

The Codification of directors' Duties Has Done Little to Clarify the Law

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Abstract: In the traditional British judicial system, no unified statute has been enacted to clarify directors' duties until 2006, based on the idea that the codification of directors' duties can better guide the behavior of directors, Companies Act 2006 provided principled legalization of directors' obligations. This essay will argue that the codification is still unable to clarify the controversial issues caused by common case law concerning the judgment and application of directors' obligations in practice.

1. Introduction

According to Article 171, the behavior of shareholders must comply with the articles of association and they should exercise their rights for authorized purposes only. The codified regulations on shareholders' duties especially stipulate that directors' exercise of rights should serve legitimate purposes, otherwise, it constitutes breach of directors' duties [1]. However, even after the codification of directors' duties, it remains undefined and unclear how to judge whether the behavior is conducted for illegitimate purposes. The court admits that regarding share allotment, as long as the company needs to increase extra capital, directors are entitled with unrestricted exercise of the right to allotment under the premise of not violating laws or articles of association. However, in the case of *Howard Smith Ltd v Ampol Petroleum*[1], although directors showed sincerity and didn't violate any rules in share allotment, the court held that the main purpose of directors' exercise of right to allotment was not to increase company capital, but to dilute shares of major shareholders so that another shareholder could gain an edge in acquisition. This means that, despite that the share allotment decision of directors was beneficial to the company and its success, it was invalid due to improper purpose of exercise of the right. In the case of *Punt v Symons & Co Ltd*[2], directors allotted shares to obtain enough votes for passing a resolution, and the judge concluded that they had improper purpose and issued an injunction. In the case of *Piercy v S Mills & Co Ltd*[3], directors allotted shares to shareholders to weaken the voting control of original major shareholders, which was also concluded invalid by the judge for an improper purpose. In the case of *Hogg v Cramphorn*[4], the court had similar conclusion of acting in improper purpose when directors allotted shares to ensure that their supporters could gain control of the company. Notably, cases above have the same premise: directors' behavior of allotment complies with legal requirements and articles of association. For example, according to Article 551[5], directors' allotment should be authorized by the articles of association or resolution. In fact, in practice, the standard for judges to decide whether directors' behavior has improper purposes is value judgment in nature [2]. Principled stipulation of Article 171 fails to clarify the judgment standards, and judges still make conclusions following principles of equity and rules of Common Law.

2. The Code of Directors' Duties Does Not Clarify or Solve the Disputes and Perplexities in Judicial Practice.

Article 172 stipulates those directors are obliged to facilitate the company's success, which originated from directors' obligation to act on behalf of the company in good faith stipulated in common law. For instance, in cases of *Re W v M Roith Ltd*[6] and *Re Smith v Fawcett*[7], directors were deemed to violate their obligations if they were not for the interests of the company, but for

the interests of themselves or the third party. The common law of British tends to equate the interests of the company with those of shareholders. In the case of *Brady v Brady*[8], the judge clearly pointed out that interests of the company were equal to present and future interests of shareholders. However, in addition to shareholders, other parties such as employees, consumers, suppliers, and creditors are also stakeholders in a company. With the Companies Act 2006, interests of the company are no longer a synonym for interests of shareholders; yet unfortunately, the codification of directors' duties hasn't stipulated what to prioritize or how to weigh against various interests when conflicts of interests occur. Regarding how to decide whether the behavior of directors conforms to the interests of the company, Justice Grimm made it clear in the case of *Re Smith v Fawcett*[9] that, it depends on whether directors themselves, not the judge or others, think that their exercise of the right abides by the company's interests. In the case of *Regentcrest plc v Cohen*[10], the judge held that, the real thoughts of directors at that time must be figured out, the director's state of mind is crucial. In other words, the good faith of the directors must be determined subjectively and subjective standards are used to judge whether the behavior of directors complies with the company's interests. The problem is how to determine whether directors are in good faith in the decision-making process. Judge Parker, on the other hand, held that the court should delve into the decision-making process by examining various factors in order to make the judgement. He also proposed that the determination of whether directors conform to the company's interests should be based on the standard of whether a reasonable third-party will make similar decisions, which is a judging method of an objective, reasonable third party. The problem with codified regulations on directors' duties is that it remains the uncertainty on whether to adopt a subjective or objective standard for the judgment of company's interest and good faith. Article 172 also stipulates that serving creditors' interests in the company are also part of directors' duties. In *West Mercia Safetywear Ltd v Dodd*[11] and *Kinsela v Russell Kinsela Pty Ltd*, the court held that, if a company has the possibility of bankruptcy due to insolvency, directors are responsible to serve creditors' interests if they know that the company will go into liquidation. In juridical practice, however, the type and nature of duties of directors to creditors are controversial [3]. Common law fails to answer the question of whether duties of directors to creditors are duties of fidelity or duties of care, the codification of directors' duties did not clarify that either. Regarding the nature of duties, shareholders are deemed to have indirect duties to company creditors, because in normal business operation of a company, directors are only responsible for the company, not for shareholders. When the company goes into liquidation and creditors replace shareholders, directors are only responsible for the company, rather than being directly responsible for creditors. However, in *Peoples Department Stores v Wise*[12], the judge believed that directors were directly responsible for creditors. From my perspective, directors' duties to creditors are not direct but indirect. The reason is that, when directors violate their obligation, it's the parties who liquidate or manage the company, not creditors, that have the right to sue for enforcing the obligation. If directors' duties to creditors are direct, creditors should be entitled to sue without relying on the mentioned two parties. The codification of directors' duties stipulates their duties in a general, descriptive, and principled way, but haven't clarified or resolved the controversies and confusions in this regard in juridical practice and theories.

3. Summary

In summary, the codification of directors' duties does not provide clear guidance for judicial practice, in judicial practice, the uncertainty caused by common law has not been well resolved by codification.

But there is no denying that codification does provide a very valuable reference for the use of law in judicial practice.

References

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