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Directors' Decisions and the Law

Promoting success

Alice Belcher

ROUTLEDGE

Directors' Decisions and the Law

Directors are key decision-makers in any organisation, whether it is in the public sector, a family business or a transnational company. The UK Companies Act 2006 codified directors' duties for the first time and describes the director as the "most likely to promote the success of the company for the benefit of its members as a whole".

This book addresses key tensions and problems involved in the duties and responsibilities of the director in promoting success, including corporate culture and credibility, trust, risk and uncertainty, collective responsibility, and the degree of control. The book considers directors' decision-making in both private and public sector organisations and explicitly examines aspects of decision-making during periods of financial distress. The book compares the legal contexts of directors' decisions in the UK to those of the USA, Germany and Australia, and takes an interdisciplinary approach in its combination of management theory, economic theory and behavioural studies. In doing so the book addresses issues key to the understanding of corporate governance in light of recent financial crises.

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Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published 2014
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon, OX14 4RN

and by Routledge
711 Third Avenue, New York, NY 10017

Routledge is an imprint of the Taylor & Francis Group, an informa business

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

Library of Congress Cataloging-in-Publication Data
Belcher, Alice, 1959– author.
Directors' decisions and the law: promoting success/Alice Belcher.
pages cm. – (Routledge research in corporate law)
Includes bibliographical references and index.
1. Directors of corporations – Legal status, laws, etc. – Great Britain.
2. Corporation law – Great Britain. I. Title.
KD2089.B45 2014
346.41′06 – dc23 2013033928

ISBN: 978-0-415-67193-4 (hbk)
ISBN: 978-0-203-71437-9 (ebk)

Typeset in Garamond by
Florence Production Ltd, Stoodleigh, Devon

Contents

Acknowledgements

Parts of this book have been published in alternative forms in the following publications, and gratitude is extended to these publishers for allowing use of this material.

Alice Belcher, "The Boundaries of the Firm: The Theories of Coase, Knight and Weitzman", *Legal Studies* (1997) 17 (1), 22–39. Alice Belcher, "'Something Distinctly not of this Character': How Knightian Uncertainty is Relevant to Corporate Governance", *Legal Studies* (2008) 28 (1), 46–67. Alice Belcher, "Governance Reform Pressures and Processes in the NHS in Scotland", *Northern Ireland Legal Quarterly* (2009) 60 (1). Alice Belcher, "Boundaries, Corporate Decision-making and Responsibility", *Northern Ireland Legal Quarterly* (2007) 58 (2), 211–227. Alice Belcher, "Imagining How a Company Thinks: What is Corporate Culture?", *Deakin Law Review* (2007) 11 (2), 1–21. Alice Belcher, "The Evolution of Business Knowledge in the Context of Unitary and Two-tier Board Structures" with Till Naruisch, *Journal of Business Law* (2005) July, 443–472. Alice Belcher, "Metaphysical Spookiness? The Collective Responsibility Company Directors", *Griffith Law Review* (2012) forthcoming. Alice Belcher, "Trust in the Boardroom", *Griffith Law Review* (2006) 16 (1), 151–170. Alice Belcher, "Audit Quality and the Market for Audits: An Analysis of Recent UK Regulatory Policies", *Bond Law Review* (2006) 18 (1), 1–21. Alice Belcher, "Top-Down Meets Bottom-Up Meets Mutuality: Governance in the NHS in Scotland", *Bulletin of Comparative Labour Relations* (2011) 77, 311–326. Alice Belcher, "Inside the Black Box: Corporate Law and Theories", *Social and Legal Studies* (2003) 12 (3), 359–376.

Table of cases

Table of statutes

UK Statutes

UK Statutory Instruments

Foreign and European legislation

1 Introduction[1]

1.1 Introduction

Directors are key decision-makers. This is true for organisations in the private sector and the public sector, and whether a company is a family business or part of a transnational group. The UK Companies Act 2006 includes directors' duties in a codified form for the first time. The title of this book is taken from one of the newly codified duties:

> **172 Duty to *promote* the *success* of the company**
>
> (1) A director of a company must act in the way he considers, in good faith, would be most likely to *promote* the *success* of the company for the benefit of its members as a whole . . .[2]

It is a book about directors individually and collectively and about their organisations. It is a book rooted in the law, but willing to explore the basic

1 The corporate strategy section of this chapter is based on A. Belcher (2010) "Corporate Risk Management and Legal Strategy", in A. Masson and M. Shariff (eds) *Firm's Legal Strategies*, Springer, pp. 247–266. The Economics section is based on A. Belcher (1997) "The Boundaries of the Firm: The Theories of Coase, Knight and Weitzman", *Legal Studies*, 17 (1), 22–39, with some material from A. Belcher (2003) "Inside the Black Box: Corporate Law and Theories", *Social and Legal Studies*, 12 (3), 359–376.

2 Emphasis added. The section continues:

and in doing so have regard (amongst other matters) to –

(a) the likely consequences of any decision in the long term,
(b) the interests of the company's employees,
(c) the need to foster the company's business relationships with suppliers, customers and others,
(d) the impact of the company's operations on the community and the environment,
(e) the desirability of the company maintaining a reputation for high standards of business conduct, and
(f) the need to act fairly as between members of the company.

issues involved in *being* a director in ways that go well beyond the law.[3] In this opening chapter some of the key tensions and problems addressed in more detail later in the book are exposed for the first time. These include the distinction between human persons and other forms of person, in particular the legal person that is the company; the difficulty for a director posed by the multiple levels of responsibility that could attach to a single decision (individual, collective as a board, collective as the company itself); and the problem of the degree of control – this can be a real and a theoretical issue but comes down to whether company culture, strategy, etc. can be controlled or must be in some sense emergent. In order to introduce these topics in ways that go further than the superficial phrases just given, but without spoiling the reader's pleasure in the later chapters, this introduction is presented as a set of vignettes showing the directors through a series of lenses. The aim is not to complete a picture, rather it is to tempt the reader into the rest of the book. The lenses are linked with and prefigure topics in the book, which is in three parts. Part I – Contexts – explores the settings for directors' decision-making in chapters on the private sector; the public sector; and the organisation in (or close to) financial distress. Part II – Themes – approaches directors' decisions via a set of themes that each prompt innovatory interdisciplinary investigations. However, each theme has a practical basis and came out of the author's experience as a non-executive director of an NHS body in Scotland.[4] For instance, the reason for exploring "trust in the boardroom" was the statement made to board members of public bodies in Scotland that "the effective board member . . . gains the trust and respect of other board members". This felt odd when juxtaposed with case law in which courts have disqualified directors, in effect, for trusting their fellow directors too much. Other themes in Part II are risk and uncertainty, corporate culture, and credibility. Part III – Levels – is structured around levels of decision-making and responsibility. The chapters explore a director's individual responsibility; the rhetoric of collective responsibility (of the board or its subcommittees); and finally governance between organisations. This last topic has a very practical application in the public sector where the use of protocols and memorandums of understanding abound and these often involve pseudo organisations that sit somewhere between organisations as constituted, but it could also apply to the exposure of private sector organisations to risk through joint venture agreements and agreements between companies and nation states. The vignettes included in this introduction are about the directors within

3 The reader will find references to works in the following disciplines: Law, Mathematics, Politics, Philosophy, Economics, Finance, Psychology, Anthropology, Accounting, History, Management, etc.

4 A ministerial appointment. The author was first appointed in 2006 and currently holds an appointment to 2014. She chairs her organisation's audit committee overseeing an annual budget of c. £400m.

Company Law, the directors within Corporate Strategy and the directors within Economics.

1.2 Directors through the lens of the company

The company is such a familiar thing that to view the directors through it seems an odd beginning, especially as this book also aims to study directors operating not only in the private sector but also in the public sector where organisations are mostly not constituted as companies. However, the company that is used for this vignette is Aron Salomon and Company Limited, the company that caused arguably *the* most significant case in all company law: *Salomon v Salomon* heard by the House of Lords in 1895.[5] The persons involved in the drama of *Salomon v Salomon* are: A. Salomon & Co. Ltd, a company incorporated under the Companies Act 1862; the trade creditors of the business, those supplying raw materials on credit with no security; and the debenture-holders, those supplying a large loan to the company secured on its assets. We also meet Mr Salomon himself, wearing various hats; first Mr Salomon, the Victorian entrepreneur and self-made man; second Mr Salomon, the major shareholder of the Company; third Mr Salomon, a debenture-holder of the company; and finally Mr Salomon, the director of the company. One of the reasons for approaching directors' decisions in the context of this case is to emphasise the importance of the formal legal constitution of an organisation. It also serves to point up first the tensions between substance and form; second the differences in possible attitudes to risk taking (from protecting risk takers from themselves to leaving them to face consequences); and third the difference between expecting individuals to obtain and understand information that is theoretically available to them and placing the onus on those with information to provide it.

What company law students remember about the case of *Salomon v Salomon* is that the House of Lords held the *company* to be a legal person separate from its *shareholders*. Mr Salomon, the director and business decision-maker, is not significant in the case; only Mr Salomon, the shareholder, and Mr Salomon, the secured creditor, are significant. It should also be noted that although *Salomon v Salomon* is also a case about corporate insolvency. Mr Salomon successfully managed his business; indeed, he promoted its success, and is praised by the House of Lords for doing so. However, the Mr Salomon who directed his company into insolvency is missing from the case. The principle that a company has an independent legal personality, separate from its shareholders, means that a veil (of incorporation) is drawn around the company, and that the company is capable of independent actions, as a legal person, such as suing, being sued, holding property, and having an insurable interest in property. In coming to its decision the House of Lords reversed the decisions

5 [1897] A.C. 22.

of both Vaughan Williams J. and the Court of Appeal. These basics about the case will be well known to law students and later developments where the veil of incorporation has, and has not, been lifted have been written about extensively. The consequences of this decision have been played out in the context of very small companies where the veil can prevent the court from seeing an individual human being hiding behind the company, and in the context of very large corporate groups where the veil can prevent the court from seeing beyond the particular individual company to reach the assets of other companies within the group. In order to recognise the independent legal person that is the company, the courts have been obliged to also recognise its separation from other legal actors such as shareholders, other companies within a group structure, and the directors. Sometimes this separation has not been tolerated by the courts for instance where the human shareholder is an enemy alien at a time of war. Sometimes the result of the separation produces an apparent injustice – for instance, where industrial disease is the fault of one company in a group, the assets of the group as a whole are plentiful but held by group companies that cannot individually be held at fault, and the assets of the company at fault are small or non-existent. Faced with various scenarios of apparent injustice in the application of the decision in *Salomon v Salomon*, there are now a range of cases where the veil of incorporation has been lifted. These cases form the basis of an extensive academic literature that reveals the subsequent importance of the main principle laid down in 1896. The importance of the decision was not underestimated at the time, as shown by the fact that six judges sat in the House of Lords. While the consequences of the decision have been covered extensively, the background to the case has been less widely written about. The House of Lords judgment should perhaps be seen in its social, policy and legal context by focusing on the Victorian setting that covers a period of over 40 years from the first Limited Liability Act in 1855 to the reporting of the decision in 1897. It also allows a discussion on Victorian attitudes to information gathering, risk-taking and matters of substance rather than form – matters that appear again later in the book.

1.2.1 The facts

The case concerned a company formed in 1892 that by 1893 was in default on its debentures, resulting in an action being brought by Broderip, the main debenture-holder, on behalf of himself and all the other debenture-holders, including the appellant, Salomon. A debenture-holder is a secured creditor usually entitled to demand that the assets securing the loan are sold and the proceeds used to return the amount loaned plus accrued interest. If the assets used as security are vital to the running of the business, an action by debenture-holders will lead to the liquidation of a company. By the time the case reached the House of Lords, Broderip had been paid off, but the company was in liquidation and the main practical consequence of the decision was to allow Salomon as the other debenture-holder to take the remainder of the company's assets by ranking ahead of both the unsecured creditors and the shareholders. Salomon was, up to the incorporation, a sole trader operating on his own account with unlimited liability to his trade creditors. After incorporation the assets of the business were transferred to the company, the existing debts were paid off and a loan was raised using debentures coupled with a floating charge as security. At the time of the default the lender, Broderip, held the debentures and Salomon had a beneficial interest in their residual value. In his capacity as debenture-holder, Salomon would rank ahead of trade creditors and shareholders, including himself. The bargain he made when the company was incorporated was that the business assets that were his personally as a sole trader were transferred to the company in exchange for paid up shares and his interest in the debentures. In his capacity as shareholder Salomon held paid-up shares. There was no further capital available to be called up and his liability was limited if the company was properly constituted as a limited liability company under the Companies Act 1862.

The crucial issue before the House of Lords became the interpretation of the provisions of that Act, which was itself consolidating legislation with the relevant provisions first appearing in the Limited Liability Act 1856 as amendments to the first Limited Liability Act dated 1855. This puts a gap of forty years between the passing of the relevant statutory provisions and the House of Lords' interpretation in *Salomon v Salomon*. Other salient facts are that 20,001 of the company's 20,007 shares were held by Salomon with the other 6 held one each by Salomon's wife, a daughter and four sons, all the terms of sale of the business to the company being known to and approved by the shareholders. Salomon was also appointed director of the company.

1.2.2 Self-help and the "self-made man"

Although *Salomon v Salomon* can be seen as a case that turns on the interpretation of the relevant sections of the Companies Act 1862, the speeches are littered with value judgements that reflect what would now be considered "Victorian values". *Self-Help* was both the title of Samuel Smiles's best-selling book of 1859, which presented many anecdotes of successful "self-made men", and a Victorian value in the shape of a belief that by thrift and hard work any moral person could rise to eminence. It is clear that the influence of this idea remained present in Lord MacNaghten's speech in *Salomon v Salomon*. He said:

> I cannot help thinking that the appellant, Aron Salomon, has been dealt with somewhat hardly in this case.
>
> Mr. Salomon, *who is now suing as a pauper, was a wealthy man in July, 1892*. He was a boot and shoe manufacturer trading on his own sole account under the firm of "A. Salomon & Co.", in High Street, Whitechapel, where he had extensive warehouses and a large establishment . . . *Beginning with little or no capital, he had gradually built up a thriving business, and he was*

> *undoubtedly in good credit and repute . . .* there was a substantial surplus of assets over liabilities. And it seems to me to be pretty clear that if Mr. Salomon had been minded to dispose of his business in the market as a going concern he might fairly have counted upon retiring with at least 10,000l. in his pocket.[6]

1.2.3 Speculation as gambling and individual responsibility to be informed

Self-help was seen as morally virtuous, but gambling was a vice. Investment in joint stock companies could be constructed either as uninformed speculation akin to gambling, or as informed investment and therefore a form of self-help. Earlier in the century first unlimited liability companies and then limited liability companies with large amounts of unpaid capital left shareholders exposed to massive liabilities on liquidation. An example of this in the context of unlimited liability is the 1878 failure of the City of Glasgow Bank, which was followed by the extension of the possibility of limited liability to banks. The early operation of limited liability with its wide use of partly paid-up capital was somewhat better for shareholders than unlimited liability, but still left them with significant exposure if the company failed. Taking all the companies given in *Burdett's Official Intelligence* the proportion of paid-up to issued capital was 60 per cent in 1885 and 67 per cent in 1895. This left shareholders exposed to the amounts represented by 40 per cent and 33 per cent of issued share capital respectively. The shareholders in Aron Salomon and Company Limited were in a much better position than the average speculator as they held fully paid-up shares and were fully informed, not relying on a prospectus but on inside family knowledge of the business. The company was a private one with no shares offered to the general public.

The Victorian attitude to speculative losses and the possibility of introducing legal protections for risk takers, whether they were shareholders, debenture-holders or unsecured creditors, is a repeating story of unwillingness to introduce state protection in place of individual responsibility. There are two strands to the argument against government interference: one is that it would "place private affairs under the management of the State"; the other is that uninformed speculation is close to gambling and to be discouraged. The collapse of the discount house Overend Gurney & Co. (a limited company) in 1866 where the shareholders were kept in ignorance of the true liabilities of the company, caused a financial panic and within three months a further 200 joint stock companies had failed. However, contemporary thought was not of increased state interference, rather *The Times* reported that the public themselves were the true authors of this huge mischief being an ignorant multitude, wilfully blind to the realities of their investments. So, even though

6 [1897] A.C. 22 at 47 (emphasis added). 10,000l. = £10,000.

shareholders were victims of fraudulent companies, they were also seen as the only effective regulators of company behaviour and state regulation would make them less vigilant. A bill of 1888, which would have provided for the standardisation of balance sheets, failed. Objections included an argument that it would establish what the credulous would take to be a sort of government guarantee against fraud and an argument that the state had no responsibility to legislate for the "unintelligent".[7] There was some criticism of the practice of issuing debenture bonds on the security of unpaid capital:

> Directors who trade on uncalled capital say in effect to depositors and debenture holders "If we mismanage this business and lose your money, we have alot of *unsophisticated old ladies* behind us, whom you can sell up to the last chair or table they have got".[8]

Note here that the reference is not to "companies" that trade, but to "directors". Despite this sort of criticism, policy throughout the period from the Limited Liability Acts of 1855 and 1856 to *Salomon v Salomon* tended to treat the uninformed investor (unsophisticated old lady) harshly. In 1894 the Board of Trade appointed a committee under Lord Davey to set out a programme of company law reform. It was not until 1900 that the government succeeded in securing the passage of a new Companies Act, but the Davey Committee reported in 1895 and stressed that they had:

> dismissed from their consideration every suggestion for a public inquiry by the registrar or other official authority into the soundness, good faith, and prospects of the undertaking . . . It would be *an attempt to throw what ought to be the responsibility of the individual on the shoulders of the State*, and would give a fictitious and unreal sense of security to the investor, and might also lead to grave abuses.[9]

Individual responsibility is another theme that will be picked up again in Chapter 10, where it is contrasted not with the responsibility of the state but with collective responsibility more generally. Even by the time of the Davey Report (1895) and the decision in *Salomon v Salomon* (1896) the harsh attitude to the culpably uninformed individual investor can be seen. In *Salomon v Salomon*, Lord Watson's speech includes this passage:

> The unpaid creditors of the company, . . . could have informed themselves of the terms of purchase by the company, of the issue of debentures to

7 James Taylor (2006) *Creating Capitalism: Joint-Stock Enterprise in British Politics and Culture 1800–1870*. Woodbridge: The Boydell Press, p. 219.

8 Written in 1883, cited in Peter Payne (1980) *Early Scottish Limited Companies*. Edinburgh: Scottish Academic Press (emphasis added).

9 Cited in Taylor (2006), op. cit., p. 222.

> the appellant, and of the amount of shares held by each member. In my opinion, the statute casts upon them the duty of making inquiry in regard to these matters. Whatever may be the moral duty of a limited company and its share-holders, when the trade of the company is not thriving, the law does not lay any obligation upon them to warn those members of the public who deal with them on credit that they run the risk of not being paid. One of the learned judges asserts, . . . that creditors never think of examining the register of debentures. But *the apathy of a creditor cannot justify an imputation of fraud against a limited company or its members, who have provided all the means of information which the Act of 1862 requires; and, in my opinion, a creditor who will not take the trouble to use the means which the statute provides for enabling him to protect himself must bear the consequences of his own negligence.*[10]

The information that creditors (and uninformed or unintelligent, shareholders) are expected to obtain and correctly interpret can be contrasted with the information that would be readily available to Salomon, but is not factored into Lord Herschell's condemnation of apathetic creditors or into Lord MacNaghten's presentation of Salomon's transformation from wealthy man to pauper. Asymmetry of information is at the very heart of corporate governance. The fact that directors have access to the company's (or organisation's) inside information gives them the power to deceive or mislead the shareholders. This led in the nineteenth century to developments in company law demanding that the directors draw up accounts for the shareholders and that those accounts should be independently audited. Communications and their credibility are discussed in Chapter 8.

Information readily available to Salomon included information about the general state of the economy and information about the specific state of boot and shoe manufacturing, in particular the level and strength of trade union activism at the time of incorporation. The year 1889 was at a peak in the trade cycle and was recognised as a boom year even in the midst of a period known as "the great depression" (1873–1896). The year 1893 was, in contrast, a year at a trough in the trade cycle. In 1889 there was a shortage of labour and "new unionism" led to a rise in union membership and power.[11] The main union for workers in Salomon's industry was renamed the National Union of Boot and Shoe Operatives. Some of the antagonism between employers and workers came from a tendency for the self-made man to flaunt himself and his position offensively before those who circumstances had placed under him. From the employers' side, in 1891 the view was that the National Union was becoming dangerously strong and the Manufacturers' Federation was formed

10 [1897] A.C. 22 at 40 (emphasis added; see also Lord Herschell at 46).

11 A. Fox (1958) *A History of the National Union of Boot and Shoe Operatives 1874–1957*. Oxford: Basil Blackwell.