

Stakeholders in Modern UK Company Law

Introduction

The concept of a “stakeholder” is now well established in the terminology of UK Company Law. But it is not defined in the legislation. The most obvious (though non explicit) manifestation of the concept is to be found in the complex provisions of Companies Act 2006 s. 172, but in fact it has a more extensive heritage. Its true substantive lineage arguably goes back to the statutory response in the form of the Redundancy Payments Act 1965 to the restrictive decision of the court in *Parke v Daily News Ltd* [1962] Ch 927 and indeed might be traced even as far back as the conferment of preferential claims status on arrears of “servants” wages in the late 19th century by the Preferential Payments in Bankruptcy Acts 1888 and 1897. Its linguistic heritage is more modern, only really arriving on these shores from North American management discourse for the attention of legal academics through the pioneering work of the late John Parkinson (see in particular his classic Corporate Power and Responsibility, first published by OUP in 1993, where the associated notion of corporate social responsibility was highlighted).

Policymakers have taken on board the concept of the stakeholder. Will Hutton’s works, published in the edited collection The Stakeholding Society (1999)(Polity Press), were influential in raising a wider awareness. There is an outward manifestation in the form of the concept of Enlightened Shareholder Value. A perusal of the various iterations of the Company Law Review (1998-2001) will testify to that. The Final Report (URN 01/242) in para 3.8 in effect notes the need for directors to take account of stakeholders’ interests when exercising managerial powers.

The purpose of this editorial is to review current developments in UK stakeholder law, paying particular attention to those interest groups already well identified as stakeholders in modern corporations.

Shareholders and minority shareholders

No one would deny the fact that a shareholder is a stakeholder in a company. Shareholders can in general exercise their vote in their own economic interests. But, in some cases, the courts have placed limits upon their rights – witness the reflective loss rule as an example. Strictly speaking, a member of a company enjoys personal property rights in the shares held, but not in the company itself. That said, the concept of “shareholder primacy” is well established as the dominant philosophy: *Hutton v West Cork Railway Co Ltd* (1883) 23 Ch D 654 at 673 per Bowen LJ. It is prominently embedded in the terms of s. 172(1) of Companies Act 2006 by the requirement to run the business in the interests of members of the company. The real problem in practice is determining what protective rights such a person should have when enjoying only a limited economic stake in firm through a minority shareholding. We note here s.172(1)(f) and the duty of directors to have regard to the need to act fairly between members.

The main options for minority shareholder protective measures would appear to be via an unfair prejudice petition under s. 994 of the Companies Act 2006 or a derivative claim pursuant to Part 11 of said Act. The unfair prejudice option has been firmly established since the jurisdiction was

revitalised in 1980 and is heavily dependent upon its attendant jurisprudence, with the cautionary decision of the House of Lords in *O'Neill v Phillips* [1999] 1 WLR 1092 still being the dominant precedent. We are still getting used to the workings of the new derivative claims procedure introduced via Part 11 of the Companies Act 2006. This reversed the common law position that there was no right to bring such a claim unless one of the exceptions to *Foss v Harbottle* (1843) 2 Hare 461 could be established. The statutory presumption now favours a derivative claim in defined circumstances. But, in reality, the majority of such claims fail to surmount the judicial permission hurdle. Sometimes that failure is because s. 263 compels the court to take into account whether a person acting in accordance with s. 172 would proceed with such a claim. Those applicants that achieve leave or permission from the court to proceed with the derivative claim then have to face the further and major pragmatic issue of litigation costs.

On a European level we note the Shareholder Rights Directive (2007/36), as upgraded by Directive (2017/828). The impact of these measures in UK Corporate Law has not been great but they do represent steps in the direction of further empowering shareholders.

Directors

Directors have a stake in the company under all circumstances. That stake is both directly economic and can also be non-economic in nature (particularly in a family firm). That interest may be increased if, as is the normal course of events, they own shares in the company and also if they are employees. Their managerial interest is reflected by the fact that improper exclusion from management may justify an unfair prejudice finding or even a winding up on the just and equitable ground (s. 122(1)(g) of the Insolvency Act 1986). But they are in an anomalous position because directors owe duties to other stakeholders when exercising corporate powers as part of their managerial role. Failure to perform those duties may have personal consequences.

Creditors

The status of creditors as members of the stakeholder family is also undeniable these days. That was not always so obvious – witness *Mills v Northern Railway of Buenos Aires* (1870) 5 Ch App 621 where the court denied them locus standi to block ultra vires activity by the company. But we must remember that the concept of a creditor as stakeholder is a broad church. Rights (and the power to constrain managerial discretion) differ depending on whether the creditor has security and, if so, on the nature of such security. Equally, unsecured creditors may be divided up into different classes, a bugbear if a scheme of arrangement under Part 26 of the Companies Act 2006 is in contemplation.

Building upon a common law jurisprudence developed via decisions such as *West Mercia Safetywear v Dodd* (1988) 4 BCC 30 we have a clear statutory statement of the position of creditors laid down in s. 172(3) of the Companies Act 2006. This provision was further explained by John Randall QC in *Re HLC Environmental Projects Ltd* [2013] EWHC (Ch), [2014] BCC 337. Objectivity can be used by the court when reviewing whether directors' actions live up to the requirement to protect creditors. There are however limitations to this protection, with the main curb being that the protection only kicks in if the company is insolvent or nearly insolvent. Actions carried out on behalf of a solvent company that threaten the interests of creditors in the long term may not be protected under s. 172. But s. 172(3) has been extended by the application of the general avoidance provision found in Insolvency Act 1986 s. 423 in cases such as *BTI 2014 LLC v Sequana SA* [2016] EWHC 1686 (Ch),

[2017] 1 BCLC 453 and *Dickinson v NAL Realisation (Staffordshire) Ltd* [2017] EWHC 28 (Ch). In *BTI* (supra) Rose J in a lengthy judgment indicated that the s. 172(3) duty arose at a time when the directors ought to be contemplating the future insolvency of the company either because it was on the verge of insolvency or there was a potential long term liability that had not been provided for. Neither condition was met on the facts of the case before the court. But Rose J did indicate that the possibility of s. 423 of the Insolvency Act 1986 coming into play was much greater because the statutory language of the provision was deliberately wide. A dividend payment could be found to be a transaction at an undervalue within the meaning of s. 423 of the 1986 Act. In *Dickinson* (supra) the point was again made by HHJ McKenna (following *BTI*) that it would be difficult to engage s. 172(3) where the company was solvent, but not so difficult in the case of engaging s. 423. In this case certain property transactions and share buybacks were under the microscope and were in part successfully challenged. If this thinking becomes the norm we may be witnessing a significant development in upgrading directorial stewardship requirements in UK Company Law through these apparently obscure cases.

The prescribed part (or reserved fund) introduced in s. 176A of the Insolvency Act 1986 via the Enterprise Act 2002 was an important symbolic message of support for unsecured creditors. It has alleviated their predicament in some cases by top slicing realisations destined for the floating charge holder, but in reality we are talking about crumbs of comfort rather than a major improvement in the distributional position. For a recent review of this subject see Akintola [2017] 30 *Insolvency Intelligence* 55.

A number of reforms made by the Small Business, Enterprise and Employment Act 2015 offer further assistance to unsecured creditors. It is made clear by s. 119 (inserting s. 176ZB into the Insolvency Act 1986) that proceeds of certain recovery claims brought by office holders belong exclusively to unsecured creditors and not to the floating charge holder. The advent of the possibility of financial compensation under new disqualification regime (SBEEA 2015 s. 110: CDDA 1986 ss. 15A-C) may ultimately serve to alleviate their position. Indeed such compensation may be directed towards individual creditors rather than unsecured creditors generally. But, we must not get carried away with this latter provision: claims under this provision are expected to be rare birds.

The Law Commission in its July 2016 Report on Consumer Prepayments on Retailer Insolvency (LC No. 368) may, if implemented, offer further protection to prepaying customers of failed retailers by offering them limited preferential creditor status. Thus prepayments made within 6 months of insolvency may under certain conditions be treated as preferential debts up to a maximum of £250.

Subordinated creditors of the company have little leverage if the company runs into difficulty, though they may assert themselves in the distribution of assets of a concern that turns out to be solvent with a resultant surplus— see the *Lehman* “waterfall” litigation resulting in the ruling of the Supreme Court reported in [2017] UKSC 38.

Employees and former employees

Employees are indisputably stakeholders on any view of the modern company. But their input of labour is not always as well protected as is the input of capital by shareholders and creditors. Since 1980 directors have been under a statutory obligation to have regard to their interests and that is now confirmed by s. 172(1)(b) of the Companies Act 2006.

To complicate matters an employee may, of course, be a shareholder. This can create a curious relationship. This “half way house” of employee shareholders had the potential to become more significant post the enactment of the Growth and Infrastructure Act 2013, but that experiment was short lived. Another complication lies in the fact that a director will usually be an employee and will probably own some shares in the company. On the question of directors as employees it is pertinent to ask whether they should they enjoy the same level of protection as other employees, particularly with regard to the recovery of unpaid wages and rights to access state compensation funds. This general question was before the court in the test case of *Secretary of State for BERR v Neufeld* [2009] EWCA Civ 280 and was answered in the affirmative. One can understand why the court felt compelled to reach this conclusion, but might ask whether the issue should be reconsidered.

We noted *Parke v Daily News* (supra) earlier. It was neutralised by the introduction of the general redundancy scheme in 1965 and was specifically reversed by Companies Act 1980 s. 74 (reconsolidated as Companies Act 1985 s. 719 and now located in Companies Act 2006 s. 247). A similar provision is to be found in s. 187 of the Insolvency Act 1986 where a liquidator is faced with a surplus. It is made clear by s. 247(2) of the Companies Act 2006 that this power to make provision for displaced employees can override any obligations arising under s. 172.

As a result of our current EU membership, employees enjoy consultation rights and other protections through the Acquired Rights Directive 1977 (as originally adopted) and the TUPE Regulations 2006 (SI 2006/246) (as amended).

The controversial possibility of placing worker representatives on the board was raised by Theresa May shortly after she assumed office as Prime Minister, but that was watered down in the Green Paper of November 2016 on Corporate Governance and replaced by a suggestion that workers’ interests should be represented by a particular non-executive director. The future pattern of things is very unclear, not least because of the state of political uncertainty in the UK. The House of Commons BEIS Committee in April 2017 in Corporate Governance (HC 702) opposed the idea of compulsion in terms of having worker representatives on the board but favoured recruitment of more diverse groups as NEDs. It also recommended the setting up of stakeholder panels consisting of employee and consumer representatives in order to advise directors. We await developments here.

Employee protection in Company law does not by definition extend to self-employed service providers, sometimes called indirect workers. These are a growing constituency in the modern economy. The City Link affair underscores this and it is arguable from a perusal of the resulting Parliamentary report in Session 2014/15 from the DBIS Committee, Impact of the Closure of City Link on Employment (HC 928) (para 74) that there is an appetite to extend preferential claims protection to them in respect of sums due to them for labour services provided. No legislative action has been taken on this matter and there are concerns that it would be unwise to revert to a practice of reintroducing more preferential claims via the back door. Suppliers of labour services are presumably covered by s. 172 and the directors should have regard to their interests. Looking to the future, a lot might depend upon litigation before the courts which is currently looking at the boundaries between employed and self-employed “workers”.

The focus of attention in recent times, particularly in the wake of the BHS affair, has been on the protection on offer to employees (past and present) in the context of the security of their occupational pensions. The Pension Protection Fund has raised this issue in respect of the payment of dividends and it may be that a more restrictive approach will be adopted in future. It is clear that employees are covered by the terms of s. 172, but why not add pensioners (i.e. former employees)

to the list of parties whose interests the directors should have some regard to when performing their duties pursuant to s. 172?

Suppliers

The need to take into account the interests of suppliers to the company is implicit in the language adopted by s. 172(1)(c). Section 172 does therefore recognise the position of suppliers when fostering business relationships, as it does with regard to customers and “others” (who are unspecified).

Suppliers of raw materials have of course found a powerful protective tool in the form of the reservation of title clause, which was upheld by the Court of Appeal in the *Romalpa* decision [1976] 1 WLR 676. But retention of title has its limitations, particularly with regard to the nature of the supplies. Looking beyond title retention, some suppliers are in an especially strong bargaining position because of limited competition and their rights have had to be restricted in the interests of other stakeholders. So we have seen curbs on monopoly suppliers introduced via s. 233 of the Insolvency Act 1986 and further strengthened by the Enterprise and Regulatory Reform Act 2013 s. 92 has extended the protection enjoyed by a distressed company from the cut off of essential supplies. The mechanism for this change is the Insolvency (Protection of Essential Supplies) Order 2015 (SI 2015/989). Contractual ipso facto clauses may be overridden in cases of administration or company voluntary arrangement; this is achieved by the introduction of a new s. 233A into the Insolvency Act 1986. This may impact upon suppliers who in the past have been able to play hardball with manufacturers who cannot source supplies elsewhere.

Before leaving our discussion of the position of suppliers in the modern company context we should note that the company itself has new responsibilities as a result of the enactment of the Modern Slavery Act 2015. This legislation imposes transparency requirements with regard to labour practices in supplier chains. From a director’s perspective the linkage with the duty to have regard to the reputation of the firm imposed by s. 172(1)(e) should be borne in mind.

The local community

The need to have regard to the interests of the community is listed in s. 172(1)(d) in terms of the business operations of the company. Presumably, business operations would include any downsizing of the said operations. This is one further area of commercial activity where the state often picks up the bill at the end of the day by requiring the establishment special regional investment funds and other local initiatives to address any attendant unemployment. This brings corporate social responsibility into a sharp focus.

The environment

This is also mentioned in s. 172(1)(d) and for many years there has been special discrete legislation rendering companies and their officers liable for breaches of environmental regulation. Where the state is a major investor in a company it can try to influence the directors to adopt an environmentally friendly policy, but the final decision must be for the directors who should have regard to the interests of members – on this see the comments of Sales J in *R (on the application of People and Planet) v HM Treasury* [2009] EWHC 3020 (Admin).

The state

As it has the deepest of all pockets it is not surprising that in many cases it is faced with expenditure where a company defaults on its obligations to other stakeholders (particularly employees). Therefore why not add it to the s. 172 list? An explicit recognition would be welcome in that it might focus the minds of certain company directors who might view the public exchequer as fair game.

In the absence of such a change we should concede that the state already has at its disposal a range of protective tools. It can refuse registration of a new company, but that is rarely done, save on grounds of morality. It can seek the disqualification of those persons who are not fit to enjoy the facility of limited liability. It can seek to have companies wound up in the public interest pursuant to s. 124A of the Insolvency Act 1986. We note in this context the s. 172(1)(e) duty imposed on directors to have regard to the desirability of maintaining a high reputation for standards of business conduct. The latest Insolvency Service Enforcement Outcomes published in April 2017 show that 85 companies were wound up in the public interest in 2016/17. This is a drop of 35% on the previous year but is partly explained away by the use of alternative regulatory actions to deal with suspected abuse. It is generally accepted that the state should use its powers more extensively to root out improper behaviour. There is an issue of available public resources here.

The problem(s) with s. 172

Section 172 has not been an unqualified success. Its flaws lie partly in its design as a statutory provision. The use of the elastic phrase “have regard to” is derived from Companies Act 1985 s. 309. But it sets the barrier at a very low level requiring reflection on the part of directors rather than compliance with stakeholder needs. That is inevitable unless we are prepared to fundamentally change our attitudes to capitalism. The list of identified stakeholders is not comprehensive, as s. 172(1) concedes (“amongst other matters”). This lacuna is of limited importance because none of the designated constituencies can, as such, enforce s. 172 directly in the courts. Question marks remain about who enforces the obligations imposed by s. 172. Presumably we are looking at the company or, if it fails to do so and it is solvent, a shareholder by means of a derivative claim. If the company is insolvent then the office holder does the enforcing. Critically there is no prioritisation between competing stakeholder interests. Such competition is inevitable – witness *Re Welfab Engineers Ltd* [1990] BCC 600 where the court had to weigh up conflicting employee and creditor interests.

These weaknesses in s. 172 have attracted official notice. On 5 April 2017 the Parliamentary Select Committee on Business, Enterprise and Industrial Strategy published its third report of Session 2016/17 on Corporate Governance (HC 702). This called for a strengthening of s. 172 by urging the Financial Reporting Council to amend the UK Corporate Governance Code so as to require directors to publish a statement each year indicating how they had complied with their obligations under s. 172. It also suggested conferring power on the Financial Reporting Council to initiate litigation on the back of s. 172 in defined circumstances where persuasive action had failed to correct behaviour.

Conclusion

Clearly considerable advances have been made in recent times to put the concept of the stakeholder on a firmer footing in modern UK Company Law. But the debate continues. That discussion will be played out in the context of the Green Paper on Corporate Governance which was published by the Government on 28 November 2016. Current political uncertainty may delay a clear outcome to that debate.

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