

## **14<sup>th</sup> June 07 Seminar – Directors Duties**

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It seems pertinent to talk about the duties that directors have, as ultimately it is the directors of companies who are the “decision-makers” within companies. This can be either acting individually or acting as members of boards of directors.

Therefore, when a company makes a decision to enter into a particular contract for the provision of security for example, or makes a decision to purchase goods from a particular organisation, it is the company directors who ultimately make those decisions and who are ultimately responsible for them. Such decisions, as we have seen, can have an enormous impact on human rights generally, a huge impact on the environment and very acutely they can have a huge impact on human rights in the arena of armed-conflict.

What is very interesting is the design of the law relating to directors duties. It is interesting that directors duties were designed and have evolved with good intentions. They were designed to encourage business and also to encourage shareholders to invest in companies.

Therefore directors have a key duty to act, “in the best interests of the company.” It is important to note two things. Firstly, this is a legal responsibility, it is not something that a company director can avoid. Secondly it means that the director, in the event of a conflict with another interest group, has the legal responsibility to act in the interests of the company and not in the interests of that other group.

When companies act in what may appear a rather inhuman way on occasions, what they are often doing is complying with the legal responsibility that they have to act in the best interests of a company.

In today’s world, with an ever-increasing awareness of the interests of stakeholders other than companies themselves, why does this principle still hold firm? In fact it is perfectly logical. Many investors in companies are not individuals but institutional investors. This means pension providers, trust funds and so forth. Many people, have personal pension plans or money invested, which ultimately is invested in the stocks and shares of a variety of companies. Investors will only invest in companies that are going to either:

- a) increase in wealth (ie increase in share value); or
- b) provide attractive dividend payments.

Either way, the financial success of a company will encourage people to invest. No-one would be advised to invest in a company which did not have a prospect of economic success. Therefore, for a company to operate

successfully and to attract investors, it needs to have built into it, a mechanism which means that the “decision-makers” within the company are under a responsibility to make decisions which will bring financial success to it.

Therefore the responsibility that companies’ directors have, to act in the “best interests of the company”, is perfectly logical and it can be argued that it is an essential requisite if investment in business is to continue.

Naturally there are variations on the precise duties of directors around the world and the structures under which directors operate within companies. However, this fundamental principal is found globally and you would expect it to be, as it is a logical mechanism that protects the interests of the owners (or shareholders) of a company.

Under English law, the duty of company directors to act in the “best interests of a company” is well established. This principle and legal origin is similar for the law of United States corporations. I recently carried out a case study of the Camisea natural gas extraction development in Peru. The Peruvian General Law of Companies<sup>1</sup> provides details relating to the responsibilities of company directors. For example in Article 180 it states that,

[t]he directors cannot adopt agreements which do not protect the interests of the company, its owners or related parties, nor can they use for their own benefit or for the benefit of third parties the commercial or business opportunities that they have knowledge of through their position. They cannot participate in activities that compete with the company without its express consent. The director that in whatever way has an interest which is contrary to that of the company must declare it and abstain from participating in the deliberation and resolution of the issue concerned. The director that contravenes the provisions of this article is responsible for the damage and losses caused to the company and can be removed by the board or by the general membership at the proposal of either a shareholder or a director.

Clearly the drawback to this legal mechanism is that it forces company directors to make decisions which may well satisfy the legal criteria of being in the “best interests of the company” but which are not in the best interests of other actors or stakeholders within a region where the company is operating.

It is hardly surprising then that this can turn companies into, what can appear to be, avaricious organisations that have no interest except their own wealth creation. In some respects this can be right.

Imagine a situation where a company director has a choice between spending a large amount of money on a particular security system or paying

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<sup>1</sup> Ley General De Sociedades (1997). Ley No 26887. (Nov. 19. 1997).

half that sum of money for another security system which may be more socially conscious. The truth is that he or she is under a legal responsibility to act in the best interest of the company and not in the best interests of other interest groups – as long as he/she is operating within the law.

There are two key points here relating to regulation:

1. As we know, companies are not responsible directly to international law in the conventional sense and therefore they are responsible to the laws of the country in which they operate.
2. Where the company director is faced with the hard law responsibility of acting in the best interests of the company or satisfying a soft law obligation or a voluntary code, the company director is more likely to follow the hard law rather than the soft law option.

In practice, a company director who were to put his own preferences before the interests of the company for which he were working, would have to face his colleagues on the board of directors and explain to them why he or she is making decisions that are reducing the profits of a company rather than maximising them. In the real world the director that makes such decisions could be regarded as brave but also could be regarded as foolish, because he or she could ultimately end up losing his or her job.

In terms of armed conflict there are many decisions that have to be made by directors which would not necessarily mean that they were clearly breaking the law of the country in which they were operating but which could have a negative effect on the welfare of the country as a whole or upon the rights of groups of people living within that region. Examples have already been given.

Therefore, in the absence of hard law or binding international legal obligations, perhaps other approaches to this problem could be considered:

Is it possible that directors should be under a legal obligation to act in the best interests of a variety of actors and not just shareholders of a company? This has been argued by some who state that the privilege of enjoying limited liability should have a corollary, which should be a legal responsibility to act in the interests of a wider group of stake-holders.

Steinhardt states that,

there is an important *quid pro quo* in operation: companies receive from the state the benefit of incorporation, meaning the right to exist and to limit the liability of stockholders to the extent of their investment, and, in exchange for that considerable and profitable right, they can be expected to serve the public interest and not abuse their privileges. From this perspective, the premise that corporations are exclusively private is fundamentally inaccurate: 'corporations really are both private and public simultaneously ...[C]orporations are not purely private individuals. They are institutions that sometimes act as quasi

governments and, even when they do not, they take actions that affect every aspect of people's lives, including people who have no formal contractual relationship with them.<sup>2</sup> From this perspective has grown a communitarian or progressive stream of corporate law scholarship.<sup>3</sup>

A representation of this is seen in the UK Companies Act 2006 section 172 which states that company directors should "take into account" the interests of a variety of other stakeholders. Section 172(1) states as follows:

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, 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 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.

It is uncertain what effect s.172(1) will have, as the reforms are worded in a manner which obviate a clear responsibility for directors to protect other interests. However it provides an interesting development, which reflects the changing expectations within societies at large as to the responsibilities that companies should have towards stakeholders other than shareholders.

What this shows is recognition of the problem. What I would suggest is that aswell as looking at the application of international law to companies, and looking at liability regimes working on an international level, perhaps there should be greater consideration by lawyers to the issue of directors duties which steer the decision-making of companies. Perhaps we should be looking at the root cause of some of the problems. Perhaps we should look to re – design the legal framework under which companies and more specifically directors operate, to ensure that interests other than those of the companies themselves become legally integrated into those decision-making processes.

For example would it be possible to provide greater legal protection to the company director that makes socially or ethically correct decisions. As has

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<sup>2</sup> Alan Wolfe, *The Modern Corporation: Private Agent or Public Actor?*, 50 WASH. & LEE L. REV. 1673, 1692 (1993).

<sup>3</sup> See Steinhardt in *Corporate Responsibility and the International Law of Human Rights: The New Lex Mercatoria*, in NON-STATE ACTORS AND HUMAN RIGHTS (Philip Alston Ed.) (Oxford University Press) (2005).

been stated the likeliness under the current legal framework is that such a director could lose his or her job. We hear in the workplace about sexual discrimination cases frequently but we don't hear about ethical discrimination cases. Is there sufficient legal protection for the company director who acts ethically?

Additionally companies at one time used to be restricted in the work that they could carry out by the doctrine of "ultra-vires". This meant that companies would not legally be able to enter into certain types of contract, unless they had been set up for those purposes. These days, companies can enter into any legal contract and this position protects the unwary creditor. Perhaps greater consideration should be given to the concept of making certain types of decisions which are unethical, outside of the legal scope of companies' objects and thus making them "ultra vires". If adequate sanctions were put in place to constrain companies who acted "ultra vires", it could be possible to design a system that would mean that the existing duty that directors have to act in the "best interests of the company" could be modified from within companies themselves.