

# REFLECTIONS ON THE ENGLISH AND SCOTTISH LAW COMMISSIONS' PROPOSALS FOR DIRECTORIAL DISCLOSURE

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## I INTRODUCTION

An enduring legacy of the corporate abuses of the 1980s is the on-going world-wide corporate governance debate. The subject has generated a plethora of academic commentaries and a burgeoning list of consultation papers, reports and codes.<sup>1</sup> The term 'stakeholders' has become the mantra of the debate and the quest for some ideal model in which those who control the company are rendered properly and effectively accountable to its constituents continues to gather momentum. In Eng-

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<sup>1</sup> See, for example, the Law Commission Consultation Paper No 162, *Shareholder Remedies* (1996) and the ensuing Law Commission Report, No 246 (1997). See also, the *Report of the Committee on the Financial Aspects of Corporate Governance* (1992) (the 'Cadbury Report'); *The Study Group on Directors' Remuneration* (1995) (the 'Greenbury Committee'); *The Committee on Corporate Governance* (1998) (the 'Hampel Committee')—these reports were consolidated and adopted by the Stock exchange, see the *Committee on Corporate Governance, The Combined Code* (1998). For the government's view on the issue see *Modern Company Law for a Competitive Economy* (1998) and *The Strategic Framework* (1999). For the overseas dimension see, for example, the American Law Institute's (ALI) *Principles of Corporate Governance* (1994). It is noteworthy that in May 1999 the OECD Council approved the ALI's *Principles of Corporate Governance* (endorsed at the OECD Council Meeting at ministerial level, Paris, May 27, 1999). Academic commentaries abound but see, for example: Klaus J Hopt and Gunther Teubner (eds), *Corporate Governance and Directors' Liabilities* (1984); John E Parkinson, *Corporate Power and Responsibility—Issues in the Theory of Company Law* (1993); Daniel David Prentice and Peter R J Holland (eds), *Contemporary Issues in Corporate Governance* (1993); S Sheikh and W Rees (eds), *Corporate Governance and Corporate Control* (1995); Geoff S Stapledon, *Institutional Shareholders and Corporate Governance* (1996).

installation of a government with a zeal for reform. Within its first year in office the new government announced that the Department of Trade and Industry (DTI) would be undertaking a root and branch review of company law. This initiative has to be viewed against the mountain of reports which followed closely on the heels of the Cadbury Report, including the Law Commission's work on shareholder remedies. However, the DTI's project appears to mark a discernible shift in approach towards the question of reform—away from patchwork amendment and consolidation, and towards the recognition that for the millennium, company law requires a fundamental rethink if we are to have a regulatory framework which is 'forward-looking ... clear and accessible and which promotes business competitiveness.'<sup>2</sup>

The Law Commissions' examination of Part X of the Companies Act 1985 was already underway at the time of the DTI's announcement in March 1998 of its company law review. As part of this wider project the English and Scottish Law Commissions undertook to place their final report before the DTI's Steering Group of the Company Law Review, the DTI having charged the Commissions with the objective of determining whether or not the relevant statutory provisions could be 'reformed, made more simple or dispensed with altogether.'<sup>3</sup> The exercise was not, therefore, self-contained; its aim was to examine the presentation of the law governing directors' duties rather than its reform. The report was lodged with the Steering Group in July 1999. Although the DTI's review is not likely to be completed until March 2001, the approach nevertheless adopted by the English and Scottish Law Commissions in examining Part X of the 1985 Act provides an insight into the likely mould of future legislative reform of directors' duties.<sup>4</sup> Indeed, it was the declared objective of the Law Commissions to complement the DTI's exercise.<sup>5</sup>

There is a clear and obvious resonance in the approaches of the Law Commissions and the DTI to the question of company law reform. For example, the DTI's Consultation Paper states that its terms of reference for the project should include, *inter alia*, how company law can be

modernised in order to provide a simple, efficient and cost-effective framework for carrying out business activity which:

- (a) permits the maximum amount of freedom and flexibility to those organising and directing the enterprise;

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<sup>2</sup> Speech by Mrs Beckett, then President of the Board of Trade, to PIRC Conference on 4 March 1998, DTI Press Release, 4 March 1998.

<sup>3</sup> See the Law Commissions Consultation Paper (LCCP No 153/SLCDP No 105), [1.7] ('Consultation Paper').

<sup>4</sup> See the Law Commissions' Report, *Company Directors: Regulating Conflicts Of Interests And Formulating A Statement Of Duties*, (Law Com No 261; Scot Law Com No 173), Cm 4436 (1998) ('Report').

<sup>5</sup> See the Consultation Paper, above n 3, Executive Summary, [5].

- (b) at the same time protects, through regulation where necessary, the interests of those involved with the enterprise, including *shareholders*, creditors and employees.<sup>6</sup>

In a similar vein, the hall-mark of the Law Commissions' approach is their regard for the wider economic context in which company law, particularly that regulating corporate directors, operates. It is asserted that in regulating the enterprise, the law should operate efficiently, promoting prosperity.<sup>7</sup> More particularly, Part 3 of the Consultation Paper recommended that the law 'should move towards a general principle of meaningful *disclosure*, and that *approval* rules should be seen as the exception.'<sup>8</sup> This article will focus on the Commissions' recommendations which impact upon the monitoring of self-interested or conflict-transactions (which typically arise where a contract is concluded with the company in which a director has a personal interest) in listed or open companies. Whilst the bulk of our remarks will focus upon what is proposed in relation to s 317,<sup>9</sup> it will be valuable to locate the discussion in the context of the current shape of the common law—the more so given the view expressed by the authors of the empirical survey that the common law requirement of directorial disclosure to shareholders should 'inform reform of Part X.'<sup>10</sup>

This article is primarily concerned with the position in the United Kingdom and the current agenda for reform within the English and Scottish Jurisdictions. Yet, it is to be hoped that our observations will be of more than tangential interest to the Australian legal scholar. This is not simply because of the global convergence of corporate business and the legal problems arising therefrom. It stems more specifically from the fact that Australia and the UK continue to share striking similarities as far as the common law regime of ratification is concerned. This is not to overlook the indisputable fact that there are differences in the legislative provisions regulating directorial disclosure between the jurisdictions. However, it is our contention that many of the sentiments both within and underpinning the Law Commissions' report are relevant to the operation of the Australian legislative provisions.

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<sup>6</sup> *Modern Company Law For a Competitive Economy*, DTI/Pub 3162/6.3/98/NP, [5.2]. The DTI did not change the terms of reference following the consultation exercise, see *Modern Company Law For a Competitive Economy: The Strategic Framework*, DTI/Pub 3955/6k/2/99/NP, URN 99/654, [1.13] (emphasis added).

<sup>7</sup> Report, above n 4, [2.8]. Part 3 of the Consultation Paper, above n 3, contained a report on Economic Considerations by Dr Simon Deakin and Professor Alan Hughes. This Research Report appears in Appendix B of the Law Commissions' Report ('Empirical Research Report').

<sup>8</sup> Consultation Paper, above n 3, [3.72].

<sup>9</sup> There are, of course, a plethora of other proposals both concerning detailed aspects of s 317, such as the appropriate civil remedy for and voidable consequence of breach and the introduction of a register of directors' interests which are beyond the scope of this article. Similarly, we do not deal with the reform agenda for other statutory provisions concerned with conflict-transactions in Part X. By way of summary, the Law Commissions' principal recommendations are: (i) that the common law duties a director owes a company should be set out in statute; (ii) this statutory statement should also appear on the official form of consent which a director signs when she is appointed a director; and (iii) the legislation on directors' conflicts of interests should be modernised and simplified.

<sup>10</sup> Report, above n 4, Appendix B, 224.

Before discussion can begin on the main issues, there is a further preliminary matter of significance to gain a proper appreciation of the Law Commissions' work and its limits. It resides in the question as to the extent to which different types of companies exist, and in particular, the divergent management structures that pertain within such companies, should play a part in the Commissions' recommendations. It is not always entirely clear how far the proposals acknowledge such differences. One of the laudable and novel dimensions to the empirical survey that underpins the Report lies in its recognition that the corporate landscape is far from uniform, and its 'key finding' that there is, in practice, a diversity in corporate governance mechanisms.<sup>11</sup> The survey notes: '[g]iven this degree of diversity, the general approach of the law should be one of encouraging corporate actors to adopt the types of measures which best suit them in practice.'<sup>12</sup>

It is entirely sensible that the law should heed the practicalities of the corporate world. It is therefore unfortunate that ultimately this is one of the matters in which the Law Commissions are content to defer to the DTI whose *Strategic Framework* is seized with the special needs of small, closely held companies because it is felt they are ill served by the Companies Act 1985.

The underlying basis of the disclosure requirements envisaged for directors pivots upon the need of the relevant ratifying organ to have sufficient information to enable it to fulfil its monitoring role effectively. This, however, is made subject to two significant provisos. Firstly, the overriding need to ensure confidentiality. In this respect the Report notes the tension which arises where 'excessive disclosure of information' carries the adverse consequence of destroying the economic value of the information in question.<sup>13</sup> Secondly, it states that due cognisance should be given to the question of excessive costs which can be incurred in disseminating information.<sup>14</sup>

From this perspective, a range of principles are formulated by the Law Commissions against which their anxiety in ensuring that Part X of the Companies Act 1985 provides an economically efficient regulatory framework is to be tested. Part 3 of the Report lists twelve guiding principles which are designed to inform the conceptual framework of the Commissions' recommendations and to provide necessary benchmarks for testing respondents' views to the questions raised in the earlier Consultation Paper. With respect to directorial disclosure of self-interested or conflict transactions, three of the twelve principles (expressed in the form of incantations) appear to be particularly pertinent: 'an "enough but not excessive" principle'; '[A] principle of ample but efficient disclosure'; and '[T]he principle of efficiency and cost effectiveness.'<sup>15</sup>

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<sup>11</sup> *Ibid.*

<sup>12</sup> *Ibid.*

<sup>13</sup> *Ibid* [2.17].

<sup>14</sup> *Ibid.*

<sup>15</sup> *Ibid* [3.4 (8), (9) and (10)] respectively.

These economic tenets underpin the approach of the Commissions in their review of directorial disclosure of conflict transactions. In their quest for striking the optimum balance between economic efficiency and effective directorial accountability, the Law Commissions attempt to inject some coherence into the differing common law and section 317<sup>16</sup> requirements. However, in relation to reforming section 317, the Report seemingly fails to exploit the potential of non-executive directors as monitors of the executive which, judging from the empirical research, would be a feasible and realistic way forward. That the combined effect of the common law requirements and section 317 is to produce a system which is mired in complexity and confusion is beyond dispute. It is therefore unfortunate that the Report stops short of prescribing for large companies a single model of directorial accountability for conflict-transactions which is centred on the monitoring potential of independent non-executive directors.

This article is divided into the following four main parts. Part II briefly considers the nature and scope of the core fiduciary duty of loyalty. The foundational notions of *disclosure* and *approval* of conflict transactions (as discussed in the Report) are inextricably linked to the wider framework of the fiduciary duties in which they operate. The Commissions perpetuate the modern tendency of defining the standard of disclosure by reference to a realistic and more flexible view of the fiduciary obligation.<sup>17</sup> This makes it all the more critical to ensure firstly, that there is adequate protection for the company in the way directors achieve approval for conflict transactions; and secondly, that the economic considerations which lie at the root of the Law Commissions' deliberations are properly located within the broad spectrum of interests which company law should serve. Otherwise, the development of the law stands in danger of disturbing its equilibrium, to say nothing of falling short of preserving a necessary synergy between the rigour of the fiduciary duties of directors (appropriately set for modern companies) and the regime for ratification in the event of directorial breach.

In Part III we will review the current common law and statutory regime governing the ratification of conflict-transactions. It is our contention that the Law Commissions' particular recommendations for reform of the duty of disclosure are too narrowly focused on formalistic considerations based on the drive for efficient disclosure. It will be seen that whilst the duty of disclosure cast upon directors was originally formulated along strict lines, the modern judicial tendency has been to adopt a more equivocal view of the duty—a tendency which the Law Commissions implicitly endorse. Part IV will examine Part 8 of the Law Commissions' Report which is predominantly devoted to section 317 of the 1985 Act. They rightly identify this legislative provision as 'arguably one of the most important provisions in Part X for regulating conflicts of interests.'<sup>18</sup> In respect of this aspect of the reform

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<sup>16</sup> *Companies Act, 1985* (UK). References to 'section 17' throughout the article will be to this 1985 Act unless otherwise specified.

<sup>17</sup> Report, above n 4, [8.30].

<sup>18</sup> *Ibid* [8.1].

proposals, it is contended that scant attention is paid to constructing a regime of corporate decision-making which is both open and transparent. More particularly, whilst the Commissions seem intent upon easing the burden on directors in terms of what and when disclosure is called for, they appear content to leave the board of directors as the repository for and primary arbiter of such information.<sup>19</sup> This leaves out of the equation a full and critical determination of the suitability of the board for the role of ratification. Moreover, it ignores overseas experience that points in the direction of alternative monitoring mechanisms which deploys disinterested, non-executive directors.

To gain an insight into the potential direction the Law Commissions might have taken, Part V argues that the Law Commissions' proposals might have explored the contribution that non-executive directors could make to the statutory regime concerning disclosure and approval of directorial breaches of duty. It is suggested that this would have better served to reinforce directorial accountability, and better regulated conflict-transactions in a manner that would have prevented directorial abuse without inhibiting economic efficiency.

Our primary argument proceeds from the manifest deficiencies of the existing provisions governing ratification in English company law. These shortcomings leave the requirements of the law in a state of uncertainty. As will be shown, there is also scope for companies to avoid the application of a number of key legal requirements. For present purposes two central issues lie at the root of the ratification process as it applies in the corporate legal context. The first is the need for a standard of disclosure which requires directors to declare all material information surrounding a conflict-transaction. This, in part at least, is recognised by the Law Commissions. The second is the need for systematic appraisal and monitoring of such information by an impartial body which, taking account of the economic considerations highlighted in the Report, is nevertheless equipped to act as the guardian of the wider interests of the company and its constituents. This is not explored as fully as might have been expected. Although, that said, the Commissions may well have had in mind the empirical evidence which suggests that in practice many larger companies do require their non-executive directors to perform a monitoring role over conflict-transactions.<sup>20</sup>

## II THE CORE FIDUCIARY DUTY

In line with the objective of modernising company law and its statutory duty to promote codification,<sup>21</sup> the Law Commissions recommend partial codification of the

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<sup>19</sup> Although the court will be the final arbiter of whether a particular interest should have been disclosed, see Report, *ibid.*, [8.23].

<sup>20</sup> The Empirical Research Report, above n 7, acknowledges that although smaller companies do not have non-executive directors, for them the problem of impartial appraisal is less critical given that it is easier in such firms to obtain direct shareholder appraisal: [5.3.3].

<sup>21</sup> *Law Commission Act 1965*, s 3(1).

principal fiduciary duties of directors. The proposed code is drafted in broad language so as to facilitate flexibility and continuing judicial development. It is not intended to be exhaustive. For our purposes, the following extracts from the Draft Code are material:

#### Loyalty

(3) A director must act in good faith in what he considers to be the interests of the company.

#### No secret profits

(5) A director must not use the company's property, information or opportunities for his own or anyone else's benefit unless he is allowed to by the company's constitution or the use has been disclosed to the company in general meeting and the company has consented to it.

#### Conflict of interest

(7) If there is a conflict between an interest or duty of a director and an interest of the company in any transaction, he must account to the company for any benefit he receives from the transaction. This applies whether or not the company sets aside the transaction. But he does not have to account for the benefit if he is allowed to have the interest or duty by the company's constitution or the interest or duty has been disclosed to and approved by the company in general meeting.<sup>22</sup>

The principles encapsulated in this code have been developed by Chancery judges over the last two hundred years or so.<sup>23</sup> Company directors are subject to the full rigour of fiduciary duties on the basis that they occupy a position of trust which, given the nature of mankind, is open to abuse. Accordingly, and as with trustees, they will be held strictly liable for any breach of duty.<sup>24</sup> Lord Justice Millett, considering the scope of the fiduciary duties, has observed:

The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict.<sup>25</sup>

In terms of the core fiduciary duty of loyalty,<sup>26</sup> the policy underlying the regime is premised upon the notion of *prophylaxis*.<sup>27</sup> How strict these fiduciary duties (par-

<sup>22</sup> Report, above n 4, 185.

<sup>23</sup> See, for example, *Keech v Sandford* [1726] Sel Cas Ch 61.

<sup>24</sup> See further, Len S Sealy, 'The Director As Trustee' (1967) *Cambridge Law Journal* 83.

<sup>25</sup> *Bristol & West Building Society v Mothew* [1998] Ch 1, 18.

<sup>26</sup> The duty cast upon directors not to profit from their position is part of the 'wider rule that a trustee must not place himself in a position where his duty and his interest may conflict'—Lord Upjohn in *Phipps v Boardman* [1967] 2 AC 46, 123. The classic formulation of the rule was made by Lord Herschell in *Bray v Ford* [1896] AC 44, 51: 'It is an inflexible rule of a Court of Equity that a person in a

ticularly the no conflict rule) need to be cast is as much a matter of debate as the present state of the law on the question. At one extreme, liability is triggered without inquiry into the circumstances surrounding the breach of duty and irrespective of whether the company itself suffers loss.<sup>28</sup> Further, on this view, in the determination of directorial liability for breach of fiduciary duties, no consideration is given to the fides of the errant director.<sup>29</sup> Whatever the merits and demerits of this uncompromisingly absolutist application of fiduciary standards, it is regarded, at least in the orthodox legal canon, to be the minimum necessary to provide an effective deterrent and ensure the highest degree of loyalty.<sup>30</sup> There is a rival and more moderate construction of the content of the standard which finds favour with the Law Commission. It is well represented in the case law, perhaps most notably in the expression of the no-conflict rule advocated by Lord Upjohn in *Phipps v Boardman*,<sup>31</sup> and in the earlier Court of Appeal decision in *Boulting v Association of Cinematograph, Television and Allied Technicians*.<sup>32</sup> In *Boulting*, Upjohn LJ (as he

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fiduciary position ... is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict.' See also, Lord Russell in *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134, 144-5, who summarised the position thus: 'The rule of equity which insists on those, who by use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of bona fides; or upon such questions or considerations as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited by his action. The liability arises from the mere fact of a profit having, in the stated circumstances, been made. The profiteer, however honest and well-intentioned, cannot escape the risk of being called upon to account.' Similarly, in *New Zealand Netherlands Society Oranje Inc v Kuys* [1973] 1 WLR 1126, 1129 Lord Wilberforce succinctly described the duty as one 'not to profit from a position of trust, or, as it is sometimes relevant to put it, not to allow a conflict to arise between duty and interest.' Applying the rule in the context of directorial wrongdoing, Lord Cranworth LC in *Aberdeen Railway Co v Blaikie* (1854) 1 Macq 461, 471-2 said that 'no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect.' See also, *Bentley v Craven* (1853) 18 Beav 75, 76-7, in which Lord Romilly MR stated that a fiduciary 'will not be allowed to place himself in a situation which, under ordinary circumstances, would tempt a man to do that which is not the best for his principal.'

<sup>27</sup> See Peter Birks, *An Introduction to the Law of Restitution* (1989) 332-3.

<sup>28</sup> See *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134.

<sup>29</sup> See *ibid*, in which it was accepted by the House of Lords that the directors were acting in good faith. In the trust context see, *Phipps v Boardman* [1967] 2 AC 46. See further, Robert Goff and Gareth Jones, *The Law of Restitution* (1998) 715, in which the authors provide the following explanation of equity's prophylactic anxiety: 'A fiduciary's duty of loyalty is "unbending and inveterate"; equity's rule is "inflexible" ... and must be applied inexorably by this court. "The safety of mankind" requires that the court should not be required to determine whether a fiduciary acted honestly or whether the beneficiary did, or did not, suffer any injury because of the fiduciary's dealings, for "no court is equal to the examination and ascertainment" of these facts.' See also, John Lowry, 'Regal (Hastings) Fifty Years On: Breaking The Bonds Of The Ancien Régime' (1994) 45 *Northern Ireland Law Quarterly* 1.

<sup>30</sup> For a critical examination of the extent to which prophylaxis demands such an absolute standard see John Lowry and Rod Edmunds, 'The Corporate Opportunity Doctrine: The Shifting Boundaries of the Duty and its Remedies' (1998) 61 *Modern Law Review* 515.

<sup>31</sup> [1967] 2 AC 46 ('*Phipps*'). The Law Commissions emphasise that Lord Upjohn dissented on the facts, in which case his statement of the law on the scope of the duty can be taken as reflecting the current state of the law.

<sup>32</sup> [1963] 2 QB 606 ('*Boulting*').



then was) said that the rule 'must be applied realistically to a state of affairs which discloses a real conflict of duty and interest and not some theoretical or rhetorical conflict.'<sup>33</sup> In *Phipps*, Lord Upjohn developed his view of the rule further by adding that there must be 'a real sensible possibility of conflict.'<sup>34</sup> Countering authorities such as *Bray v Ford*, which espouse the stricter interpretation, the Report observes:

On the basis of authorities such as these it will be objected to any lessening of the disclosure obligation in section 317 that it runs dangerously counter to the policy in the rule of equity that the rule of equity is a strict one so as to ensure compliance by a fiduciary with this obligation to disclose. However the rule of equity has not always been regarded as inflexible. For instance it has also been said from time to time the conflict must be a real one.<sup>35</sup>

In this way disclosure is to be confined to those occasions when there is a realistic, rather than merely theoretical, conflict between a director's and his or her company's interests. In this passage the Law Commissions' emphasis may rightly lie in correcting any misconception that equity's rule is inflexible. But it is noticeable that in so doing they recognise, as a premise, that there is a need to maintain a strict enough standard of disclosure to ensure that an appropriate level of functioning integrity on the part of directors is preserved. The issue then becomes how strict a rule is required to achieve this end. If, as they suggest, the issue of liability is approached with less than full rigour, it is arguable that preserving an appropriate degree of prophylaxis will become even more difficult if the regime in English company law for ratification of self-interested transactions is marked by too much leniency and indulgence. For example, a director who effectively exerts influence over the board and who controls the general meeting,<sup>36</sup> will be able to avoid liability to disgorge a secret profit with relative ease.

In the company law context the traditional view, which has its origins in equity,<sup>37</sup> is that shareholder ratification permits an errant director to avoid liability for breach of

<sup>33</sup> Ibid 637-8.

<sup>34</sup> *Phipps* [1967] 2 AC 46, 124. As the Law Commissions point out, confining the conflict rule to a real rather than fanciful (albeit not necessarily substantial) risk was also seen as the orthodoxy by Lord Millet in *Prince Jefri Bolkiah v KPMG (a firm)* [1999] 1 All ER 517, 528.

<sup>35</sup> Report, above n 4, [8.28].

<sup>36</sup> For example, through the device of proxy votes.

<sup>37</sup> The notion that a fiduciary may receive absolution for breach of duty has long been recognised by equity. For example, in an action by a beneficiary against a trustee for breach of trust, the trustee may plead by way of defence that the breach in issue was committed with the concurrence or agreement of the beneficiary. The classic statement of the rule was made by Romer LJ in *Fletcher v Collis* [1905] 2 Ch 24, 32, who said: '[a] beneficiary who knowingly consented to the breach could not, if of full contracting age and capacity, and in the absence of special circumstances, afterwards be heard to say that the conduct of the trustee in committing the breach of trust was, as against him the particular beneficiary, improper.' See also, *Nail v Punter* (1832) 5 Sim 555; *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589; *Re Pauling's Settlement Trust* [1964] Ch 303; *Re Bucks Constabulary Widows' and Orphans Fund Friendly Society [No 2]* [1979] 1 WLR 936; *Swan v Perpetual Executors and Trustees Association of Australia Ltd* (1897) 23 VLR 293; *Spellson v George* (1992) 26 NSWLR 666. See further, A J Oakley (ed), *The Modern Law Of Trusts* (1998) 702 *et seq*; J E Martin (ed), *Hanbury & Martin: Modern Equity* (1997) 644 *et seq*; Roderick P Meagher & William M C Gummow, *Jacobs' Law of Trusts in Australia* (1997) 647 *et seq*.

fiduciary duty where it can be shown that the company ratified the conflict-transaction either prospectively or retrospectively.<sup>38</sup> Indeed, in his speech delivered in *Regal (Hastings) Ltd v Gulliver*,<sup>39</sup> Lord Russell recognised that the directors ‘could, had they wished, have protected themselves by a resolution (either antecedent or subsequent) of the Regal shareholders in general meeting.’<sup>40</sup> Since the directors controlled the voting of the company, they could then have voted in their own interests to expunge their breach of duty. This is so because the effect of shareholder ratification is that it

protects the director not because it operates to release him from the consequences of a breach of the self-dealing rule but because, to the extent that the company in general meeting gives its informed consent to the transaction, there is no breach; the conflict of duty and interest is avoided.<sup>41</sup>

Ratification therefore absolves the director from the consequences of his or her breach of duty. This gives all the more cause to be concerned about the outcome in cases involving dominant directors who are able to control the decision to ratify a breach of duty and sanction the retention of any profit. Further, in terms of the disclosure standard as it currently operates, an errant director will not necessarily be required to reveal every detail of his or her interest in a conflict transaction.<sup>42</sup> Nor will ratification have to take the form of an express board decision to ratify a director’s breach.<sup>43</sup>

The effectiveness of the current legal regime governing disclosure and approval of conflict-transactions is therefore ripe for review. The problem is especially critical in the context of listed or open companies (in contrast to owner-managed companies) where shareholders are generally widely dispersed and therefore cannot effectively monitor the activities of the executive. If the core fiduciary duty is to fulfil its ordained role of ensuring that the interests of the company remain the paramount concern of its directors, some mechanism for independent assessment of conflict-transactions should be constructed which operates transparently, requiring full and proper disclosure of all material circumstances surrounding the conflict transaction and which, thereby, achieves effective and efficient directorial accountability.

<sup>38</sup> *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666, 679-89.

<sup>39</sup> [1967] 2 AC 46 (‘*Regal*’).

<sup>40</sup> *Ibid* 150. But where the profiteering directors are fraudulent and in a position to control the voting of the company, a shareholder may bring a derivative action. The one true exception to the principle of majority rule, as encapsulated by the rule in *Foss v Harbottle* (1843) 2 Hare 461, is where a fraud has been perpetrated by those who ‘hold and control the majority of shares in the company and will not permit an action to be brought in the name of the company’ per Lord Davey in *Burland v Earle* [1902] AC 83, 93. See also, *Dominion Cotton Mills v Amyot* [1912] AC 546; *Cook v Deeks* [1916] 1 AC 554; *Foster v Foster* [1916] 1 Ch 532; *Estmanco (Kilner House) Ltd v GLC* [1982] 1 WLR 2; *Atwool v Merryweather* (1867) 5 LR Eq 464. See further, Paul L Davies and Daniel Prentice, *Gower’s Principles of Modern Company Law* (1997) ch 23. See also, A J Boyle and J Birds, *Company Law* (1995) ch 15.

<sup>41</sup> *Movitex Ltd v Bulfield* (1986) 2 BCC 99, 403, 430 (Vinelott J). See also *Canada Safeway Ltd v Thompson* [1951] 3 DLR 295.

<sup>42</sup> *New Zealand Netherlands Society Oranje Inc v Kuys* [1973] 1 WLR 1126.

<sup>43</sup> *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1.

### III CURRENT MECHANISMS FOR DISCLOSURE AND APPROVAL

Two parallel bodies of law govern the ratification process of conflict transactions, namely, common law principles and the statutory provisions contained in Part X of the Companies Act 1985. Statute and common law appear to proceed from the same fundamental and underlying premise that directors who profit personally via a conflict-transaction may avoid liability by disclosing their interests in the transaction to the appropriate organ of the company.<sup>44</sup> That said, there is little consistency between the statutory and common law provisions. The focus of the common law is upon the shareholders as the appropriate ratifying organ although it is not always entirely clear when shareholder approval of directors' conduct is required. Nonetheless, where the general meeting is called upon to ratify a conflict-transaction, this is achieved by the relatively straightforward process of obtaining an ordinary resolution of the shareholders.<sup>45</sup>

Although both common law and statute place emphasis upon the need for disclosure and approval, the procedures provided may be easily manipulated to abrogate the proper protection that disclosure is meant to afford the company. The current provisions in English law prompt a reconsideration of how successful they are in ensuring integrity and effective management within companies. In this respect, the Law Commissions appraisal of the process is to be welcomed. But while the Report is informed by the excellence of its empirical research, it stops short of recommending a normative model which would be seen as injecting proper accountability into the disclosure process.

It was noted above that as a means of informing its deliberations on the issue of reforming the scope of directorial disclosure, Simon Deakin and Alan Hughes reaffirm that disclosure to shareholders, which they indicate as applicable to conflicts of interest at common law, should serve as the general principle.<sup>46</sup> This

<sup>44</sup> But where a director has fraudulently expropriated a company asset, the breach of duty is non-ratifiable and the director may be impeached by a shareholder instituting a derivative action. See, for example, *Cook v Deeks* [1916] 1 AC 554, in which the Privy Council held that where directors misappropriate corporate assets which they are regarded as holding in equity on behalf of the company, they cannot by using their votes cause the company to ratify the breach.

<sup>45</sup> *Benson v Heathorn* (1842) 1 Y C Cha Cas 326; *Aberdeen Rly Co v Blaikie* (1854) 1 Macq 461; *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589, 593-4 (Sir Richard Baggallay). A breach of duty is equally ratifiable by obtaining the informal approval of every member who has a right to vote on such a resolution: *Re Duomatic Ltd* [1969] 2 Ch 365; *New Zealand Netherlands Society Oranje Inc v Kuys* [1973] 1 WLR 1126. The notice convening such a meeting of the company must state in explicit terms the purpose for which it is being called, insofar as it must provide a 'fair, candid and reasonable explanation' of the business proposed: *Kaye v Croydon Tramways Company* [1898] 1 Ch 358, 362 (Kekewich J). In *Tiessen v Henderson* [1899] 1 Ch 861 it was held that the notice calling the extraordinary general meeting in which ratification is to be sought must disclose all facts necessary to enable the shareholder receiving it to determine in his own interest, whether or not he ought to attend the meeting. He concluded that the pecuniary interest of a director in the matter of a special resolution to be proposed at the meeting is a material fact for this purpose.

<sup>46</sup> Report, above n 4, Appendix B and associated text. Deakin and Hughes recognise exceptions to the general principle, most notably in the case of information that is confidential for, which disclosure to the board is acceptable in principle although this might in their view require strengthening the procedure under provisions such as s 317.

prompts a closer consideration of the current state of play in the case law governing the ratification process at common law.

### A *The Common Law Requirements*

The common law proceeds on the basis that ratification of conflict-transactions, including those where a director has exploited a so-called corporate opportunity, lies within the province of the shareholders in general meeting. However, against this general proposition stands part of the reasoning of the Privy Council in *Queensland Mines v Hudson*.<sup>47</sup> There, without resting his decision firmly on the point, Lord Scarman expressed the view that the board's decision that the company was unable to pursue a mining licence operated as fully informed consent to the licence being exploited by Hudson (the company's former managing director) for his own personal profit. Debate has raged about the scope and correctness of this part of the reasoning.<sup>48</sup> In an effort to confine the decision to its own special facts, it has been pointed out that Hudson was the minority shareholder and the other two shareholders were also board members.<sup>49</sup> As to what the general rule should be today, there is undoubtedly much to commend the analysis adopted by the New Zealand High Court in *Equitcorp Industries Group v The Queen*.<sup>50</sup> The Court rejected the view that Lord Scarman was laying down a rule of universal application in *Queensland Mines*. Drawing upon principles which indicate that when attributing acts to a company it is important to take into account the terms and policies of the substantive rule in issue,<sup>51</sup> Smellie J continues:

What then are the "terms and policies" behind the fiduciary duties directors owe the company? It cannot be that directors can unilaterally excuse their own failure to perform. That would frustrate the policy behind the concept of the imposition of fiduciary duties. In order to maintain that policy I consider the shareholders in general meeting alone must be vested with the power to ratify the director's unauthorised actions. It cannot reside in the directors themselves.<sup>52</sup>

This view properly recognises the overriding need for any ratification process to be impartial and that it should be seen to reinforce the integrity and high standards inherent in a director's fiduciary duties. After all, it is settled that a company has the

<sup>47</sup> (1978) 18 ALR 1 ('*Queensland Mines*').

<sup>48</sup> See Davies and Prentice, above n 40, 620 *et seq.* See also, G R Sullivan, 'Going it Alone—*Queensland Mines v Hudson*' (1979) 42 *Modern Law Review* 711, who comments that the decision in *Queensland Mines* 'suggests that many such breaches can now be forestalled or condoned by the simple expedient of obtaining the consent of boardroom colleagues who are often little more than ciphers' (at 715).

<sup>49</sup> See A J Oakley (ed), *Constructive Trusts* (1997) 165, who also observes that the decision is difficult to square with that in *Regal*.

<sup>50</sup> [1998] 2 NZLR 481.

<sup>51</sup> Articulated in *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500.

<sup>52</sup> *Equitable Industries Group v The Queen* [1998] 2 NZLR 481, 487.

right to the unbiased views and advice of its directors.<sup>53</sup> In this context, it follows that a director who anticipates the possibility of personally exploiting a business opportunity about which he or she first came to learn when acting for the company, may not be vigorous in commending the venture to fellow directors. However, whatever the force of such arguments, the current state of the law is less clear cut. *Queensland Mines* is not alone in tolerating a deviation from the norm of shareholder ratification.<sup>54</sup> Further, judicial statements exist which lend support to the view that in a small company informal consent may be as valid as a properly convened shareholder's meeting.<sup>55</sup> Whether or not these lingering uncertainties undermine, at least in theory, the credibility of the machinery for ratifying directorial conduct, they provide interesting contextual material against which to compare the Law Commissions' thinking. This backdrop includes the extent to which the law may, in the context of conflict-transactions, already have a pragmatic approach to the approval mechanisms in the context of the smaller/closely held companies. But, of wider significance, there is perhaps a sense in which relying upon an understanding that disclosure to the shareholders is the normal expectation of the law does not accord with reality; especially when viewed from the perspective of the case law and the Companies Act itself, irrespective of the type of company in issue.

## B Statutory Regime: The Quest for Efficient Disclosure

Where a director is interested in a contract with the company, the common law requirement of disclosure to the general meeting is apparently augmented by section 317(1) of the Companies Act 1985. This provision, which is mandatory in effect, provides that a director who is in any way interested in a proposed or subsisting contract, transaction or arrangement with the company 'must declare the nature of his interest at a meeting of the directors of the company.'<sup>56</sup> Section 317(3) permits a director to give general notice of his or her interest in any contracts with specified persons, but does not require further details. On the face of it there is a dual requirement, disclosure must be to both the shareholders and to the board. It has been held that compliance with section 317 requires disclosure to a duly convened and constituted board meeting, a function which cannot be delegated to a sub-committee of the board.<sup>57</sup>

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<sup>53</sup> See *Imperial Mercantile Credit Association v Coleman* (1873) 6 LR 189, 198 (Hatherley LC); and *Benson v Heathorn* (1838) 1 Y C Cha Cas 326.

<sup>54</sup> There is some support in the reasoning adopted by the Court of Appeal in *Costa Rica Railway Co Ltd v Forwood* [1901] 1 Ch 746. See also *Woolworths Ltd v Kelly* (1991) 22 NSWLR 189.

<sup>55</sup> See, for example, *Hurley v BGH Nominees Pty Ltd* (1984) 2 Australian Company Law Cases 497, 504. See also below, n 72 and associated text.

<sup>56</sup> The duty is also imposed on shadow directors by virtue of s 317(8).

<sup>57</sup> *Guinness plc v Saunders* [1988] BCLC 43 (Browne-Wilkinson J). The issue was not directly addressed in the House of Lords decision. Fox LJ in the Court of Appeal opined that even if all the members of the board had known of a contract this would not validate payments made thereunder, (see [1988] 1 WLR 863, 868).

The Law Commissions regard the section 317 disclosure requirement<sup>58</sup> as ‘consistent with the principle of “efficient disclosure”’.<sup>59</sup> On this view, the narrower statutory requirement is justified on the basis that a ‘declaration of interests in prospective contracts may involve the disclosure of confidential commercial matters which should not be brought into the public domain through shareholder disclosure.’<sup>60</sup> Viewing the provision in terms of economic efficiency, the Commissions consider it to be the manifestation of a ‘penalty default rule’,<sup>61</sup> whereby the parties are required to share risk and information by providing the necessary inducement to alter or shift a rule which would otherwise result in liability. Explaining the policy here, the Consultation Paper stated that ‘efficiency-minded lawmakers’ should choose penalty defaults where the desired result is to induce knowledgeable parties to disclose information by contracting around the provision.<sup>62</sup>

The empirical evidence underlying the Law Commissions’ approach to reforming directorial disclosure demonstrates how accountability operates in practice and serves to show that the shortcomings of the current regime, at least at the theoretical level, do not necessarily assume significance in the day-to-day operation of directorial accountability. Perhaps not surprisingly, given the diverse nature of corporate enterprises, the survey found that corporate governance processes do not fit any particular template. Rather, companies tend to adapt to the prevailing circumstances and conditions under which they operate.<sup>63</sup> Accordingly, the empirical survey concludes that the law should be facilitative insofar as it should operate to encourage effective and workable corporate governance arrangements. It therefore starts from the premise that

the law should require *disclosure* to shareholders of information concerning self-dealing, conflicts of interests and terms of service contracts, subject only to those constraints which could be shown to be necessary on the grounds of protecting confidential information. Such disclosure should be meaningful, that is to say, it should take a form which was cost-effective and useful to the recipients of the information. However, *approval* or *ratification* by the shareholders should be required only in two sets of circumstances: firstly, where there was a particularly high danger of shareholder losses because of a lack of information or transparency concerning directors’ conduct (as in the rules concerning substantial property transactions); and, secondly, where the agreed division of power between shareholders and the board was otherwise in danger of being circumvented (as in the rules requiring shareholder approval for decisions of the board taken in contravention of the articles.<sup>64</sup>

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<sup>58</sup> The emphasis being on disclosure rather than upon approval, see Report, above n 4, [8.2].

<sup>59</sup> Report, above n 4, [8.2]. See also Empirical Research Report, above n 7, and associated text.

<sup>60</sup> Empirical Research Report, above n 7, [9].

<sup>61</sup> See the Report, above n 4, [8.2]; the Consultation Paper, above n 3, [3.34 -3.40].

<sup>62</sup> Consultation Paper, above n 3, [3.34], citing Ian Ayres and Robert Gertner, ‘Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules’ (1989) 99 *Yale Law Journal* 94.

<sup>63</sup> Report, above n 4, Appendix B, [4.3].

<sup>64</sup> *Ibid.*

This so-called general principle no doubt seeks to accommodate the requirements of *disclosure* and *approval* within the prophylactic anxiety of the fiduciary duty proscribing conflict-transactions. But, as has been seen, the approach adopted is not based upon the classic strict view of the fiduciary duties as epitomised by *Bray v Ford*, but on the more open-textured approach of Lord Upjohn to the effect that the law should be so framed that it addresses realistic conflict situations not 'some theoretical or rhetorical conflict.'<sup>65</sup>

To make a proper evaluation of the effectiveness of section 317 as it currently operates, and indeed the Law Commissions' proposals for its reform, it is crucial to appreciate a number of qualifications derived from the statute, cases and the practice of modern corporate entities. First, directors need not disclose interests to a duly convened board which are patently obvious, for example, their interests in their own service contracts, provided such contracts are known to exist by their board colleagues.<sup>66</sup> Second, in *Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald*,<sup>67</sup> it was held that when holding the meeting alone, a sole director had to make the declaration to himself or herself and record the declaration in the minutes. Justice Lightman said:

a sole director cannot evade compliance with s 317 by considering or committing the company to a contract in which he is interested otherwise than at a director's meeting or by delegating the decision-making to others.

In the context of legislation which specifically authorises sole directorships and where Table A provides for a committee of one, the legislature cannot have intended by use of the word 'meeting' in s 317 to exclude from its ambit and the achievement of the statutory object sole directors, and I so hold.<sup>68</sup>

The learned judge went on to add that where the meeting is attended by anyone else, for example the company secretary, the declaration must be made audibly so that it can be duly recorded. This seems to place an admirable premium on ensuring that the proper procedures are observed. There is also a sense in which the provisions are being applied in a common sense way. It is however possible to conclude that in cases of sole directors (and possibly with smaller, closed companies) the current statutory regime is only geared to ensuring the form of ratification rather than its substantive integrity. As far as sole directors are concerned, the Law Commissions build upon this judicial relaxation by proposing that they should be exempt from the operation of the disclosure requirement in section 317 altogether. For this form of business, it is recommended that it is sufficient and more appropriate that either

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<sup>65</sup> *Regal* [1967] 2 AC 46, 124.

<sup>66</sup> *Runciman v Walter Runciman plc* [1992] BCLC 1084, noted by John P Lowry, [1993] *Journal of Business Law* 279, 280-2. See also the remarks of Dillon LJ in *Lee Panavision Ltd v Lee Lighting Ltd* [1992] BCLC 22, 33.

<sup>67</sup> [1995] 1 BCLC 352.

<sup>68</sup> *Ibid* 359-60.

directors should record their interests in the proposed register of directors' interests, or in a written memorandum or in the minutes of the director's meeting.<sup>69</sup>

Thirdly, it must be borne in mind that in practice the statutory provision is generally relaxed by the company's articles. The articles typically bestow prospective consent to directors' self-interested transactions with the company subject only to compliance with the statutory duty of disclosure 'of the nature and extent of any material interests' to the board.<sup>70</sup> Article 85 of Table A appears to have the detrimental potential of promoting the board as the organ to be called upon to give the company's consent to the director's proposed transaction. It allows for the duty to obtain shareholder ratification of transactions between the company and a director to be avoided, retaining only the section 317 requirement of disclosure to the board of directors. Although article 85 underpins section 317 insofar as the requirement for disclosure of 'the nature and extent of any material interest' is preserved, it goes on to relieve the director from his liability to account for any gains made, and provides that 'no such transaction or arrangement shall be avoided on the ground of any such interest or benefit.'<sup>71</sup>

Curiously, subject to any provision in the articles to the contrary, there is no prohibition contained in section 317 against a director voting on a matter in which he or she has an interest.<sup>72</sup> However, article 94 of Table A, if adopted, does prohibit a director of the company from voting at any board meeting, or a committee of the board, on any resolution concerning a matter in which the director, or a person with whom the director is connected, has a material interest. The term 'material interest' is not defined. It has been held that such a director cannot be counted in the quorum for such a resolution.<sup>73</sup> However, the general prohibition contained in article 94 does not extend to cover director/members voting on a resolution at a company's general meeting.<sup>74</sup>

If it is accepted that good corporate governance requires directorial accountability to an organ which is impartial and which exists to protect the wider interests of the

<sup>69</sup> Report, above n 4, [8.88]. Interestingly, the empirical survey notes that it was not possible to gather information directly on whether s 317 served any purpose in companies with a sole director; but legal advisors expressed the opinion that it might operate to protect creditors of such entities: [5.3.6].

<sup>70</sup> See article 85 of Table A, The Companies (Tables A to F) Regs, S I 1985 No 805 as amended by S I 1985 No 1052. See also *Re BSB Holdings Limited* [1996] 1 BCLC 155, 249-50.

<sup>71</sup> It is also common practice to adopt art 86 which provides for disclosure of a continuing interest to the board.

<sup>72</sup> Cf the recommendations in the Hong Kong Consultancy Report (Review of the Hong Kong Companies Ordinance, 1997) [6.20], the effect of which would be that no director could vote on a matter in which he is interested. The Stock Exchange Listing Rules require the articles of association of a listed company to prohibit a director voting on any contract in which he has an interest unless he is voting by virtue of his interests in shares.

<sup>73</sup> *Re Greymouth Point Elizabeth Railway and Coal Company Ltd* [1904] 1 Ch 32; *Re North Eastern Insurance Co Ltd* [1919] 1 Ch 198. See now the exceptions specified in art 94. Note also, art 96 whereby the members may, by ordinary resolution, suspend or relax the prohibition either generally or in respect of any particular issue. It is common for small private companies not to adopt art 94 thereby permitting their directors to vote on resolutions on contracts in which a director has an interest.

<sup>74</sup> See, for eg, *North-West Transportation Co v Beatty* (1887) 12 App Cas 589.



company, then the case for a broadly based review of section 317/article 85 of Table A becomes self-evident. In this respect, the Law Commissions' attempts to identify a rational and coherent guiding principle for the disclosure and approval mechanisms is commendable and timely. One of the starting points is to engage with an aspect of the existing section 317/article 85 regime, by asking what level of information needs to be disclosed. In this, their proposals maintain the current emphasis on materiality.

#### IV RE-DRAWING THE PARAMETERS OF SECTION 317

Of particular interest in considering reform of the disclosure process is the Commissions' empirical evidence which points to the fact that in larger companies, the board of directors is the most important body through which conflicts of interest are monitored. For such companies, it is felt that the section 317 requirements are not prohibitively costly in their operation. In any case, it was found that the internal regimes of larger companies embodied, at the minimum, the requirements of the section. Unlike close companies in which shareholders are able to effectively monitor the activities of board members, shareholders in larger companies are generally a dispersed body with the consequence that it is not feasible to expect them to perform an effective monitoring role. The authors of the survey opine that policy makers should give due cognisance to the fact that rules dealing with intra-board monitoring will in all probability function most effectively within larger companies which, in any case, already have in place effective monitoring systems. For small companies, which generally lack sophisticated internal procedures and which rely more on provisions in the articles of association together with shareholder agreements, the compliance costs are likely to be significant.

The Commissions note that section 317 has two principal aims. Firstly, that the board should be properly informed about any transaction it may be considering or, for which in its supervisory role, it should be made aware. Secondly, to facilitate the monitoring role of the board over conflict-transactions. From this standpoint, it is concluded that the provision is too widely framed for the purposes of efficient disclosure,<sup>75</sup> and the policy underlying the provision is not furthered by requiring disclosure of immaterial interests or where there is no realistic possibility of conflict. However, recognising that a provision which is too narrowly drawn could open the gateway to directorial abuse, the Commissions concede that any limitation on the obligation to disclose would have to be restricted if the deterrent value of disclosure is to be maintained. In the majority of cases it is suggested that directors will generally opt for disclosure as being more cost-effective than taking advice on whether the obligation has been triggered. Given the Law Commissions focus on the disclosure requirement as representing the core obligation underpinning directorial accountability under Part X of the Companies Act, the standard of the duty is accorded considerable emphasis in the Report.

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<sup>75</sup> Report, above n 4, [8.16].

## A Refining the Disclosure Standard

The Commissions recommend that directors should not be under an obligation to disclose immaterial interests under section 317. Fixing on Lord Upjohn's approach to the duty to avoid a conflict of interests, it is proposed that the obligation should not, therefore, apply where:

- (1) the director satisfies the court that the interest did not give rise to a real risk of an actual conflict of interest between his position as the holder of that interest and his position as a director of the company; or
- (2) the director satisfies the court that the rest of the board were aware of the nature and extent of his interest before the directors approved the transaction.<sup>76</sup>

It is further proposed that section 317 should be amended so as to require directors to disclose the 'nature and extent' of his or her interest.<sup>77</sup> The Report suggests that this is necessary if the board's deliberations are to have any value. Additionally, and in line with modern case law together with the views expressed by the majority of respondents to the Consultation Paper, it is recommended that the interests of directors in their own service contracts should be exempted from the section 317 disclosure duty,<sup>78</sup> as should interests of which the director has no knowledge (although the burden of proof in this instance would be on the director).<sup>79</sup>

It is stated that the aims of section 317 are not served by the need to disclose immaterial interests which create no realistic possibility of conflict. However, given the difficulties of reaching a satisfactory definition of what interests should be deemed material,<sup>80</sup> the governing principle is stated as being that disclosure should be made of 'all interests (which include the interests of connected persons<sup>81</sup>) which are material in relation to either the company *or* the director,'<sup>82</sup> and that the obligation should continue to extend to interests in a transaction whether or not it came before the board.<sup>83</sup> Rejecting any test based purely on financial value, it is concluded that the court will have to be the final arbiter in determining whether or not an interest should have been disclosed.

Whether or not the Law Commissions' view of the requisite standard of disclosure is sufficiently rigorous to underpin the integrity of the prohibition against conflict-transactions remains to be seen. It is suggested, however, that the Commissions could have adopted a bolder approach to the issue of delineating the term 'material'

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<sup>76</sup> Ibid [8.33].

<sup>77</sup> Ibid [8.96], thereby incorporating Table A, art 86(A) into the provision.

<sup>78</sup> Ibid [8.44].

<sup>79</sup> Ibid [8.57].

<sup>80</sup> The Commissions rightly conclude that materiality 'cannot be exhaustively defined' (see *ibid* [8.22]).

<sup>81</sup> Ibid [8.62].

<sup>82</sup> Ibid [8.21] (emphasis added).

<sup>83</sup> Ibid [8.38].

for the purposes of disclosure. They state that consideration of this issue cannot be taken in isolation from the remedies which flow from breach of the disclosure duty. Given that the Commissions recommend that a civil remedy should replace the criminal sanction contained in section 317(7), they comment that less weight need be given to the question of defining materiality.<sup>84</sup> Yet, sanctions apart, if an open and effective mechanism for proper corporate governance is to be attained, then it should be founded upon rules which are certain, clearly defined in terms of minimum responsibilities expected of corporate actors and, of course, economically efficient. The Commissions somewhat equivocal stance may only serve to compound the trend discernible in modern case-law which suggests that a more fluid view is being taken towards the disclosure standard. The value and credibility of the disclosure proposals must ultimately depend upon how far they facilitate the proper flow of information in an open and transparent manner. Otherwise, it is difficult to justify why disclosure should be sufficient to relieve the director from the consequences of his or her interest in a conflict-transaction.<sup>85</sup> It is suggested that at the minimum, recipients of the disclosed information should be informed by a knowledge of: (i) the circumstances leading up and surrounding the self-interested transaction; and (ii) the consequences which will flow from the conflict-transaction.

Arguably, the timidity of the Law Commissions in not proposing guidance against which materiality can be gauged may denude the proposed disclosure regime of much of its force. This failure represents a lost opportunity for remedying the unsatisfactory state of the current case law which appears to be developing away from its original strictness towards a more lenient view of the standard of directorial disclosure.

The traditional judicial stance on the duty of disclosure was stated by Moss JA in *Burland v Earle*,<sup>86</sup> who stressed that the duty cast upon directors not to profit secretly from their position is strict unless such profit is made after obtaining the unanimous consent of all the shareholders, which comes after fully explaining all the circumstances and with full knowledge.<sup>87</sup> In *Imperial Mercantile Credit Association (Liquidators) v Coleman*, Lord Cairns opined that it is not enough for a director to merely declare that he has an interest for 'in my opinion, a man declares his interest, not when he states that he has an interest, but when he states what his interest is.'<sup>88</sup> The term 'the nature of his interest' contained in section 317 of the 1985 Act was considered by the Privy Council in *Gray v New Augarita Porcupine*

<sup>84</sup> Ibid [8.19].

<sup>85</sup> See *ibid* [8.113].

<sup>86</sup> [1902] AC 83. See also, *Baillie v Oriental Telephone & Electric Co Ltd* [1915] 1 Ch 503; *Grant v United Kingdom Switchback Railways Co* (1888) 40 Ch D 135; *Imperial Mercantile Credit Association (Liquidators) v Coleman* (1871) 6 Ch App 558; on appeal (1873) 6 LR 189.

<sup>87</sup> See also, *Furs Ltd v Tomkies* (1936) 54 CLR 583, 602, in which Starke J stated that disclosure 'requires [the director] to make a full disclosure of all information which is then or may thereafter during the currency of the agreement be within his knowledge or power.'

<sup>88</sup> *Imperial Mercantile Credit Association (Liquidators) v Coleman* (1873) 6 LRHL 189, 205.

*Mines Ltd*,<sup>89</sup> when construing a similar phrase contained in the Canadian *Companies Act* 1937, section 94. Lord Radcliffe stated that

[t]here is no precise formula that will determine the extent of detail called for when a director declares his interest or the nature of his interest. ... His declaration must make his colleagues 'fully informed of the real state of things' ... If it is material to their judgment that they should know not merely that he has an interest, but what it is and how far it goes, then he must see to it that they are informed.<sup>90</sup>

This early formulation reflected the strict view of equity in adopting a prescriptive approach towards the issue of consent in the trustee/beneficiary context. In this respect a series of principles have evolved against which the apparent consent of beneficiaries to any breach of trust is tested.<sup>91</sup> For example, the need for unanimity of consent if a trustee is to avoid liability completely was recognised by Wilmer LJ in *Re Pauling's Settlement Trusts*.<sup>92</sup> Those beneficiaries who dissent can still bring an action for breach. The point was made by Fry LJ in *Re Massingberd's Settlement*,<sup>93</sup> that passive assent is insufficient: 'Consent is not a mere formality. It is a judgment of a person who is interested.'<sup>94</sup> Further, the consent must be freely given by an adult who is *sui juris*,<sup>95</sup> and it must be fully informed insofar as the beneficiary 'fully understands what he is concurring in'.<sup>96</sup>

Notwithstanding the strident approach adopted in earlier cases, a more benevolent view is emerging towards the issue of directorial disclosure. This tendency is apparent in modern dicta which suggest that some conditional duty of disclosure will suffice. For example in *NZ Netherlands Society Oranje Inc v Kuys*,<sup>97</sup> Lord Wilberforce stated that a fiduciary will not be in breach if he or she can show that the information withheld would not, in any case, have affected the beneficiaries' decision. His Lordship remarked: '[b]ut the appellant was quite unable to point to any matter relevant ... which, had it been disclosed, would have affected the society's decision.'<sup>98</sup> This approach is mirrored by Hutley JA in *Walden Properties Ltd v Beaver Properties Ltd*,<sup>99</sup> who said:

The court of equity has always been a jealous guardian of the rights of the person entitled to the benefit of the performance of fiduciary duties. How-

<sup>89</sup> [1952] 3 DLR 1.

<sup>90</sup> *Ibid* 10 (citations omitted). Lord Radcliffe cited the speech of Lord Chelmsford in *Imperial Mercantile Credit Association (Liquidators) v Coleman*, (1871) 6 LRHL 189, 201.

<sup>91</sup> See Martin, above n 37, 645 *et seq*.

<sup>92</sup> [1964] Ch 303, 335.

<sup>93</sup> (1890) 63 LT 296.

<sup>94</sup> *Ibid* 299.

<sup>95</sup> *Ade v Feuilletau* (1783) 3 Swan 84; *March v Russell* (1837) 3 My & Cr 31. Cf *Overton v Bannister* (1884) 3 Hare 503.

<sup>96</sup> *Re Pauling's Settlement Trusts* [1962] 1 WLR 86, 108 (Wilberforce J), approved by the Court of Appeal in *Holder v Holder* [1968] Ch 353, 394, 399 and 406.

<sup>97</sup> [1973] 1 WLR 1126.

<sup>98</sup> *Ibid* 1135.

<sup>99</sup> [1973] 2 NSWLR 815.

ever, where the fiduciary duty is to provide information, and the information can be shown by the fiduciary to be *incapable of affecting the result*, I consider that the beneficiary cannot take advantage of the breach of duty.<sup>100</sup>

It is suggested that these more recent formulations of the duty can be interpreted as representing an erosion of the disclosure standard. They seemingly depart from the unequivocal language used by Moss JA in *Burland v Earle* in as much as there is a significant shift in emphasis. Taking a literal view of Lord Wilberforce's and Hutley JA's formulation, those charged with disclosing information can themselves decide what is a material fact.<sup>101</sup> Only in the event of a subsequent legal challenge will the materiality of the non-disclosed fact in issue have to be established.

That said, it is noteworthy that the Law Commissions do, however, go some way towards addressing this particular problem. Observing that any limitation on the duty of disclosure needs to be approached with caution,<sup>102</sup> the court is charged with being the final arbiter of what is material. In this respect, the burden of showing that an interest need not be disclosed will be on the director. Yet, no guidelines are framed to guide the court in its determination. The direction of their thinking is to be found in their overarching concern of promoting efficiency. This is largely driven by their desire to ease the burden (not least in terms of cost) that might fall upon the boardroom in its monitoring role. They recognise as another sensitivity, and it is perhaps one with which they become preoccupied, the need for the duty to ensure commercial confidentiality. There are a number of sections in the Consultation Paper and the Report which demonstrate such anxieties. It is, as we indicated above, a pervasive theme.

Whether or not these should be the predominant considerations in crafting the model for disclosure and approval is open to question. There is a more straightforward solution available here, and it is not necessarily unduly burdensome on corporate managers. This would be to resort to a presumption that *all* information surrounding the conflict-transaction should be deemed material.<sup>103</sup> Only thus can it be truly said that the recipients of the declared information received a 'full explanation of all the circumstances.'<sup>104</sup> The advantage of this approach lies in its simplicity and certainty. The director knows where he or she stands. It avoids the situation whereby the court is put in the position of speculating whether or not a non-disclosed fact would have affected the decision of the board. As Chelmsford LC observed in *Smith v Kay*:<sup>105</sup> 'can it be permitted to a party who has practised a deception, with a view to a particular end, which has been attained by it, to speculate

<sup>100</sup> Ibid 846-7 (emphasis added).

<sup>101</sup> Cf the position in the United States which was summarised in *Kahn v Lynch Communication Systems Inc* 669 A2d 79, 88 (Del, 1995) in which the Court stated that materiality is 'determined from the perspective of the reasonable shareholder, not that of the directors ... who undertakes to distribute information.'

<sup>102</sup> Report, above n 4, [8.23].

<sup>103</sup> See Moss JA in *Burland v Earle* [1902] AC 83.

<sup>104</sup> Ibid 561.

<sup>105</sup> (1859) 7 HL Cas 750.

upon what might have been the result if there had been a full communication of the truth?’<sup>106</sup>

Significantly, this erosion of the disclosure standard seen in English company law is not being replicated in all Commonwealth jurisdictions. The Law Commissions, in expressing their anxiety over striking the appropriate the disclosure standard, could have drawn some relief from the approach adopted by the New Zealand Court of Appeal in *Witten-Hannah v Davis*,<sup>107</sup> a case involving a solicitor’s breach of the fiduciary duty of loyalty to his client. The client had not been independently advised in respect of a financial arrangement she had entered into with the solicitor in which she had suffered loss. Richardson J stated that:

In discharging fiduciary responsibilities a solicitor cannot have a personal interest in a transaction unless the client is fully informed of all the facts and of all the implications for the client and then freely consents. In some circumstances and because of the insidious potential for conflict of interest, the discharge of that responsibility can only be established by ensuring that the client is independently advised. Ensuring independent advice is not a separate fiduciary duty but rather a means of discharging the responsibility of ensuring that the client is fully informed and freely consents to her solicitor’s participation in the transaction.<sup>108</sup>

It is evident that in Richardson J’s view, the issue of whether or not the fiduciary in question has done all that is necessary to obtain the genuine consent of the ‘beneficiary’ is synergistic with the discharge of the fiduciary duty in question. Further, the duty does not end with disclosure of material facts without more, but extends to explaining the implications which ratification, if granted, would give rise to.<sup>109</sup> If directorial accountability is to achieve some measure of effectiveness, not only should the standard of disclosure be clearly defined but the organ to which the information is communicated should be impartial. Herein lies the potential of constructing a regime which gives statutory recognition to the monitoring role of non-executive directors while holding the tension with the need for economic efficiency. This model would at least meet the concern expressed in the empirical report that shareholder approval should be limited to cases ‘of exceptional risk to shareholders, such as those relating to substantial property transactions.’<sup>110</sup>

To summarise our argument thus far. If directorial disclosure is to be seen as a legitimate mechanism for deterring conflict-transactions, the injection of impartial-

<sup>106</sup> Ibid 759. In *Re Imperial Mercantile Credit Association* (1869) 8 LR Eq 223, 225-6, James V-C said that ‘I do not think a Court of Equity is in the habit of considering that a falsehood is not to be looked at because if the truth had been told the same thing might have resulted.’

<sup>107</sup> [1995] 2 NZLR 141. See also, *Haira v Burberry Mortgage Finance & Savings Ltd (In Receivership)*; *Koya v Haira* [1995] 3 NZLR 396.

<sup>108</sup> *Witten-Hannah v Davis* [1995] 2 NZLR 141, 149.

<sup>109</sup> In reaching his conclusion, Richardson J was mindful of the statement of Chelmsford LC in *Smith v Kay* (1875) 7 HL Cas 750, and of the observation of James V-C in *Re Imperial Mercantile Credit Association* (1871) 6 LR Ch App 558.

<sup>110</sup> Report, above n 4, Appendix B, 225.

ity into the process must be founded upon strict rules of disclosure of all material information surrounding the conflict transaction. The decision making body to which the disclosure is made must be seen to be both neutral in terms of its disinterest and competent in so far as its deliberations are based upon full knowledge of all material facts. Only thus can a reviewing court, as the final arbiter, be certain that the transaction is fair to the company both at the time it was concluded and at the time of its approval. Looking at the current regime for disclosure and approval in England it is our belief that it is not founded upon either neutrality or full and open disclosure. In this there is much that can be learnt by scrutinising the operation of the duty of 'complete candour' that is to be found in the directorial disclosure regimes found in the USA.<sup>111</sup> Yet the Law Commissions, including their empirical survey, neither endorse this appraisal, nor subscribe to the view that the needs of company law demand such rigorous standards in practice. Such differences of opinion aside, it can be argued that the Law Commissions' proposals will inject some coherence into the disclosure regime, at least to the extent of restricting the scope of the requirement as to what has to be disclosed. This makes it all the more important to reflect upon the Law Commissions' failure to address the value of constructing a neutral and impartial body to which disclosure of what material information surrounding the conflict-transaction they propose should be made.

## V TOWARDS NEUTRALITY AND EFFICIENCY—EXPLOITING THE POTENTIAL OF NON-EXECUTIVE DIRECTORS

Given the findings in the empirical survey demonstrating the expanded involvement of non-executive directors (NEDs) in the intra-board monitoring of large, listed companies,<sup>112</sup> the reluctance of the Law Commissions to investigate how and whether this might be formalised is unfortunate. However, there remains an opportunity for the DTI to consider reform of the current unitary board structure so as to encompass a distinct monitoring function for NEDs. There is much in the current corporate governance debate upon which to draw. Developments in the European Union and domestic reviews such as Cadbury and Hampel have set the agenda. It is not easy to discern the extent to which this agenda is recognised in the Law Commissions' recommendations.

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<sup>111</sup> See, for example, *Lynch v Vickers Energy Corp* 383 A2d 278 (Del, 1977) in which the Delaware Supreme Court held (at 281) that its function in determining whether the duty had been discharged was limited to determining whether the directors had disclosed 'all information in their possession germane to the transaction in issue.' The court defined 'germane' as 'information such as a reasonable shareholder would consider important in deciding whether to sell or retain stock.' The Court took the view that the duty required disclosure of precise information not mere generalities. See further, L A Hamermesh, 'Calling Off The Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty' (1996) 49 *Vanderbilt Law Review* 1087; and John Lowry and Rod Edmunds, 'Promoting Impartiality and Candour in the Ratification Process: Transatlantic Reflections on the Role of the Disinterested Director' [1999] *International and Comparative Corporate Law Journal*, (forthcoming, copy with authors).

<sup>112</sup> It was also seen as an area ripe for further empirical work.

## A *The Fifth Directive, Cadbury and Beyond*

From the European perspective, the draft Fifth Directive contains a range of proposals for reforming the board of directors.<sup>113</sup> For present purposes two of its proposals are particularly apposite in outlining the structure for a supervisory board. The first provides for a two tier board of directors—a supervisory board, the members of which are appointed by the shareholders, and a management board, on which sit the executive directors who are appointed, depending on the constitution of the company, either by the supervisory directors or by the shareholders. The ‘supervisory’ directors are to receive financial reports on a quarterly basis and are to have open access to information; they are also given wide investigatory powers. The second proposed model provides for a single board consisting of executive directors but with a majority of ‘supervisory’ directors who are appointed by the shareholders. In this case, a board meeting must be held at least quarterly at which any director can insist that a particular issue be placed on the agenda for discussion.<sup>114</sup>

In England, the growing recognition of the potential of non-executive directors to fulfil a monitoring function by virtue of their perceived independence has gained endorsement from a number of sources. In 1987 a group calling itself the Promotion of Non-Executive Directors (PRO NED)<sup>115</sup> published a voluntary code of practice applicable to companies with a turnover of at least £50 million or which employed 1000 or more people, whereby such companies should appoint at least three independent non-executive directors, who should make-up about one-third of the board.<sup>116</sup> This followed the guidelines issued in 1982 by the Institute of Directors.<sup>117</sup> More significantly, the Cadbury Committee’s report added impetus to the debate despite its limited remit which focused exclusively upon financial reporting and accountability.<sup>118</sup> In terms of the importance of the monitoring model the tenor of the report is convincing. It is expressly premised on the notion that effective corpo-

<sup>113</sup> Official Journal of European Communities, 1972 No C 131/49. See the 1988 Draft: appended to the DTI’s Consultative Document, *Amended Proposal for a Fifth Directive on the Harmonisation of Company Law in the European Community*, January 1990. The original draft provided for a mandatory two-tier structure for public companies mirroring the German model. See Van Ham Peter Westermann, ‘Tendenzen der gegenwertigen Mitbestimmungsdiskussion in der Europaischen Gemeinschaft’ (1984) *Rabels Zeitschrift* 123. The latest version provides for a choice between a two-tier or unitary board. The Preamble to the current draft Directive states that the ‘general introduction of the two-tier system on a compulsory basis is for the time being impracticable though such systems should be made generally available at least as an option for public limited companies.’ The Directive continues to languish, and the prognosis for it ever seeing the light of day is poor.

<sup>114</sup> See further, A J Boyle, ‘Draft Fifth Directive: Implications for Directors’ Duties, Board Structure and Employee Participation’ (1991) 13 *Company Lawyer* 6; Mads Andenas, ‘The Future of EC Company Law Harmonisation’ (1994) 15 *Company Lawyer* 121.

<sup>115</sup> The initial sponsors were the Bank of England, the London Stock Exchange, the British Merchant Banking & Securities Houses Association, the British Institute of Management, the CBI, The ISC, 3 i plc, and ECI Ventures Ltd.

<sup>116</sup> See PRO NED *Code of Practice on Non-Executive Directors* (copy on file with authors).

<sup>117</sup> Institute of Directors, *A Code of Practice for the Non-Executive Director*.

<sup>118</sup> See also, Vanessa Finch, ‘Corporate Governance and Cadbury’ [1994] *Journal of Business Law* 51; Andrew Griffiths, ‘Directors’ Remuneration: Constraining the Power of the Board’ [1995] *Lloyd’s Maritime and Commercial Law Quarterly* 372.



rate governance is to be achieved through striking a balance between allowing directors freedom of action to further the commercial interests of their companies on the one hand, while instituting a framework of effective accountability on the other. To this end, Cadbury promulgated a Code of Best Practice which is supplemented by a series of recommendations on 'good practice'.

It would perhaps be naive to conclude that Cadbury represents a radical response to the need for accountability. By and large it accords with the current ethos of self regulation;<sup>119</sup> and it must be acknowledged that this resonates with the spirit, if not the letter, within the Law Commissions' Report. Seemingly building on the 'supervisory' ethos of the Draft Fifth Directive, the Committee's Code of Best Practice stresses the need to empower independent non-executive directors to perform a 'control function'.<sup>120</sup> Particular emphasis is given to the role of outside or non-executive directors in terms of them exercising a supervisory or monitoring function given that such directors can 'bring to the board's deliberations ... independence of judgment'.<sup>121</sup> It is on this basis therefore, that Cadbury recommended that non-executive directors should be totally independent of the company, which means that 'they should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment'.<sup>122</sup> Within the limited terms of reference of Cadbury, it proposed a committee system, operating in the key functional areas of the corporate structure, as a means of reinforcing the strength and influence of independent non-executive directors.

In keeping with Cadbury, its successor committee, under the chairmanship of Sir Ronald Hampel,<sup>123</sup> laid emphasis on the role of non-executive directors. However, addressing the criticism that the appointment of non-executive directors often smacked of cronyism, insofar that many companies appointed non-executive directors from among the ranks of those who had previously held executive posts with them, Hampel went further by stressing the need for non-executive directors to be truly independent. Hampel's view was that the board of directors should include a balance of executive and non-executive directors (including independent non-

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<sup>119</sup> Although it should be noted that the Committee recommended that a listed company should make a statement in its annual report and accounts describing the extent to which it was complying with the Code and that such statement should identify, with reasons, any areas of non-compliance (see Cadbury Report, above n 1, [3.7]). It further recommended that the statement of compliance should be reviewed by the company's auditors before publication [3.9]. The statement of compliance as recommended by Cadbury has now been made a continuing obligation of listing by the Stock Exchange (see The Listing Rules, 12.43(j)). Although compliance with the Code is encouraged by the London Stock Exchange, which requires in its listing rules that companies disclose the extent to which they are adhering to its terms, compliance is not a pre-condition of listing.

<sup>120</sup> Cadbury Report, above n 1, [4.11].

<sup>121</sup> *Ibid* [4.12].

<sup>122</sup> *Ibid*.

<sup>123</sup> See Hampel Committee, above n 1, 66. The Committee also reviewed the work of the Greenbury Committee, above n 1, which drafted a Code of Best Practice for public companies in determining directors' remuneration.

executives) so that no one individual or small group of individuals can dominate the board's decision-making.

In informing the quest for the most effective way to deploy the non-executive in the disclosure and approval of directorial conflict transactions this wealth of material from within Europe does not stand alone. The DTI might also review transatlantic trends and developments.<sup>124</sup> The potential of independent directors to perform a strict monitoring or policing role identified by the Cadbury and Hampel Committees has in fact long been recognised in the United States.<sup>125</sup> Developments in the United States have been positive in striking the optimum balance between voluntary adherence to standards of good practice with mandatory provisions. The American Law Institute's *Principles of Corporate Governance*<sup>126</sup> advances the monitoring model of governance in which the independent director forms the 'linchpin of the regulatory and procedural provisions'.<sup>127</sup> Many states have enacted elaborate provisions governing the appointment of independent directors to corporate boards.<sup>128</sup> It has been commented that

[t]he immediate goals of the provisions are to stimulate a more inquiring boardroom atmosphere and to forestall transactions that appear to be tainted by managerial self-interest—transactions that are likely to lead to lawsuits. In other words, the [statutory provisions are] structured to permit and encourage the independent director to be an effective monitor of management, particularly in the area of managerial integrity.<sup>129</sup>

<sup>124</sup> To say nothing of those taking place in the Antipodes. See, in particular, *Daniels v Anderson* (1995) 16 ACSR 607, in which the court stated that non-executive directors should be so placed as to guide and monitor the management of the company and should meet as often as is considered appropriate to achieve this. The Court also observed that non-executive directors are under a continuing duty to keep themselves informed of the company's activities and should not passively rely on unverified information handed down by executive directors. See also, *AWA v Daniels* (1992) 10 Australian Company Law Cases 933. See further, Elizabeth J Boros, *Minority Shareholders' Remedies* (1995).

<sup>125</sup> By way of example, see Barry D Baysinger and Henry N Butler, 'Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director' (1984) 52 *George Washington Law Review* 557, in which it is argued that the primary function of non-executive directors is to police management and 'ensure that its behaviour conforms to shareholders' interests' (at 569); George W Dent, 'The Revolution in Corporate Governance, The Monitoring Board, and the Director's Duty of Care' (1981) 61 *Boston University Law Review* 623 who comments that: '[t]he theory of corporate governance underwent a revolution in the 1970's. Theorists finally abandoned the myth that a public corporation is managed by its board of directors, and constructed a new model under which the corporation is managed by its executive officers, and the board, dominated by outside directors, monitors management's performance. ... Even those commentators who do not enthusiastically embrace the entire monitoring model tend to agree that monitoring management is a significant board function.' (at 623) (citations omitted).

<sup>126</sup> Report of the ALI's Corporate Governance Project (1994). The model applies to publicly held corporations with a minimum of 500 shareholders and assets of \$5 million. See, C A Riley, 'The American Law Institute's Principles of Corporate Governance' (1995) 16 *Company Lawyer* 122.

<sup>127</sup> James D Cox, 'The ALI, Institutionalization and Disclosure; The Quest for the Outside Director's Spine' (1993) 61 *George Washington Law Review* 1233.

<sup>128</sup> See, for example, the 1989 *Michigan Public Acts* 121.

<sup>129</sup> See, Cyril Moscow, Margo Rogers Lesser and Stephen H Schulman, 'Michigan's Independent Director' (1990) 46 *The Business Lawyer* 57, 59.

The weight of these initiatives is impressive. But it should not be thought that enhancing non-executive directors' participation in the monitoring of conflict transactions is in itself a perfect solution. Such directors may, albeit subconsciously, be trapped in a cult of collegiality, meaning that they will identify so closely with their fellow executive directors that it impairs their ability to represent the wider interest of the company properly.<sup>130</sup> This is clearly evident in the failure of remuneration committees, comprised of non-executive directors, to curb the board room excesses of the 1980s and the more recent controversies surrounding the privatised utilities.<sup>131</sup> Nevertheless, the recognition by the Hampel Committee of the necessity for truly independent non-executive directors to combat the charge of cronyism at least demonstrates that the problem has now been credibly identified and that steps towards injecting impartiality into boardroom decision-making can now be taken. Added to which in the empirical work underpinning the Law Commissions' Report there is now tangible evidence attesting to the rise in the reliance upon non-executive directors as an integral part of the corporate governance mechanism in practice.

## VI CONCLUSION

In summing up the value of the present proposals for reform, it must be emphasised that there is much to applaud. The Law Commissions have made a valiant attempt at striking a balance between meaningful disclosure and economic efficiency in which approval rules are seen as the exception. There may be scope to take issue with the how and why they come down in favour of little if any real substantive reform of the current statutory disclosure regime. This has been the burden of much of this article. That does not mean that their methodology has little to commend it. The resort to an empirical survey and the recourse to economic considerations are two novel and welcome developments. This goes some way to creating a legal environment that serves the realities of the corporate world. It is to be hoped that this research will continue to inform the Law Commissions' projects on company law reform. In some sense it is hard to banish the thought that ultimately the proposals did not rely sufficiently upon the empirical work. Reading the final Report also leaves the distinct impression that the constituency that will be most satisfied by what is recommended are the directors and managers themselves. Proposals for the shape of Part X frequently refer to minimising the burdens of disclosure and the need to protect the commercial confidentiality or sensitivity of information. At one level this is perhaps unsurprising. Many respondents to the Consultation Paper, as with participants in the empirical survey, were directors (or their legal advisors) who will have favoured these interests and considerations. This may not matter.

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<sup>130</sup> See further, William T Allen, 'Independent Directors in MBO Transactions: Are They Fact or Fantasy?' (1990) 45 *The Business Lawyer* 2055, 2056.

<sup>131</sup> See the Greenbury Committee, above n 1. In recent times the media has had a field day in reporting the salary levels of company directors. See, for example, 'British Gas Chief Receives 75% Pay Rise' *Financial Times* (London, England) 21 November 1994, 2.

After all, they might argue that their interests may often coincide with the company. But if this perception has any validity then it is all the more crucial to determine whether or not the model offered will promote the well-being of the company as a whole.

The Report is also notable for its views about what has to be disclosed under section 317. It starts from the standpoint that only *real* conflicts are in issue. This lends support to the view that in formulating this aspect of the director's fiduciary duty of loyalty the robust and trenchant judicial insistence that the rule is inflexible and might extend to theoretical conflicts is no longer credible. Building from that basis, the Law Commissions prefer to confine the disclosure requirement by reference to its notion of materiality. Rejecting the view that materiality should be objectively assessed, it leaves it to the court to be the ultimate arbiter of the issue without laying down any guiding principles as to the minimum level of disclosure required. It also seeks to leave the initial onus on the director to determine what and when to disclose. Again, this may be regarded as an overtly director-orientated approach, and one which is seen as economically efficient. If implemented, it remains to be seen how far, if at all, this will maintain the integrity of the fiduciary duty incumbent upon the director who wishes to engage in a conflict transaction. In this respect, it is difficult to see the recommendation for a register of directors' interests as providing an effective and substantial mechanism for limiting the potential for abuse. Like registers that exist in other contexts, such as Parliament, it may be that the value is, as suggested by the Law Commissions, more in creating a discipline of declaration and promoting a general culture of transparency. It is more difficult to envisage how this will be anything more than peripheral to the operation disclosure to the board within the specific framework of section 317. Moreover, the reasoning behind this proposal is not extensively explored in the final Report. Nor is there much more by way of explanation on the justification for the preservation of the rule that directors' may vote in their own interests.<sup>132</sup>

It must not be forgotten, however, that in its terms of reference the Law Commissions were not charged with formulating sweeping reforms. They were in a sense asked to contribute one important piece in a larger jigsaw of company law reform that is being crafted by the DTI. Perhaps it is inevitable therefore if an air of deference and hesitancy surround some of the proposals in this Report. This may be detected in their failure to embrace all aspects of the findings in the empirical survey. Of significance in this context is the empirical work that helpfully identifies the contribution NEDs are currently being made to intra-board monitoring. This does not feed through to the reform proposals as fully or directly as it might. In consequence the Law Commissions have not harnessed the growing awareness here and abroad that NEDs may form the centrepiece in constructing a truly impartial regime for disclosure and approval. Whilst it is not a perfect mechanism, it does have

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<sup>132</sup> Although it is acknowledged that the listing rules do provide some prohibition, our anxiety lies with whether or not the general law (as is the case in Australia) should disenfranchise a self-interested director. See Report, above n 4, [8.89].

advantages that seem consistent with principles that guide the Law Commissions' thinking. In short, the statistical data suggests that in practice the NED is favoured by larger companies. They have greater potential to inject a requisite degree of transparent accountability than the unitary board of directors. It may also be that having recourse to NEDs is no less economically efficient than maintaining the current regime contained in section 317 with the minor adjustments recommended by the Law Commissions.

