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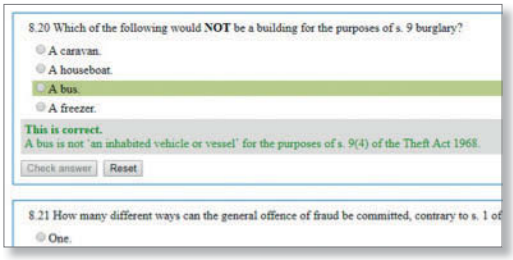

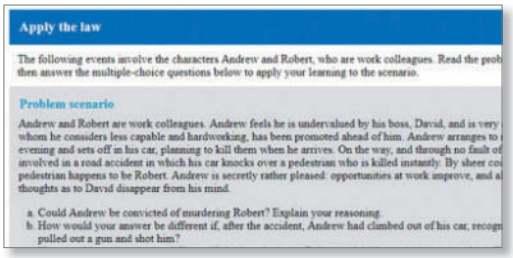

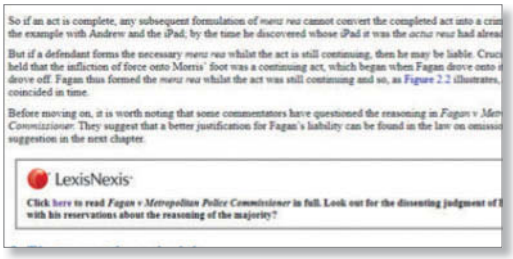

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The governance problem and the mechanisms of meetings

7.1 Alignment of managerial and shareholder interests

As has been seen,[1] corporate governance is about alignment; that is, it is about the system of legal or other mechanisms which ensure that the interests of the managers of the company are aligned with those of the shareholders.[2] The study of corporate governance is therefore concerned with the analysis of the environment in which the directors/managers operate, with a view to considering the totality of the system which is in place to ensure that managers do not pursue their own interests with the company's money, rather than those of the shareholders.

It will be recalled[3] that corporate governance systems contain mechanisms that are internal to the company and mechanisms that are external to the company. The former are the mechanisms which are put into the hands of shareholders, which give them some level of ability to control or influence the board of directors. The external mechanisms exist in the regulatory environment in which the company operates and will include the existence of state agencies for the detection of fraud or the existence of insolvency procedures as well as the market mechanisms such as the disciplining effect of the possibility of a hostile takeover. In the following chapters, the emphasis will be on consideration of the internal mechanisms of corporate governance[4] for these form an important part of basic company law and it is interesting to consider those fundamental elements of the law in the context of their efficacy as governance mechanisms.[5]

The effectiveness of the system will depend very much on what type of company is under observation. In the small closely-held company, the shareholders will also be the directors and so the problem of alignment is often not present, although if there are shareholders who are not also directors, they may well find that they do have to worry about how they can influence what the directors are doing. If, on the other hand, the 'dispersed-ownership company' is considered, the problem of who controls the managers, and how

[1] The theoretical aspects of corporate governance are discussed in more detail in Chapter 3, 3.4 above.
[2] The discussion of corporate governance will proceed here on the orthodox basis that the only stakeholders are the shareholders; the issues relating to widening this constituency have already been considered under the heading 'Stakeholder company law' in Chapter 3, 3.5 above.
[3] See Chapter 3, 3.4B above.
[4] For a discussion on the external mechanisms, see Chapter 3 above and for the explanation of the hostile takeover mechanism see further Chapter 21 below and see generally Chapter 13, 13.2C below (effect of going public).
[5] For an analytical perspective on our system see Lady Justice Arden DBE 'UK Corporate Governance after Enron' (2003) 3 JCLS 269.

will they do it, becomes acute. The shareholders of such companies will have relatively small stakes in it, and therefore little economic incentive to monitor the management or to interfere in what they are doing. Thus the mechanisms of corporate governance will have differing degrees of utility depending on what type of company is under consideration and this needs to be borne in mind in the account which follows.

The approach to the subject in this chapter will be to give an account of the workings of the meeting mechanisms, both in respect of the board of directors and the shareholders in general meetings. In Chapter 8 the general duties which the law imposes on directors will be considered, whilst Chapter 9 examines a range of other, more specific, constraints on the legal and practical position of directors. The input made by the self-regulatory mechanisms developed during the 1990s will be considered in Chapter 10. Chapters 11 and 12 will deal with the ways in which shareholders can bring litigation in respect of failures of corporate governance.

7.2 The role and functioning of the board of directors

A Directors as managers and '*alter ego*'

The legislation requires a public company to have at least two directors and a private company to have at least one director.[6] However, the articles of association may require a minimum number greater than these and/or fix a maximum. By s. 250 of the Companies Act 2006 the term 'director' is expressed to include 'any person occupying the position of director, by whatever name called' so if the directors are known by some other title, such as 'the committee of management' they will still be regarded as directors by the legislation. As a result, this will necessitate their compliance with the many statutory[7] obligations which are cast upon directors and thus it is not possible to avoid the obligations of the companies legislation by simply calling the directors something different.[8]

The normal position in a company registered under the Companies Act 1985 is that it will have adopted art. 70 of the 1985 Table A, or for companies registered under the Companies Act 2006, art. 3 of the model articles for private or public companies as the case may be.[9] Both sets of articles ensure that, *prima facie*, the directors are the managers of the business of the company.[10] In practice, it is common in larger companies for managerial power to be devolved to groups or individuals below board level, leaving the board to meet once a month or quarterly.[11]

Because of their managerial role, the directors are sometimes said to be the '*alter ego*' of a company; the word '*alter*' meaning here 'the other' (of two). There are various

[6] Companies Act 2006, s. 154.

[7] And in appropriate circumstances, with the obligations created by case law. See e.g. Chapter 8.

[8] On the question of whether or not an individual's conduct is such as to render him or her a de facto director notwithstanding the lack of formal appointment to the board, see *Revenue and Customs Commissioners* v *Holland* [2010] UKSC 5. See further, A. Lowry 'De Facto Directorships: Multiple Tests Prevail' (2011) 8 ICR 194. See also, *Re Mumtaz Properties Ltd* [2011] EWCA Civ 610.

[9] The Companies (Model Articles) Regulations 2008 (SI. 2008 No. 3229), which came into force on 1 October 2009.

[10] These articles are discussed in Chapter 5 above. See further, S. Watson 'The Significance of the Source of the Powers of Boards of Directors in UK Company Law' [2011] JBL 597.

[11] See art. 5 of the Companies (Model Articles) Regulations 2008.

manifestations of this in the case law. One is where the courts are looking for the state of mind of the company. As we have seen,[12] the courts have tended to regard the state of mind of the directors or managing director as the state of mind of the company. Similarly, there are situations where the directors are actually regarded as the company for some purposes. This was illustrated in *Stanfield* v *National Westminster Bank*,[13] where it was held that the proper person to answer interrogatories served on a company was the director or other similar officer:

> Interrogatories administered to a company have of course the special feature that as the company is an artificial person they must be answered not by the litigant, but by some human being who holds a position in relation to the company which enables him to give the answers, such as a director or [here] a liquidator.[14]

The doctrine is not applied rigidly and the courts will not invariably regard the director as a second defendant or second target in every situation.[15]

B Appointment and retirement of directors

The appointment and retirement of directors is left, primarily, to the articles, although, as will be seen, the legislation does contain a few provisions that are of relevance and which will override the articles in some circumstances. Companies registered under the Companies Act 2006 typically adopt the model articles, which contain provisions in articles 17–18 for private companies and articles 20–22 for public companies.[16] The broad principle is that directors may be appointed by ordinary resolution of the shareholders or a decision of the directors.[17] Provision is also made for public companies for the appointment of an *alternate* director who is, in essence, someone who stands in for a director who is temporarily absent; but he is not an agent and is not treated as a director for all purposes.[18] Provision is made for the retirement of directors of public companies by rotation. Article 21 of the model articles for public companies similarly provides that all directors must retire from office at the first annual general meeting (AGM). Article 21 (2) goes on to provide that at every subsequent AGM any directors (a) who have been appointed by the directors since the last AGM, or (b) who were not appointed or reappointed at one of the preceding two AGMs, must retire from office and may offer themselves for reappointment by the members.

[12] See Chapter 2, 2.1C, above. See also, *Moore Stephens* v *Stone & Rolls Ltd* [2009] 2 BCLC 563, discussed in Chapter 8.
[13] [1983] 1 WLR 568.
[14] *Ibid.* at p. 570, *per* Megarry J.
[15] *Attorney General of Tuvalu* v *Philatelic Ltd* [1990] BCC 30. The matter has been discussed in Chapter 2 above in relation to the director's liability for torts in the light of the House of Lords' decisions in *Williams* v *Natural Life* [1998] BCC 428 and *Standard Chartered Bank* v *Pakistan National Shipping Corporation (No. 2)* [2003] 1 BCLC 244.
[16] Corresponding articles for companies incorporated under the Companies Act 1985 are articles 73–80 of Table A.
[17] For companies registered under the Companies Act 2006, see art. 17 of the model articles for private companies; art. 20 of the model articles for public companies. For companies registered under the Companies Act 1985, see Table A, art. 78.
[18] Any director may appoint any other director or any other person approved by resolution of the directors to be an alternate director; see model articles of association for public companies articles 25–27; Table A, articles 65–69.

The legislation has a few scattered provisions of relevance. When a company is formed, the statement of the company's first director or directors must be delivered to the Registrar of Companies.[19] Section 157 introduces a minimum age of 16 for appointment as a company director. However, an appointment can be made below the minimum age provided it does not take effect until the person attains the age of 16.[20] Section 160 provides that for public companies the appointment of directors shall be voted on individually unless a block resolution is unanimously agreed.[21] This is to prevent an unpopular or unsuitable candidate being squeezed through the general meeting by putting him into a composite resolution to elect the directors, knowing that the shareholders will probably pass the resolution because they want all the other candidates elected.

The legislative provisions for the removal and disqualification of directors impact very substantially on the extent to which the power of the directors is constrained, and for that reason these matters are dealt with below.[22]

C Proceedings at directors' meetings

The Companies Act 2006, like its predecessor, is silent on how the directors are to conduct their meetings. However, articles 7–16 of the model articles of association for private companies and articles 7–19 of the model articles of association for public companies lay down details as to the proceedings of directors.[23] Although certain prescriptions are made (e.g. as to quorum) they are permissive in style and leave relative freedom to the board to manage the meeting process.

In the absence of express provisions to the contrary in the articles, the case law establishes a few propositions.[24] Thus, it has been held that notice of meetings must be sent to all those entitled to attend.[25] It has been emphasised that directors act collectively, as a board, and that once decisions have been reached by a majority of those present, they bind the others. This rule can sometimes have a significant effect on the opposition to a proposal, for, as was stated by Millett J in *Re Equiticorp plc*:[26] 'Once a proper resolution of the board has been passed . . . it becomes the duty of all the directors, including those who took no part in the deliberations of the board and those who voted against the resolution, to implement it . . .' As commented on above, the model articles for private companies and public companies each contain provisions covering decision making by directors. For example,

[19] Companies Act 2006, s. 12. See also s. 9, discussed in Chapter 2, 2.4,
[20] Section 157 (2).
[21] A resolution moved in contravention of this provision is void.
[22] See Chapter 23.
[23] See articles 88–98 and 100 of Table A.
[24] In *Sneddon* v *MacCallum* [2011] CSOH 59, it was emphasised by the Court of Session (Outer House) that the case law clearly establishes that where it is suggested in relation to any board meeting that the meeting was not duly held and convened, it is for the person arguing that to prove it; if it is suggested that the minutes are inaccurate in recording the proceedings at the meeting, again the onus lies on the person claiming the inaccuracy to prove it; and where any appointment was made at the meeting, the onus lies on the person disputing its validity to prove this.
[25] *Young* v *Ladies Club Ltd* [1920] 2 KB 523. It is probable that in the absence of any express provision in the articles, the notice need not state the business or any proposed resolutions; see *La Compagnie de Mayville* v *Whitley* [1896] 1 Ch 788, although there is a dictum to the contrary, in the *Ladies Club* case which suggests that it is necessary to convey to the director what is going to be done.
[26] (1989) 5 BCC 599 at p. 600. See also, *Minmar (929) Ltd* v *Khalatschi* [2011] EWHC 1159 (Ch).

both provide for collective decision making,[27] though for private companies additional provision is made for companies with one director by disapplying the general rule.

D Remuneration of directors

The law on remuneration of directors was subjected to a thorough examination by the House of Lords in *Guinness* v *Saunders and another*,[28] a civil case which arose out of the Guinness saga. This difficult case is examined in more detail below. We will also return to the subject of remuneration in the next chapter, for it has considerable significance in the self-regulatory context. Before looking at the detail of *Guinness*, it is worth attempting to summarise the main legal propositions.

As with the previous few topics, much (although not all) depends on what is in the articles. The relatively little legislation on this topic is dealt with below.[29] Directors are fiduciaries[30] and because of this they must not profit from their relationships with the company.[31] Thus, as a *prima facie* rule, it is well established, and reiterated in *Guinness*,[32] that they are not entitled to any remuneration at all. Because of this it is normal for the articles to provide for the award of remuneration. The model articles for private and public companies limited by shares provide that directors are entitled to such remuneration as the directors determine.[33] This should be contrasted with the 1985 Table A which required shareholder approval.[34] Where remuneration is fixed without complying with the articles of association, the directors will not be entitled to any remuneration. Nor will they be able to argue that they should succeed under a *quantum meruit* for the value of their services. This too was established in *Guinness*.[35] The background to these civil proceedings was a takeover battle in which Guinness made a successful bid for the shares of a company called Distillers. Various proceedings were brought against certain officers of Guinness who had been involved with the takeover.[36] Quite early on in the investigation into the matter, it was found that W, an American lawyer who was a director of Guinness, had been paid £5.2m (0.2% of the value of the bid)[37] for acting as a business consultant for advising on the takeover. Guinness immediately brought summary proceedings to recover this sum. Summary proceedings are designed to be used only if there is no arguable defence to the claim and if, during the course of the trial, it becomes clear that there is an issue, then the proceedings will fail and the case will eventually go for trial of the issues. Guinness fought the case to the House of Lords and was in difficulties over its claim that s. 317 of the

[27] See art. 7 respectively.
[28] [1990] BCC 205.
[29] See Chapter 8.
[30] For this concept see further Chapter 8 below. Broadly it means that they are like trustees and will owe duties of good faith to the beneficiaries, which in the company law context means the company.
[31] See further Chapter 8 below.
[32] [1990] BCC 205 at p. 211.
[33] Art. 19 in the model articles for private companies; and art. 23 in the model articles for public companies. The exercise of this power is subject to the duty to promote the success of the company contained in s. 172. See further, Chapter 8, below.
[34] Table A, art. 82. Readers should Monitor the website of DBIS because the current government is determined to reform the process for determining directors' renumeration.
[35] See also, *UK Safety Group Ltd* v *Heane* [1998] 2 BCLC 208; and *Re Sunrise Radio Ltd* [2010] 1 BCLC 367.
[36] Leading, in one case, to a successful Human Rights challenge.
[37] Not actually a huge amount by Wall Street standards.

Companies Act 1985 enabled it to recover.[38] However, the company came up with an alternative argument along the lines that the committee of the board of directors which W claimed had agreed to his remuneration had no power under the articles of association to award special remuneration, only the full board could do this, and it had made no such award. This was successful and W was held to be a constructive trustee of the money.[39]

The discussion above refers to the situation where someone is a bare director under the Companies Act and who does not have any full-time contract of employment with the company. However, it is common for directors, especially in the larger companies, to be appointed to paid posts requiring their full-time attention.[40] But here again, their appointments must be properly authorised by the articles or they will not be entitled to any remuneration.

Even if the remuneration is given in accordance with the articles, it will not necessarily follow that all remuneration given to directors will be unimpeachable. It is clear from the decision in *Re Halt Garage Ltd*[41] that if the sums paid to the director are so out of proportion to any possible value to the company attributable to him holding office then the court will treat the payments as gratuitous distributions of capital 'dressed up as remuneration'. In such circumstances they will be recoverable. It has also been held in *Re Cumana Ltd*[42] that excessive remuneration can amount to conduct which is unfairly prejudicial.

Traditionally, legislative provisions concerning directors' remuneration sought to address the traditional agency problem (or risk) of directors favouring their own interests (including those of their fellow directors) over that of their shareholders. In common with this tradition, the Companies Act 2006 (like its predecessors) seeks to mitigate this concern through a suite of provisions that mandate shareholder approval for various aspects of a director's employment relationship with the company. Sections 215–222 of the Companies Act 2006 regulate payments made to directors in respect of loss of office or retirement in situations where conflicts of interest may arise. Section 228 provides that directors' service contracts are open to inspection. Contracts of employment with a guaranteed term (broadly defined) of two years or more (rather than five years as was the requirement under s. 319 of the Companies Act 1985) require shareholder approval pursuant to s. 188. Lastly, s. 412 requires disclosure in the annual accounts of the aggregate amount of directors' emoluments, including present and past directors' pensions and payments received for loss of office.

Against this traditional approach to regulating directors' employment, recent (and widespread) public concern as to the level of directors' remuneration and, in particular, 'rewards for failure' has resulted in increased legislative provisions regarding directors' remuneration. In particular, ss. 79–82 of the Enterprise and Regulatory Reform Act 2013 introduced a new regime for directors' remuneration for listed companies. It applies to financial years ending on or after 30 September 2013 and amends, *inter alia*, ss. 226, 421, 422 and 439 of the Companies Act 2006. Further, the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 replaced Sch. 8 to the

[38] See now ss. 182–187 of the Companies Act 2006, discussed in Chapter 8 below.
[39] W was later acquitted in criminal proceedings arising out of the takeover.
[40] Sometimes the articles themselves appoint the director to executive office at a salary. In the absence of an express contract outside the articles, this can give rise to enforcement problems; see Chapter 4 above.
[41] [1982] 3 All ER 1016.
[42] [1986] BCLC 430, CA.