed. Directors can merely say that they acted in good faith, and their position then becomes virtually unassailable.

In the past, the courts found, in considering claims made against directors that they acted in breach of their duty to act bona fide in the best interests of the company, that it was a problem merely having a subjective test for determining whether a director had breached the duty, so objective considerations were introduced by courts in addition to the subjective test. In *Charterbridge Corp Ltd v Lloyds Bank Ltd*[221] Pennycuick J said that the court had to ask whether an intelligent and honest man in the position of a director of the company involved, could, in the whole of the circumstances, have reasonably believed that the transaction was for the benefit of the company.[222] Unless the present law on how directors are judged is applied, what is to prevent a directors saying that he or she considered, in good faith, the interests of non-shareholders, but thought that what was done was appropriate? Prima facie it would seem that any grounds that are given by a director are not able to be assessed from an objective standpoint. The famous comment of Bowen LJ in *Hutton v West Cork Railway Co*[223] that:

> "Bona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide, yet perfectly irrational."[224]

is apposite. While the comment might be using hyperbole, the principle rings true. One can have a director doing something which he or she thinks is perfectly proper, yet it is radical and no one else might agree. The question that all of this poses is whether the courts will, in interpreting any provision based on the 2005 Bill, apply the common law rules that have been applied in the interpretation of the duty to act in good faith. With respect, I believe that Professor Sarah Worthington is correct when she says that "it is unlikely that the old cases will lose their force as illustrations of the proper application of the law."[225] However, will courts be able to use objective considerations when the legislation unequivocally refers only to a subjective test? It

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220 Company Law Review, *Modern Company Law for a Competitive Economy* : Completing the Structure, 2000, London, DTI at para 3.18.
221 [1970] Ch 62; [1969] 3 All ER 1185.
222 Ibid at 75; 1194. Also, see *Shuttleworth v Cox Bros (Maidenhead) Ltd* [1927] 2 KB 9 at 23.
223 (1883) 23 Ch D 654.
224 Ibid at 671.
225 Sarah Worthington, Reforming Directors' Duties (2001) 64 MLR 439 at 456.

is submitted that the answer should be in the positive, particularly when one considers the fact that the Privy Council and the House of Lords in two notable cases, *Royal Brunei Airlines Snd Bhd v Tan*[226] and *Twinsectra Ltd v. Yardley,*[227] were of the view that in determining something as grave as dishonesty (in the context of a claim that person dishonestly assisted in a breach of trust) the test was a combined test involving both subjective and objective considerations. Nevertheless, it is likely that any attempt to argue that objective considerations warrant being taken into account will be met, on the part of directors, with the argument that Parliament did not believe that objective considerations were warranted as it decided to approve changes to the 2002 wording.

**D. Summary**

It has been said by some advocates of shareholder primacy that directors need to pay attention to other constituencies, but only insofar as such action contributes to maximising shareholder wealth.[228] It might be argued that this is what clause B3(3) provides for in stating that directors are to do that which they consider, in good faith, is most likely to promote the success of the company for the benefit of the members as a whole. Therefore, one must query how enlightened is the approach being advocated by the 2005 White Paper. Decisions that take into account the interests of those non-shareholders mentioned in clause B3(3) must ultimately serve the interests of the members of the company, and while that might well maximise the aggregate value of all those with claims on the company, some constituencies might well lose out. It would seem that the approach taken by the CRLSG and the White Papers is to subordinate the interests of non-shareholders to those of the shareholders, just as it is with shareholder primacy. The fact is that shareholder primacy appears to be pre-eminent under the White Papers, just as it is now according to some commentators.

Arguably, the benefit of the enlightened shareholder value model, is that it enables directors to take into non-shareholder interests when making decisions, without being in breach of their duties, always providing that their ultimate decisions do in fact promote the success of the company for the benefit of its members as a whole. Of course, if the actions of the directors do achieve this objective it is unlikely that shareholders would be complaining about the fact that directors have considered the interests of other stakeholders. The only scenario where shareholders might take umbrage at what the directors have done is where the company would have been more successful had the directors not taken into account non-shareholder interests.

## VII Conclusion

Undoubtedly, there is room for debate as to whether shareholder primacy has normative value. Contractarians would say "yes," while communitarians and others[229] would say, "no." This article has not sought to address that issue. What it has done is to explain the shareholder primacy principle and to consider whether it is

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226 [1995] 2 AC 378.

227 [2002] UKHL 12; [2002] 2 AC 164.

228 For instance, Jeffery MacIntosh, "Designing an Efficient Fiduciary Law" (1993) 43 *University of Toronto Law Journal* 425 at 451.

229 Such as those holding to a team production approach. See, for example, M. Blair and L. Stout, "A Team Production of Corporate Law" (1999) Va L Rev 247.

part of positive law. It has been concluded that it is questionable whether the principle applies unequivocally in either the US, where one American commentator has said that the shareholder primacy norm "may be one of the most overrated doctrines in corporate law,"[230] or the UK, and there does not seem to be a clear strain of authority, certainly in the UK and possibly in the US, that supports its use. The law has been that directors are to act in the best interests of the company, and it would appear that all too often the assumption has been made that the interests of the company accord with profit maximisation for shareholders. Certainly, the CLRSG assertion that shareholder primacy is descriptive of the law of companies in the UK is questionable, but, while acknowledging the need to take into account other interests, it accepted it as the basis for the company law reform process. The Government agreed with this in the first two White Papers that have been published.

The article has also examined the enlightened shareholder value principle that was favoured initially by the CLRSG, and latterly by the Government. It has been noted in the article that the provisions in the Government's latest White Paper effectively require directors to engage in a balancing of the interests of various constituencies, but with little or no guidance, other than that they are to be concerned about benefiting the members' interests; the directors are given virtually an unfettered discretion as to what interests, if any, they take into account. The article has asserted that if any constituent is unhappy with the way that directors have acted, they have no power to bring proceedings to have the directors' acts reviewed. Even shareholders, who can utilise the derivative suit, might find it difficult to establish that a director has failed to do that which the legislation requires him or her to do. The draft provisions in the White Paper provide that the directors must act in good faith, but this involves a subjective test and means, unless the courts employ objective considerations as a counterweight, as they have done in the past when assessing the good faith of a director, that the decisions of directors will be able to be challenged in few cases.

The enlightened shareholder value approach is seen as providing a radical reform.[231] While some might argue that directors have been doing what the latest White Paper aims to require them to do, to place this in statutory form is certainly able to be classified as radical. But how radical this is will largely depend on how the provision, if it becomes law, will be interpreted and applied first by directors and, more importantly, by the courts. It appears that in practice the approach is likely to be little different from the shareholder primacy approach. It would mean that shareholder primacy, the pre-eminence of which has been subject to no little doubt, would clearly be paramount. Arguably, non-shareholder constituents will be less advantaged under a provision in the mould of clause B3(3) of the 2005 White Paper as directors will no longer be subject to common law guidelines, but statutory directives.

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[230] D Gordon Smith, "The Shareholder Primacy Norm" (1998) 23 *Journal of Corporate Law* 277 at 322.

[231] Lee Roach, "The legal model of the company the Company Law Review" (2005) 26 Co Law 98 at 103.

# WORKING PAPER

## The First Ten Years of the World Trade Organization: How Level is the "Level Playing Field"?

Professor Surya P. Subedi, OBE*
School of Law
University of Leeds
Leeds, LS2 9JT, UK
E-mail: s.p.subedi@leeds.ac.uk

> "Peace is the natural effect of trade."
>
> - Baron de Montesquieu (1689-1755)[1]

I. Introduction

The World Trade Organization (WTO),[2] which came into existence on 1 January 1995, is celebrating its tenth anniversary this year, with the WTO officials, especially the Director-General, claiming that the past ten years have been a success for the organization.[3] King Hassan II of Morocco, host of the closing ceremony of the Uruguay Round, remarked that the establishment of the WTO represented "a gigantic leap forward towards broader and more intensive international co-operation".[4] Peter Sutherland, the then Director-General of the GATT, described the agreement establishing the WTO as the "greatest trade agreement in history".[5] Indeed, after three years of preparation and seven years of protracted negotiations, over 100 Ministers signed the Final Act of the Uruguay Round: it contained 28 agreements and had some 26,000 pages of appendices on national tariff and services schedules.[6] The WTO was

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* LLB (Tribhuvan); LLM with Distinction (Hull); DPhil (Oxford); Professor of International Law, University of Leeds, UK. An earlier version of this paper was presented by the author as the Inaugural Lecture at the University of Leeds on 3rd May 2005.

1 Montesquieu, *Spirit of Laws* (1748), Book 20, Chapter 2: Of the Spirit of Commerce. He wrote: "Peace is the natural effect of trade. Two nations who traffic with each other become reciprocally dependent; for if one has an interest in buying, the other has an interest in selling; and thus their union is founded on their mutual necessities."

2 The Uruguay Round of Multilateral Negotiations launched under the auspices of GATT in 1986 concluded in December 2003. Among the agreements concluded by the Uruguay Round was the one establishing a Multilateral Trade Organization which was later named as WTO and the agreement to establish this organization was formally signed in Marrakesh, Morocco, on 15th April 1994. In accordance with the provisions of the Final Act embodying the results of the Uruguay, the WTO came into existence on 1 January 1995.

3 Supachai Panitchpakadi, "The WTO after 10 Years: The Lessons Learned and the Challenges Ahead", a speech delivered to the Council on Foreign Relations in New York on 10 March 2005: http://www.wto.org/english/news_e/spsp_e/spsp35_e.htm (accessed on 20 April 2005).

4 See in Supachai Panitchpakadi, "Ten Years After Marrakesh: The WTO and Developing Countries", a speech delivered on 9 June 2004 in Marrakesh, Morocco.

5 *Ibid.*

6 See for a collection of the main WTO agreements, World Trade Organization, *The Results of the Uruguay Round of Multilateral Trade Negotiations* (Cambridge University Press, Cambridge, 1999).

the most important international institution to be established since that of the UN in 1945. After some 50 years, one piece of previously unfinished business of the post-war architecture for the international community was completed.

Since the WTO was begun, the world has witnessed a rapid growth in international economic activity, as well as a massive increase in the volume of international trade. Accordingly, the WTO has seen an expansion of its activities in recent years and has thus become one of the most important international organizations. Nearly 150 States, developed and developing, small and big, powerful and weaker, have now become Members of this organization.[7] The new dispute settlement system of the WTO has received over 300 trade disputes from its Members and given its rulings in more than 80 of such cases, providing for greater stability and predictability in global commercial exchanges. On the strength of such a short history, it is tempting to claim that the WTO has been a success. However, it is necessary to go deeper into the workings of this organization within the past ten years before reaching the conclusion that this is so.

The passage of a mere decade is not a long enough period of time definitively to assess the performance of an international organization against its stated objectives. It should be noted that the WTO was not created as an entirely new organization, though: rather, it is an organization with a long history behind it in the form of a Secretariat of the "Contracting Parties" to the General Agreement on Tariffs and Trade (GATT). In other words, GATT was reincarnated as the WTO in January 1995. It had expanded and clearer objectives. One of these is to ensure that the level playing field is truly level. Consequently, coinciding with its tenth anniversary, the WTO has come under closer scrutiny with regard to its ability to ensure fair play in the conduct of international trade by the trading nations of the world.

The WTO, established as it was primarily to further liberalize international trade, is supposed to create a level playing field in order for it to enable nations to compete on an equal footing.[8] As stated in a report by the Consultative Board to the Director-General of the WTO, "(t)he WTO provides a level playing field with a credible referee dealing even-handedly with the players. It is a playing field on which only governments participate in the game."[9] Has the WTO lived up to its expectations? Has it dealt even-handedly with the players? Has the level playing field become truly level or more level over the past ten years? These are the questions that this article

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7 The Number of Member States of the WTO currently stands at 148 and Cambodia and Nepal were the latest States to join the WTO.

8 See generally on the WTO law and policy, Bernard Hoekman and Michael Kostecki, *The Political Economy of the World Trading System: From GATT to WTO* (Oxford University Press, Oxford, 1995); Michael J. Trebilock and Robert Howse, *The Regulation of International Trade* (2nd edition, 1999, Routledge, London/New York); John H Jackson, et al, *Legal Problems of International Economic Relations: Cases, Material and Text* (West Publishing, St. Paul, Minn, 2002); Andreas Lowenfeld, *International Economic Law* (Oxford University Press, Oxford 2002); Daniel L.M. Kennedy and james D. Southwick (ed.), *The Political Economy of International Trade Law: Essays in Honour of Robert E. Hudec* (Cambridge University Press, Cambridge, 2002).

9 The Board consisted of eminent persons in the area of international trade. See Peter Sutherland, et al., *The Future of the WTO: Addressing Institutional Challenges in the New Millennium* (Report by the Consultative Board to the Director-General Supachai Panitchpakdi) (hereafter "*Report of the WTO Consultative Board, 2004*"), WTO, Geneva, 2004, pp. 15-16.

aims to examine. In doing so, it will assess how far the WTO has travelled in terms of achieving its objective of ensuring a level playing field, identify the difficulties it has experienced in this process, and examine the way forward for this Organization.

## II. The Idea behind the Regulation of International Trade

Trade is one of the early attributes of human activity. The very word "trade" signifies an economic activity that is voluntary and based on reciprocity. Starting with the barter system in antiquity, humans began, when forms of money were invented, to trade in goods for cash. In fact, it was trade that contributed to the invention of money. As this voluntary reciprocal economic activity began to grow both spatially and in volume, regulations were introduced to regulate it such that trade was fair; that it was free from distortions. Much of human civilization has developed with and around the expansion of trade and the desire firstly, to survive and subsequently, to create wealth through trade. The concept of free trade has been in existence since trading began. Traders and trading nations have probably tried throughout human civilization to fight off any interference in their activity. States have always competed with each other in maximizing their trade *vis-à-vis* other nations.

The role of the law here is akin to a referee or an umpire in a sports match whose purpose is to ensure fair play. Associated with the idea of fair play is the creation of a level playing field for the business participants of the day. Thus, the law of international trade lacked until recently social engineering as its main objective. The first and foremost objective of the law, in whatever form, has been in the maintenance of a safe and orderly society. In other words, the objective was to enable people to pursue their respective lives and happiness with due regard for the interests of the other members of their society. However, those not content with this basic objective of law or with wider ambitions began to expand the role of law by using it for social engineering. They may have done it with a view to advancing civilization by embracing the notion of justice, both social and economic.

The modern concept of free trade has its origin in the concept of *laissez faire* according to which a State should intervene as little as possible in the activities of the individuals. The idea was that since trade was primarily an activity carried out between individuals, it should be free of government interference. The early attempts to regulate trade were designed to facilitate trade by providing the basic code of conduct for those engaged in international trade. Hence, the private international law concept of *lex mercatoria* was about prescribing rules for the conduct of trade between private parties. Public international law had little to do with international trade until the Second World War. Of course, treaties relating to international trade were concluded between States, yet these treaties were concerned primarily with maintaining and securing trade and transit routes for trading nations - rather than with regulating trade for the purpose of furthering the higher goals of humanity *per se*. Thus, the concept of *laissez faire* allowed international trade to remain free of the kind of regulation that became loaded with the political, social and economic agenda of the international community until the Great War.[10]

[10] See generally, Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Modern Library, New York, 1937); William Ashworth, *A Short History of the International Economy Since 1850* (London: Longman, 1975); W. Arthur Lewis, *The Evolution of International Economic Order* (Princeton University Press, Princeton, N.J., 1978).

Weakened by the Great War, States started protecting their domestic market by introducing interventionist measures. The notion of *laissez faire* began to be eroded. The more the States began to resort to protectionist measures, the more difficult it became to keep the economy of the major trading nations moving forward. As a result, the inter-war period suffered high economic depression, high inflation and a huge distortion in international trade, all resulting from heavy regulation. One of the major factors for the outbreak of World War II was the economic chaos in international relations when the concept of *laissez faire* was abandoned and barriers to international trade were erected. Consequently, efforts made during and in the aftermath of World War II sought to devise a world economic order that combined the concept of *laissez faire* with the idea of the social, economic and political engineering of the world. The name of this new strategy was the liberalization of international trade through law. Thus, the Bretton Woods agreements and the institutions created thereunder heralded a new era in international economic relations whereby the regulation of international trade became one of the main businesses of international law.[11]

## III. Liberalization of International Trade and the GATT

The vision of the new world order conceived towards the end of World War II had four components:

> (1) the establishment of a new international political order through the UN with emphasis on the maintenance of international peace and security based on the collective security system;
> (2) the establishment of an international monetary system through the International Monetary Fund, to achieve monetary stability;
> (3) the development and reconstruction of the States devastated during World War II though the International Bank for Reconstruction and Development, known as the World Bank; and
> (4) the liberalization of international trade and restructuring of the world economy based on international economic justice through the establishment of an International Trade Organization (ITO).

However, the idea of working towards international economic justice through the restructuring of the world economy was not palatable to the U.S. American politicians were aware of the unprecedented opportunity and freedom offered by the Wars in terms of the international economic activity, including international trade. The U.S. had the opportunity to shape the world agenda to enhance its own interests. Of course, the U.S. has been a progressive force – a force for good – on many international matters; however, when it comes to its own economy and prosperity, the U.S. has more often than not demonstrated a preference for unilateralism over multilateralism, and for national interests over international interests. Accordingly, the U.S. was prepared to accept only one of the two main elements of the Havana Charter, i.e., the

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[11] Joan Edelman Spero, *The Politics of International Economic Relations* (London: George Allen & Unwin, 1985); J. Bhagawati, *The World Trading System at Risk* (Princeton, N.J., Princeton University Press, 1991); John H. Jackson, *The World Trading System: Law and Policy of International Economic Relations* (Cambridge, Mass.: MIT Press, 1989).

liberalization of trade, yet not the idea of international economic justice through the creation of an international institution.

Consequently, the idea of the ITO failed when the most powerful economy in the world did not ratify the Havana Charter. Instead, the GATT was concluded as a provisional measure to regulate the liberalization of international trade. Thus, the policy chosen by the world community in the aftermath of World War II was the policy of *laissez faire*; the GATT was designed to promote free trade through the liberalization of international trade.[12]

IV. The Design of the GATT

The GATT was designed initially to regulate trade primarily in manufactured goods. Thus, only those States which were industrialized would have an interest in joining the GATT. Consequently, the GATT was perceived as a "rich men's club". The premise of the Agreement was to create a level playing field among the nations trading mainly in industrial products. The Agreement regulated trading relations among nations, thus it was similar in most respects to other bilateral treaties or private international law instruments adopted until then. This was in the sense that it was designed to regulate international trade in order to facilitate trade between the contracting parties rather than to advance some public policy or achieve some higher objectives of the international community. Although the preamble to the GATT outlined the high ambitions of the international community and embodied the spirit of the Havana Charter, the operative paragraphs contained few provisions designed to achieve those objectives. The Agreement had few provisions designed to achieve international economic justice or to restructure the world economy. Thus, the GATT was a hybrid instrument containing the elements of both public and private international law.

Initially, the GATT lacked enough provisions to make it sufficiently attractive to States with a predominantly agricultural base. It did little to prevent the developed countries from pursuing a policy of protectionism with regard to the trade in agricultural products - as well as in textile and clothing. Consequently, a large number of newly independent States remained outside the GATT. More and more nations gained their independence and joined the UN, through which they sought to restructure the world economy. As a result, pressure grew on the Contracting Parties to the GATT to amend it in order to make it more attractive to the newly independent developing countries, rather than to allow these countries to pursue their respective trade agendas within the UN.[13]

In fact, many developing countries that were already party to the GATT threatened to withdraw from the GATT regime unless it addressed the economic problems of the

12 R. Hudec, *Enforcing International Trade Law: The Evolution of the Modern GATT Legal System* (New York, Butterworth, 1993); Bernard Hoekman and Michael Kostecki, *The Political Economy of the World Trading System: From GATT to WTO* (Oxford University Press, Oxford, 1995); Robert McGee, *A Trade Policy for a Free Society: The Case Against Protectionism* (Westport, CT: Quorum Books, 1994).

13 Oliver Long, *Law and Its Limitations in the GATT Multilateral Trade System* (London: Graham and Trotman, 1987); Alan Oxley, The Challenge of Free Trade (London: Harvester Wheatsheaf, 1990); Kenneth W. Dam, *The GATT: Law and International Economic Organization* (Chicago: Chicago University Press, 1970).

developing countries. Attempts were thus made through various rounds of multilateral trade negotiations to accommodate the interests of the developing countries. The attempts made within the UN by the developing States at the restructuring of the world economy were reflected in the negotiations within the GATT. Consequently, the Generalized System of Preferences was introduced in the late 1970s in favour of the developing countries; a whole new part, i.e., Part IV, designed to address the issues relating to trade and development, was added to the GATT. This Agreement went through a series of amendments in the 1960s and 1970s to emerge as a truly international regime governing international trade.

## V. The Shift in Paradigm

Attempts to restructure the world economy, through principles such as the New International Economic Order within the UN, were unavailing. Simultaneously, there was a momentum in the opposite direction, i.e., towards stronger capitalism, in much of the Western world. The following three principal factors led to the rapid rise of corporate power and global production networks:

(i) the failure of the leading mixed economies to lift people out of poverty;
(ii) the decision of China to embark on the road to market economy; and
(iii) the massive growth in the economic activity of the 1980s.

Thanks to globalization, privatization and economic liberalization, much of the global economic activity was carried out by corporate power by the late 1980s. This momentum eventually contributed to the collapse of Communism in Europe and to the breakdown of the Soviet military empire. It further accelerated the consolidation of economic power by the corporate world. Consequently, a diminution in the influence of the State began in many spheres of human activity, especially in the areas of economy and trade. The reduced role of the State in economic matters rendered redundant the economic policies pursued by many developing countries.

By the time the 1990s began, the political organization of the Eastern bloc was no longer in existence, and the developing world was in a state of confusion. Corporate power had moved in - with an unprecedented level of organization and ambition - to fill the vacuum and exploit the opportunities presented. Consequently, by the time the Uruguay Round agreements were concluded, many of the elements of social engineering or international economic justice were missing, once again, from State policy. Rather than pursuing an active economic policy designed both to bring about change and to achieve economic equality and economic justice, States began to regard themselves very much as umpires or referees willing to intervene only when things went wrong in the play among the economic actors of the society. Thus, much of the GATT/WTO law enacted by States in the early 1990s reflects this attitude.

The Uruguay Round of Multilateral Trade Negotiations was the most ambitious and most comprehensive round of trade negotiations. A whole new series of agreements was concluded, addressing different areas not only of trade such as agriculture, textiles and clothing, but also of trade-related areas such as intellectual property and foreign investment measures and the service sector. Thus, by the mid-1990s the world had come full circle in five decades. It was decided to establish a World Trade Organization although the idea of an International Trade Organization had been rejected in the mid-1940s. Indeed, the stated objectives of the two are somewhat different.[14]

VI. The Framework of the WTO Law

The main purpose of the WTO law is to provide assurance to consumers and producers that they can enjoy secure supplies and a greater choice in the finished products, components, raw materials, and services that they use. The object of the WTO law is to provide legal certainty to producers and exporters that foreign markets will remain open to them. The main functions of the WTO are:

> 1. to facilitate the implementation, administration and operation, and further the objectives, of the international trade agreements;
> 2. to provide the forum for negotiations among its Members concerning their multilateral trade relations in matters dealt with under the trade agreements;
> 3. to administer the Understanding on Rules and Procedures Governing the Settlement of Disputes; and
> 4. to administer the Trade Policy Review Mechanism.[15]

At the heart of the international trading system led by the WTO – known as the multilateral trading system – are the WTO agreements, negotiated and ratified by a large majority of the world's trading nations. These agreements provide the ground rules for the conduct of international trade and commerce among nations and peoples across the world. Essentially, such WTO agreements are contracts among nations, guaranteeing member-countries important trade rights. These agreements impose norms and disciplines requiring the governments around the globe to keep their trade policies within agreed limits, to the benefit of all. Although the agreements are public international law instruments negotiated and signed by governments, their purpose is to help producers of goods and services, traders, exporters, and importers conduct their business in an orderly manner, and also to protect the rights of creators, authors and innovators to their respective intellectual property.

The main objective of the WTO law remains to be the further liberalization of international trade. The instruments chosen under the GATT/WTO system to achieve the liberalization of trade are:

1. the MFN Principle;
2. national treatment;
3. reciprocity; and
4. non-discrimination.[16]

The aim of these principal pillars of the WTO/GATT law is to ensure a level playing field in order to enable business actors to compete on an equal footing in accordance with the notion of fair play embodied in the WTO agreements.

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[14] J.M. Finger and A. Olechowski (eds.), *The Uruguay Round: A Handbook for the Multilateral Trade Negotiations* (Washington, DC: The World bank, 1987); R. Stern (ed.), *The Multilateral Trading System* (Ann Arbor: University of Michigan Press, 1993); Jeffrey Schott, *The Uruguay Round* (Washington, DC: Institute of International Economics, 1994).

[15] Article III of the Marrakesh Agreement Establishing the World Trade Organization, 1994.

[16] Articles I and III of the GATT 1947.

## VIII. The Achievements of the WTO

### 1. Legal Certainty through a Rule-Based System

One of the main achievements of the WTO law has been to provide legal certainty to producers and exporters that foreign markets remain open to them. This certainty has been provided by creating a rule-based, fully-fledged international organization and also a more effective dispute settlement mechanism. The WTO is credited with enhancing the rule-based system created initially by the GATT. Various WTO agreements provide the ground rules for the conduct of international trade and commerce among nations and peoples across the world. In order to give credibility to this rule-based system the WTO strengthened the dispute settlement mechanism so that the risk of disputes spilling over into political or military conflict is reduced.

Thanks to the WTO agreements, 148 WTO members operate, by and large, a non-discriminatory trading system based on some key principles, such as the most-favoured nation treatment and national treatment, that spell out their rights and obligations. In other words, each WTO member receives guarantees that its exports will be treated fairly and consistently in other countries' markets in return for the same assurances that it accords to imports from other WTO members into its own market.

### 2. Liberalization of Trade in Services

The desire to liberalize trade in goods was the main reason for the conclusion of the GATT in 1947. But the Uruguay Round negotiations expanded the scope of the WTO by including the liberalization of trade in services as part of the international trade agenda. Under the General Agreement on Trade in Services (GATS), banks, insurance firms, telecommunications companies, tour operators, hotel chains and transport companies looking to do business abroad can now enjoy the same principles of freer and fairer trade that originally applied only to trade in goods. Thanks to the efforts made by the WTO, new agreements have been concluded to liberalize the telecommunications sector as well as various aspects of financial services.

### 3. Protection of Intellectual Property

It also was during the Uruguay Round of trade negotiations that a clear link was established between trade, on the one hand, and intellectual property protection, on the other. Consequently, issues surrounding trade-related aspects of intellectual property were introduced into the international trade agenda and a new agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) was concluded at the end of the Uruguay Round. The TRIPS agreement contains rules for trade and investment in ideas and creativity. The agreement regulates how copyrights, patents, trademarks, geographical names used to identify products, industrial designs, integrated circuit layout designs and undisclosed information such as trade secrets – "intellectual property"– should be protected when trade is involved.

One of the major contributions of the TRIPS agreements is that they set out in some detail the obligations of member governments to provide under their domestic law procedures and remedies to ensure that intellectual property rights can be effectively enforced, by foreign right holders as well as by their own nationals. It requires that procedures should permit effective action against infringement of intellectual property rights and allow for judicial review of final administrative decisions. The civil and administrative procedures and remedies spelled out in the TRIPS agreement deal with provisions concerning evidence of proof, injunctions, and damages. It also requires the WTO members to provide for criminal procedures and penalties at least in cases of wilful trademark counterfeiting or copyright piracy on a commercial scale.

However, the TRIPS constitutes an instrument often singled out as an agreement concluded primarily in the interests of developed countries. Owing to the protection granted to the pharmaceutical industry under the TRIPS, critics were concerned about the impact of this agreement on public health in developing countries. Consequently, some relaxation of TRIPS provisions, or a liberal interpretation of them, has taken place to soften the negative impact of the TRIPS provisions on the protection of public health in the developing countries, especially with regard to the HIV/AIDS drugs. Indeed, paragraph 4 of the Doha Declaration of the WTO states that

> the TRIPS Agreement does not and should not prevent members from taking measures to protect public health. Accordingly, while reiterating our commitment to the TRIPS Agreement, we affirm that the Agreement can and should be interpreted and implemented in a manner supportive of WTO Members' right to protect public health and, in particular, to promote access to medicines for all.
>
> In this connection, we reaffirm the right of WTO Members to use, to the full, the provisions in the TRIPS Agreement, which provide flexibility for this purpose.[17]

Paragraph 5 of the Declaration on the TRIPS Agreement and Public Health goes on to outline a non-exhaustive list of these flexibilities in the following terms:

> In applying the customary rules of interpretation of public international law, each provision of the TRIPS Agreement shall be read in the light of the object and purpose of the Agreement as expressed, in particular its objectives and principles.
> Each Member has the right to grant compulsory licences and the freedom to determine the grounds upon which such licences are granted.
> Each Member has the right to determine what constitute a national emergency or other circumstances of extreme urgency, it being understood that public health crises, including those relating to HIV/AIDS, tuberculosis, malaria and other epidemics, can represent a national emergency or other circumstances of extreme urgency.
> The effect of the provisions in the TRIPS Agreement that are relevant to the exhaustion of intellectual property rights is to leave each Member free to establish its own regime for such exhaustion without challenge, subject to the MFN and national treatment provisions of Articles 3 and 4.[18]

Thus, the WTO members made a highly significant statement that every country had not only the right to grant compulsory licenses, but also the freedom to determine the grounds upon which such licences are granted. What is more, each member was allowed to determine what constitutes a national emergency, or other circumstances of extreme urgency. This should enable developing countries with a manufacturing infrastructure to grant compulsory licences to their domestic pharmaceutical industries for them to produce the medicines necessary for the protection of public

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17 WT/MIN(01)/DEC/W/2 of 14 November 2001.
18 *Ibid*.

health. However, this concession was unlikely to benefit those developing countries and least-developed countries in particular which lacked a sufficient manufacturing infrastructure. Consequently, the WTO took another decision on 30 August 2003 agreeing on legal changes that would make it easier for poorer countries to import cheaper generics made under compulsory licensing if they are unable to manufacture the medicine themselves.[19]

4. Liberalization of Trade in Textiles and Clothing

International trade in textiles and clothing has gone through a fundamental change since the establishment of the WTO. Before the WTO Agreement on Textiles and Clothing (the ATC) took effect, quotas controlled a large portion of trade in the sector. Under the ATC, WTO members committed themselves to remove the quotas and to integrate the sector fully into GATT rules by 1 January 2005. It has now become a reality. This means that the WTO members from now on have to observe the GATT principles such as non-discrimination and MFN. During the Uruguay Round many developing countries had agreed to negotiate the new issues of intellectual property and services when they saw greater liberalization of trade in agriculture and also the prospect of ending the quota system on textiles and clothing.

International trade in textiles and clothing was regulated by the Multi-fibre Arrangement (MFA) until the conclusion of the Uruguay Round under which quotas on the importation of textiles were negotiated bilaterally. The MFA contained rules for the imposition of selective quantitative restraints when surges in imports caused, or threatened to cause, market disruption, thus representing a major departure from the basic GATT rules, especially from the principle of non-discrimination. The quota system under the MFA was replaced by the ATC with a ten-year liberalization programme. This meant that all quotas, as well as their growth rates, existing under the MFA were carried over into the WTO agreement, but their levels were supposed automatically to increase during the ten-year transition period and to reach total abolition of the quotas by the end of 2004. It was an important milestone in the development of international trade relations.

The expiry of the ten-year transition period has put an end to a special and discriminatory regime that has lasted for more than 40 years. Today, trade in textile and clothing products are no longer subject to this regime and are now governed by the general rules and disciplines embodied in the main trade agreement, the GATT. Nevertheless, it should be noted that the success of the WTO does not benefit all States equally. For instance, with the disappearance of the privileged access to the market that was based on the quota system, smaller developing countries heavily dependent on the export of textile and clothing - such as Bangladesh and Sri Lanka - are likely to lose out to larger developing countries - such as India and China - in the free-for-all environment. Consequently, China was persuaded to adopt some self-restraining measures in the export of her textile and clothing products. In the absence of such measures, certain countries, especially those within the EU were threatening to resort to the safeguard measures of the GATT under which the WTO members are allowed to take some temporary measures designed to prevent the distortion of international trade resulting from the surge in imports from other members.

19 WTO Council for TRIPS, "Implementation of Paragraph 6 of the Doha Declaration on the TRIPS Agreement and Public Health", Decision of 30 August 2003: IP/C/W/405.

## 5. Dispute Settlement Mechanism

Widely regarded as one of the most important outcomes of the Uruguay Round of trade negotiations is the establishment of a much improved system of dispute settlement within the WTO: the Dispute Settlement Body (DSB). Indeed, a mechanism for resolving trade disputes under the Dispute Settlement Understanding (DSU) is vital for enforcing the rules and therefore for ensuring that trade flows smoothly. Unlike the dispute settlement mechanism under the GATT, the DSU under the WTO is based on a strict time-table for a speedy resolution of trade disputes. Whereas the GATT system required a positive consensus to establish a panel, under the new DSU a panel *has* to be established, unless the DSB decides by consensus *against* establishment. The provision of appellate review is an important new feature of the DSU and a significant improvement on the GATT system.

The DSB has by and large been a success story, in the sense that some 325 cases have been referred to it since its establishment a mere ten years ago. However, there are doubts as to the effectiveness of its rulings because some of the more powerful States have failed to embrace the spirit behind the WTO framework. There have been difficulties in implementing certain panel and Appellate Body rulings and in bringing the laws of such powerful States into conformity with WTO rules. The risk here is that some of the more powerful States may use the WTO when it suits them and disregard it when their own vital interests are at stake. This is what has happened with regard to the attitude of certain more powerful States *vis-à-vis* the UN; the same tendency may prevail in relation to the WTO in the years to come.

# IX. Difficulties of the WTO

## 1. Liberalization of Trade in Agriculture

The Agreement on Agriculture concluded at the end of the Uruguay Round committed the Contracting Parties to achieving specific binding commitments in each of the following areas: market access; domestic support; and export competition. In other words, the Agreement has three main components:

1. reductions in farm export subsidies;
2. increases in import market access; and
3. cuts in domestic producer subsidies.[20]

Running through the provisions of this Agreement is the idea that developing countries should be able to export their agricultural products to the developed countries; simultaneously, the protection enjoyed by farmers in the developed countries in the form of subsidies should be phased out. The object of the Agreement was to initiate a process of liberalizing trade in agriculture, but the process has not yet gone very far. The main obstacle towards the liberalization of trade in agriculture is the subsidy granted by some States to protect their respective farming industries, and the main objective of the Agreement on Agriculture is to phase out such subsidies.

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[20] Surya P. Subedi, "The Challenge of Managing the `Second Agricultural Revolution' through International Law: Liberalization of Trade in Agriculture and Sustainable Development", in Nico Schrijver and Friedl Weiss (ed.), *International Law and Sustainable Development: Principles and Practice* (Martinus Nijhoff, The Hague, 2004), pp.161-184.

The Agreement represented a significant breakthrough in terms of bringing all agricultural products under the multilateral disciplines of the WTO. Prior to the conclusion of the Uruguay Round, some agricultural imports were restricted by quotas and other non-tariff measures. Now, though, the new rule for market access is "tariffs only", meaning that no other restrictions such as quotas could be applied to trade in agriculture. This was a significant achievement. The Agreement also requires States to cut back the domestic support that has a direct effect on the production and trade of agricultural products. To accelerate the process of liberalization of trade in agriculture and to review the progress in the implementation of commitments negotiated, the 1994 Agreement established a Committee on Agriculture. Article 20 committed the WTO Members to initiating negotiations for continuing the process of liberalization one year before the end of the implementation period, i.e. the six-year period from1995, the year in which the WTO agreements entered into force.

Accordingly, negotiations on agriculture had to begin in 2000; indeed, they began early in that year. However, the negotiations have not gone very far. The Cancun Meeting of the WTO held in 2003 achieved little, due mainly to the position taken by the developing countries. This was that unless there was serious progress on liberalizing trade in agriculture, they were not willing to move ahead with other areas of trade liberalization. Developed countries such as the US, Japan and those within the EU have pointed out that reforming their agricultural sector would depend upon reciprocal measures by developing countries on non-agricultural market access as well as services. Thus, trade in agriculture seems to be the make-or-break issue within the current round known as the Doha Development Round of trade negotiations. Therefore, any judgment on the performance of the WTO on this front has to have reservations.

2. Special and Differential or Preferential Treatment

Another area in which the WTO has been unable to make significant progress concerns the elaboration and implementation of the principle of special and differential or preferential treatment for developing countries. The principle is in order to enable them to develop their economies so that they can in due course compete with the developed countries on an equal footing. Various provisions of the WTO agreements speak of granting special and differential or preferential treatment for developing countries without specifying the nature and scope of such treatment. It was expected that once the WTO came into existence it would work out the detailed modalities of according such treatment to developing countries. However, little has been done in this area. Rather: there is now a debate as to which developing countries should actually qualify for such treatment. Many countries seem reluctant to accord the same special and differential treatment to *more developed* developing countries - such as China and Korea - on the one hand, and *less developed* developing countries - such as Laos and Mali - on the other hand.[21]

The Doha Declaration decided fully to take into account the principles of special and differential treatment for developing and least-developed countries embodied in, *inter*

[21] Surya P. Subedi, `The Road from Doha: The Issues for the Development Round of the WTO and the Future of International Trade', 52 (2) *International and Comparative Law Quarterly*_(April 2003), pp.425-446.

*alia*, the Decision of 28 November 1979 on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries. However, it did not go beyond acknowledging the notion of special and differential treatment for developing countries and reviewing the provisions for special and differential treatment "with a view to strengthening them and making them more precise, effective, and operational."[22]

### 3. The Treatment of the Least-developed Countries

As regards the least-developed countries, the WTO has committed itself through the Doha Declaration "to the objective of duty-free, quota-free market access for products originating from LDCs."[23] However, this commitment has not been translated into concrete and binding obligations. At present, these are promises rather than actions. Of course, with the expiry of the Agreement on Textiles and Clothing, the quota system in textiles and clothing under the global trade treaties has virtually disappeared. What primarily remains is the implementation of the duty-free system for the exports from the least-developed countries. There exists some form of a quota system under other non-WTO agreements, such as the Cotonou Agreement, successor to the more widely known Lome Conventions concluded between the EU and the ACP countries. The business of the WTO *vis-à-vis* these agreements would be limited to granting a waiver. Indeed, the request for a waiver in relation to certain products from the ACP countries was granted by the Doha Ministerial Meeting of the WTO.

## X. Challenges to the Principle of Level Playing Field

There are a number of provisions within the WTO law itself that condition the principle of a level playing field; also, there are new developments taking place that are liable to erode the ideas underlying this principle. The MFN principle is the bed-rock of international trade. The WTO law itself is founded on this principle. However, a gradual erosion of this principle has taken place over the last four decades in general, i.e., since the establishment of the EEC, and in the last ten years in particular. A report by a Consultative Board to the Director-General of the WTO recently made the following rather bold yet realistic pronouncement: "MFN is no longer the rule; it is almost the exception."[24]

Indeed, the principle of MFN seems to be undermined by a number of trading blocs[25] such as the EU and NAFTA, an increasing number of bilateral free trade agreements concluded between States and a series of waivers, concessions and special deals. Thus, the MFN principle is fast becoming a least-favoured-nation (LFN) principle applying only in trading relations between nations that are not party to any of the bilateral, the regional or the preferential trade agreements. If the recent trend of concluding ambitious and comprehensive bilateral free trade agreements accelerates, it may undermine not only the MFN principle but also the future of the WTO. Of course, the MFN principle has never been an absolute principle. Still, the gradual erosion of this principle is likely to shake the very foundations of the WTO. If the

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22 WTO, Ministerial Declaration, Doha, 14 November 2001: WT/MIN(01)/DEC/W/1, para. 44.

23 *Ibid*., para. 42.

24 *Report of the WTO Consultative Board*, 2004, p.19.

25 Article XVI of the GATT 1947 permits the establishment of regional trading blocs under narrowly defined conditions.

consensus-based decision-making process of the WTO hinders further liberalization of trade along the lines preferred by the developed countries, these States may gradually by-pass the WTO and go ahead with separate arrangements, further eroding the MFN principle and ultimately the WTO itself.

There are other measures akin to "positive discrimination" adopted in favour of the developing countries; they include the Generalized System of Preferences (GSP), concessionary trade and development treaties such as the Lome Conventions and its successor the Cotonou agreement, quota-free and duty-free arrangements for the least-developed countries, the idea of a "south-south co-operation" and the very idea behind the "special and preferential or differential treatment" principle: these are also contributing to the erosion of the global principle of MFN even though they are regarded as measures desirable in bringing about fairness in the international trading system. Thus, the challenge for the WTO is to strike a balance between, on the one hand, the principle of MFN and, on the other, fairness.

## XI. Level Playing Field and Fairness: Are They Synonymous?

The WTO system is more about creating a level playing field than achieving fairness. However, the underlying presumption within the WTO system seems to be to regard a level playing field and fairness as being synonymous. In other words, the assumption seems to be that the creation of a level playing field would result in fairness, while the dispute settlement body of the WTO would act as a safeguard and ensure fairness in the game. A WTO report published recently states that

> Neither the WTO nor the GATT was ever an unrestrained free trade charter. In fact, both were and are intended to provide a structured and functionally effective way to harness the value of open trade to principles and fairness.[26]

If this is the case, the existing exceptions to the MFN principle and to the principle of non-discrimination could in fact remain valid, and more features could be added to ensure greater fairness. In simple terms: the notion of a level playing field means creating the opportunity for all players in a game to compete on an equal footing. It does not necessarily mean assisting or empowering the players; it is about ensuring fair play among the competitors.

The counter argument seems to suggest that the creation of a level playing field would not necessarily result in fairness unless the players have equal opportunities to prepare themselves for competition on this particular playing field. It is said that equality is possible among equals. Hence, there is a need for special and preferential or differential treatment in favour of the developing countries in the interim. Only when some parity has been achieved among nations would it be possible to speak of a level-playing field. Accordingly, a perfectly level playing field is a distant objective; the immediate goal should be to providing some leeway for those States currently ill equipped to compete on an equal footing.

If the WTO is seen merely as a referee rather than as a facilitator, this in itself would not necessarily ensure fairness.[27] For instance, to use the analogy of a football match,

[26] *Report of the WTO Consultative Board*, 2004, p.15.

it is not the job of the referee to see who has taken drugs to enhance their performance or which team had access to which level of training and other facilities, etc. It should be the responsibility of the rule-making and rule-enforcement agencies such as the FIFA (with regard to football) or the IOC (with regard to the Olympic Games) to ensure that not only is the playing field level and the referee impartial, but also that the players have not taken any banned substances to enhance their performance, etc. Even then the match would not be a completely fair one because the players from better resourced countries with access to superior training facilities would do better than those from the less well equipped countries.

However, it should be noted that the WTO is not designed to do absolutely everything. It is not equipped with the powers to ensure absolute fair play. For the WTO to do so would mean undermining the ideas behind the theory of comparative advantage. The WTO is not a development agency, nor is it designed to promote international justice, in the wider sense of the term. Its role is limited to the matters necessary to ensuring fair play on the ground. The WTO is designed to play the roles parallel to - continuing the analogy of a football match - those of the FIFA and the referee - but no more. The rule-makers are the States themselves. They have mandated the WTO to play the role of both the referee and the rule-enforcement agency, yet not that of rule-maker. Only the rule-makers, i.e., the States, can take measures to promote fairness and international justice. Therefore, if the rule-makers wish to make the WTO an agency responsible also for the promotion of fairness and international justice then there has to be fundamental reform of the WTO law.[28]

There are bound to be losers and winners on a perfectly level playing field, but the claim of the WTO is to create a win-win situation for all, through competition, liberalization and openness. Therefore, there is a contradiction in the practice and the theory of the modern international trade agenda. The WTO law has sought to reconcile this contradiction by creating the ground rules designed to create a level playing field, while at the same time providing certain exceptions to these rules in order to accommodate other concerns. Thus, strictly speaking, in spite of its claim on the surface, the WTO is neither wholly about creating a level playing field nor is it solely about promoting international economic justice or fairness, in the broader sense of the term. This is because the WTO rules are the result of a compromise reached among States during the Uruguay Round of trade negotiations, especially between the developed and developing States, and the rules reflect the concerns of both groups of States.

It follows that, when a reference is made to the creation of a level playing field, it is not in the philosophical sense, but in the more practical sense of the term. According to this, the creation of such a field would be the full implementation of the package deal between different groups of States. In other words, it is about honouring the promises made at the conclusion of the Uruguay Round in 1993 and through the Doha

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27 See for an interesting analysis of the issues facing the Doha Development Round of the WTO, Joseph E. Stiglitz and Andrew Charlton, *The Development Round of Trade Negotiations in the Aftermath of Cancun* (A Report for the Commonwealth Secretariat), London, June 2004.

28 See for a detailed analysis of the difficulties within the WTO system, Oxfam, *Rigged Rules and Double Standards: Trade, Globalisation, and the Fight Against Poverty* (Oxfam, Oxford, 2002).

Declaration of 2001.[29] It is about liberalizing trade in agriculture and in textile and clothing, as well as providing protection for the trade-related aspects of intellectual property and opening up further areas of the service sector to foreign competition. From this perspective, too, what we see today is not a completely level playing field. The TRIPS agreement has been enforced with a high level of rigour and vigour around the globe and the liberalization of the service sector has gathered momentum. In contrast, progress has been slow in other areas, especially in the agricultural sector. Of course, since the establishment of the WTO great advances have been made in rendering the playing field level. For instance, the abolition of the quota system and the integration of international trade in textiles and clothing into the main GATT rules were huge steps in this direction, marking the end of more than 40 years of managed trade in this sector.

However, it is not as yet as level a playing field as was expected of the WTO. For this, the WTO has to facilitate greater liberalization of trade in agriculture and perhaps agree on a drastic reduction of tariffs across the board. As was seen in the preceding paragraphs, reduction in tariffs is the prime motive for the erosion of the principle of MFN through the conclusion of free trade agreements, or the explosion in the number of regional trading blocs, or the demand for special and differential treatment for developing countries, or the demand for duty-free access for least-developed countries. None of these schemes has ever resulted in the increase in the level of tariffs. All are about reducing tariffs. Since differentiation in tariff is the main reason why the playing field is not fully level and the MFN principle is coming under greater attack - thereby shaking the very foundation of the WTO itself - one of the ways of making the playing field truly level would be, as suggested in a WTO report,[30] to make a major reduction in tariffs across the board.

## XII Conclusions

The establishment of the WTO was a great event for the extension of the rule of law at the international level. The Uruguay Round succeeded in establishing the legal and institutional pillar of international trade for the twenty-first century; the WTO has in these past ten years been a success, in the sense that it has further liberalized international trade. The WTO has been taking rather far-reaching decisions more or less every year since its establishment and the WTO DSB has been making its own contribution by delivering rulings designed to ensure a level playing field.[31] Still, though, the question remains as to whether the WTO has made the playing field truly level. In this respect, the picture is not as rosy as it is elsewhere among the WTO's achievements. Hence, it can be submitted that the WTO has achieved a qualified or selective success. The irony is that the world is still witnessing a match played between unequal players on an uneven playing field. The challenge for those who

[29] The Mid-Point Deal also known as the `July Package' of 31 July 2004 of the WTO outlines the framework for further liberalization of trade in agriculture and puts on track the Doha Round which was stalled when the Cancun conference failed to agree on the modalities for further liberalization of trade in agriculture. See for the 2004 July Package, General Council, WT/GC/W/535 (1).

[30] *Report of the WTO Consultative Board*, 2004, p.26.

[31] An example of this is the recent ruling of the WTO declaring that the US cotton subsidies were not consistent with its WTO obligations. *United States – Subsidies on Upland Cotton (Brazil V. US),* WT/DS267/AB/R, 21 March 2005.

believe in the idea of a global village, fairness, equity and equality is to strive to ensure that not only is the playing field truly level, but that all players are equally well equipped with the appropriate sports tools, kit and accessories for each to stand a fair chance of winning the game.

Of course, the idea behind the WTO is to allow nations and individuals to race to the top by freeing trade. As does democracy, free trade offers an opportunity to succeed. Accordingly, it was decided to have a level playing field to give all competitors an equal opportunity to succeed. As a society, of course it is necessary to protect the weak, the disadvantaged and the marginalized by offering them a helping hand in this race. Otherwise, they would be left behind. Although the WTO is not designed to guarantee success to all, if the underlying idea behind this organization is human welfare through the liberalization of trade, then the WTO law should pay attention to the welfare of all and not just that of the powerful, the big and the well-resourced. At the centre of the WTO are the people, the consumers, who live in an increasingly complex and interdependent world. Achieving a level playing field should be about balancing the respective environments and interests of different traders and consumers living in different countries rather than about ensuring fair play in the narrow technical sense of the term. To conclude, the playing field is not truly level; nor can a truly level playing field be fair at this stage of economic development across the globe.

The issue is relevant not only in relations between the developed and developing countries, but also between the more developed and larger developing countries, on the one hand, and less developed, smaller, countries, on the other. For instance, when trade in textiles and clothing was fully integrated into the main GATT system, larger developing countries - such as China and India - have emerged as the winners, while the smaller countries - such as Bangladesh and Sri Lanka - stand to lose out. Therefore, it is in the next phase of evolution of the international trade agenda that the WTO may be able to create a playing field that is truly level. To reach the next phase the present one has to be completed through all States' honouring in good faith the promises made at the conclusion of the Uruguay Round in 1993 and the Doha Ministerial Conference of the WTO in 2001.

# APPENDIX 1

## Constitution of the Centre for Business Law and Practice

**1. Objectives**
The objectives of the Centre are the promotion of research and teaching in all aspects of business law and practice, including but not limited to the interaction between legal rules and business practice. These objectives may, where appropriate, be pursued through links with other constituent parts of Leeds University or departments or centres within other Higher Education Institutions, as weII as through links with businesses and professions in Leeds and elsewhere.

**2. Membership**
2.1 Any member of the academic or research staff of the Department of Law or the Leeds University Business School may be a member of the Centre.

2.2. Other individuals, whether members of the University or not, may be appointed to membership of the Centre by the University Council on the nomination of the Executive Committee.

2.3 Institutions or firms may become associate members of the Centre if they fulfil the conditions established in by-laws made from time to time by the Executive Committee of the Centre.

**3. Administration**
3.1 The Centre shall be administered by a Director and an Executive Committee.

3.2 The Director shall be appointed by the University Council on the nomination of the Head of the Department of Law after consultation with the members of the Centre. S/he shall hold office normally for a period of three years and shall be eligible for immediate re-appointment.

3.3 The Director shall be responsible to the Executive Committee for the running of the Centre and the representation of its interests. The Director shall have regard to the views and recommendations of the Executive Committee and the Advisory Committee. The Director may be assisted by a Deputy Director or Directors appointed by the Executive Committee normally for a period of three years. Any Deputy Director so appointed shall be a member ex officio of the Executive Committee.

3.4 The Executive Committee shall consist of the Director and any Deputy Director together with the Head of the Department of Law, two representatives of the Leeds University Business School and up to three nominated members of whom not more than two may be members of the teaching staff of the Department of Law. The Executive Committee shall have power to co-opt up to two) additional members. Nominated and co-opted members shall be appointed normally for two years and shall be eligible for immediate re-appointment.

3.5 The Executive Committee shall meet as often as necessary to carry on the work of the Centre, but in any event at least twice a year, the Director acting as convenor. Any member of the Executive Committee shall have the right to require the holding of a meeting of the Committee.

3.6. Minutes of the meetings of the Executive Committee shall be presented to the following Staff Meeting of the Department of Law.

3.7 There shall be an advisory Committee appointed by the Executive Committee which shall formulate advice and recommendations concerning any aspect of the administration or activities of the Centre. The Advisory Committee shall consist of:
(a) all members of the Executive Committee;
(b) up to three members of the teaching staff of the University of Leeds in departments other than Law, being individuals 'those activities or interests have relevance to the objectives and work of the Centre;
(c) up to fifteen persons from outside the University of Leeds with experience in the fields of activity covered by the objectives and work of the Centre.

3.8 The Executive Committee may also nominate up to ten persons to act as Advisers to the Centre. Advisers shall be persons who agree to offer advice on the work of the Centre at the invitation of the Executive Committee

3.9 The Advisory Committee shall meet once a year with the Director acting as convenor. Special Meetings may be held at the request of the Executive Committee.

**4. Amendment to the Constitution**

This constitution may be amended by the University Council (or any committee acting with authority delegated by the Council) on the recommendation of the Department of Law and the Executive Committee of the Centre.

# APPENDIX 2

## OFFICERS OF THE CENTRE

Director :

Andrew Campbell (appointed 1st August 2005)

Deputy Director :

Professor Roger Halson (appointed 1st August 2005)

Executive Committee:

Mrs Judith Dahlgreen

Dr Jane Frecknall-Hughes (Leeds University Business School)

Dr Oliver Gerstenberg

Ms Juliet Jenkins

Professor Andrew Keay

Dr Paul Lewis (Leeds University Business School)

Ms Joan Loughrey

Professor Surya Subedi