Written evidence from the Durham Company Law Project (CGV0029)

## Executive Summary

(Recommendations with legislative implications are shown in bold type)

- **The success of the company should be understood as the success of the business enterprise which it conducts**.
- **Qualifying employees should be recognised by statute as members of the company and any group that employs them**. The company can then be understood as the legal reflection of the human community of enterprise that produces goods and services and serves customers and society as a whole. Deemed employee membership would empower directors to pursue the success of the enterprise in which long-term shareholders and workers have a common interest. Without it, s. 172 is a dead letter.
- Such recognition would not be sufficient without some transfer of sovereignty over takeover decisions from shareholders to directors and workers. **Directors need to be free to pursue the success of the enterprise without the threat of hostile takeover**. Furthermore, since an enterprise may be worth more to shareholders dead than alive, **the consent of workers as well as of long-term shareholders should be required for takeovers recommended by the directors**.
- The election of worker directors follows naturally from the recognition of deemed membership and this understanding of success helps to overcome the conflicts of interest. Trade unions should play a complementary but separate role.

# The Durham Company Law Project Steering Group

The Durham Company Law Project is a project of Durham University Business School (www.dur.ac.uk/business) and the Centre for Catholic Social Thought and Practice (www.ccstp.org.uk). Its purpose and the reason for this submission is to draw on Catholic Social Thought to inform the reform of company law.

Nick Deeming has over 25 years' experience as a lawyer and businessman, the majority of it at the heart of global and listed organisations, including Transocean, Christie's and BOC. He currently holds a number of non executive director positions, he is a senior executive coach and he is a senior advisor to *A Blueprint for Better Business*.

Maurice Glasman is an English academic, social thinker and Labour life peer in the House of Lords. He is Director of the Common Good Foundation.

Mark Hayes was until recently St Hilda Reader in Catholic Social Thought and Practice and is now an Honorary Fellow in the Department of Theology and Religion at Durham University. He is an economist with a background in finance, as an investment manager at 3i, and as principal founder and Managing Director of Shared Interest, a financial co-operative supporting the Fair Trade movement. He has acted as the primary draftsman of this submission.

Clifford Longley is an author, broadcaster and journalist who has specialised since 1972 in the coverage and analysis of British and international religious affairs. He currently has a column in *The Tablet*, of which he is also Editorial Consultant. He has written extensively on Catholic Social Thought and is a Trustee of the Centre for Catholic Social Thought and Practice.

Geoff Moore is Professor of Business Ethics at Durham University Business School. His areas of work include corporate social responsibility, stakeholder theory, corporate moral agency and Fair Trade. His particular area of interest is around the application of moral philosopher Alasdair MacIntyre's virtue ethics approach to organisations.

*The members of the Steering Group make this submission in their personal capacities and the views expressed do not necessarily reflect those of any organisation with which they are associated.*

## Terms of Reference – Points Addressed

### Directors Duties

- Is the duty to promote the long-term success of the company clear and enforceable?
- How are the interests of shareholders, current and former employees best balanced?

### Composition of Boards

- Should there be worker representation on boards and/or remuneration committees? If so, what form should this take?

*Is the duty to promote the long-term success of the company clear and enforceable?*

1. The key issues are a confusion between 'the company' and 'the enterprise' and the need for statutory recognition of employees as deemed members of the company.

2. The Company Law Review (CLR, 1999, chapter 5), which led to the Companies Act 2006, tends to use the words 'enterprise' and 'company' interchangeably. Lord Denning held that the duty of directors "was to do their best to promote its business and to act with complete good faith towards it" in a context where the interests of the controlling shareholders conflicted with those of the company's business and minority shareholders.[1] The CLR recognised that the interests of shareholders and employees would clash in the case of the closure of a plant and wrote "An appeal to the 'interests of the company' will not resolve the issue, unless it is first decided whether 'the company' is to be equated with its shareholders alone (enlightened shareholder value), or the shareholders plus other participants (pluralism)" (CLR, 1999, p. 39). Yet in the following paragraphs the CLR argues for legislation – that clearly issued in s. 172 CA 2006 – "to ensure that directors recognise their obligation to have regard to the need, where appropriate, to build long-term and trusting relationships with employees, suppliers, customers and others, as appropriate, in order to secure the success of the *enterprise* over time" (CLR, 1999, pp. 41–42, emphasis added).

3. For the CLR the enterprise is not bounded by the limits of the actual business of a particular company at any time but includes the business of any potential acquiring company, which may find it profitable to make:

> cost savings in the form of redundancies, or plant closures, and may involve the transfer of corporate headquarters. Such changes may also be very unwelcome to the directors of the target company in question. Under the present law and practice directors are prevented by the 'proper purpose' principle, and, in the case of takeover offers for public companies resident in the UK, by the City Code on Takeovers and Mergers, from exercising their powers in a way which frustrates the bid. (CLR, 1999, p. 47)

[1] *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324.

4. The CLR is thus enabled to interpret the success of the enterprise solely in terms of shareholder value. Having adopted that criterion, there is no difference between, on the one hand, merging the target enterprise into a larger continuing enterprise and, on the other, closing the target enterprise, transferring its sales, brand value and other assets elsewhere or simply eliminating the competition; provided that the share price is acceptable to the shareholders in either case.

5. Nevertheless the distinction, between a business, trade or profession (the 'enterprise') and the person (including a company) that conducts the enterprise, is important. A company can conduct a number of different enterprises and an enterprise can be conducted by an individual or unincorporated partnership. This distinction is fully recognised, capable of legal definition and of considerable importance in tax law.

6. The interests of employees and long-term shareholders in the success of a particular enterprise are for the most part aligned, in a manner that does not necessarily apply to other stakeholders, with whom there is greater scope for conflicts of interest. Both employees and long-term shareholders can benefit from the success of the enterprise without doing so at the expense of the other. The conflict arises if the enterprise is not successful or one group seeks to gain at the other's expense. Workers cannot legitimately expect shareholders to fund continuing losses. Shareholders cannot legitimately expect workers to accept (at least, without substantial compensation) the loss of their livelihoods from a viable enterprise, which is worth more to the shareholders dead than alive.

7. The recognition of workers as members of the company is a necessary condition for the sustainability of adopting a corporate purpose beyond shareholder value. At one level this is relatively straightforward. **Legislation could provide that qualifying employees are members of the company which employs them, and of any parent company and its parent, all the way up to the ultimate holding company.** In itself this provision would provide no rights to vote or participate in management or profits, yet this would be the first step in recognising the intrinsic membership of workers in the community of enterprise of which they are part.

8. In the context of s. 172, such deemed membership would require the directors to pursue the benefit of workers as part of the 'members as a whole' and 'acting fairly as between members of the company' – which broadly means not pursuing the benefit of either group at the expense of the other. Membership would also provide the platform for a derivative claim under s. 260 CA 2006 so that workers could challenge the directors' interpretation or performance of their duties. Without deemed worker membership, s. 172 is a dead letter.

9. There would be considerable work for the Parliamentary draftsmen in defining a qualifying employee. No definition would be perfect yet the problem is surely not insurmountable for practical purposes. Account would need to be taken of length of service and hours of work (a short qualifying period and minimum hours seem

reasonable; the practices of the John Lewis Partnership, for example, provide guidance) and in particular of indirect employment, which has become very significant through the use of various forms of service company and contractor to reduce the obligations to workers. HMRC has become very adept in distinguishing employment from self-employment; the key element is the identification of who ultimately benefits from and controls an individual's working time. **There is a parallel case for limiting the franchise to long-term shareholders as defined by the carpet-bagger defences of mutual and co-operative institutions.**

10. However, the question of purpose cannot be separated from the market for corporate control, addressed below. It is possible that remedies in that area alone would in themselves be sufficient to overcome the ambiguity of s. 172 and allow the 'success of the company' to be interpreted by the courts as 'the success of *the business enterprise carried on by* the company'. **It would put the matter beyond doubt if the six extra words (or better wording to similar effect) were inserted into the primary legislation.**[2]

11. Even if directors were enabled to see their duty in terms of the success of the business enterprise, rather than shareholder value alone, the meaning of success would remain undefined. There remains a case for a statement of the purpose of the business against which success might be judged. The question is whether this statement of purpose should have legal force, in the same way as the Objects clause of a memorandum of association. The requirement of an objects clause was abolished by CA 2006 as redundant in the light of previous changes in the law to place a company's capacity beyond challenge as *ultra vires*. Such clauses had become compendious with a view to covering every imaginable contingency. It is likely that the re-introduction of such a requirement, albeit for different reasons, would run into the same problem. Furthermore precedent suggests that the courts are reluctant to challenge judgements made by directors about the conduct of a business, however defined. It must also be acknowledged that the creation of deemed employee membership would not directly address the possibility of a conflict between the interests of the enterprise (encompassing those of both long-term shareholders and workers) and those of non-member stakeholders. A statement of purpose would be better left to the discretion of the directors, while noting that it might be expected that an enterprise should be able to articulate how it contributes to the common good.

*How are the interests of shareholders, current and former employees best balanced?*

12. The CLR recognised that "one of the most important influences on the behaviour of directors and members is the market in corporate control" (CLR, 1999, p. 34). This strictly economic rather than legal factor cannot be neglected when considering director's duties and corporate purpose. The surest way for directors to lose their office and any employment is in consequence of a hostile takeover. Personal interest

[2] Such an amendment would also clarify that s. 172 does not create a duty to avoid tax, which cannot have been the intention of Parliament.

aside, the UK legal framework and the culture and practice of the City prohibits directors from blocking a hostile bid by one of the many devices common in the US, and regards as absolute the sovereignty of shareholders over the disposal of their property, namely the shares in a company, subject only to a limited understanding of the public interest in terms of national security and competition policy. It is only to be expected that the interests of shareholders will rank paramount in the minds of directors as they consider s. 172. This factor has become ever stronger as technology has made equity markets more and more liquid, shareholding periods shorter and shorter, and hedge funds more and more powerful. The share register can change dramatically within days of the initial offer and become dominated by those with a purely short-term financial interest.

13. There is no prospect of a sustainable commitment by a public company to a corporate purpose other than enlightened shareholder value (and perhaps not even enlightened, as many critics point out) without **the prohibition of the hostile takeover**.[3] This is another pre-condition of change, alongside the recognition of qualifying employees as members. For directors to be able to pursue the success of the actual enterprise for which they are responsible, as opposed to the interests of shareholders, they must have the discretion to make an impartial judgement in the terms of s. 172. Thus any takeover offer should, at the very least, be recommended by the board of directors.

14. If the company is understood as a legal reflection of the community of persons engaged in the enterprise, even the prohibition of the hostile takeover is not sufficient. Boards may recommend a takeover as in the interests of shareholders without outside pressure and even if this is not in the interests of the company's continuing business enterprise. This implies that **the minimal rights of the employee member, in addition to being considered a member for the purposes of s. 172, should include the approval of any takeover recommended by the Board**.[4]

15. There are many occasions when workers will approve a takeover, even if this involves redundancies for some or all of them. A struggling business has few options and its workers usually understand this better than anyone. A merger with a larger business may make strategic sense. They may even approve the closure of a viable enterprise when an offer is too good to refuse, provided that an appropriate share of the benefit flows to them.

16. This last option should strictly not be recommended by the directors as it deprives future generations of the opportunity to participate in the enterprise, in the same way that demutualisation removes the opportunity to participate in a more socially-

[3] This may not be so much a question of a prohibition as of a removal of the duties imposed by the Takeover Code in its present form. The Code might be limited to the conduct of recommended takeovers (i.e. recommended by the Board) including the requirement for employee consent here proposed.

[4] This would also require amendment of s. 168 CA 2006 accordingly to limit the exclusive right of shareholders to remove directors. Each proposal in this submission will require detailed drafting including consequential amendments.

oriented enterprise. In practice, without an external public interest test, it would be hard to prohibit a takeover approved by both shareholders and workers, if only because there would be no change in legal form as in the case of demutualisation.

*Should there be worker representation on boards and/or remuneration committees? If so, what form should this take?*

17. With the market in corporate control limited in the above fashion, there is some chance of the emergence of a different understanding of corporate purpose. Room is created for a sense of vocation and a genuine (rather than purely instrumental) commitment to excellence of practice. While the above conditions are necessary and may be sufficient, further measures are desirable. First of all, the advocates of the market in corporate control (CLR, 1999, p. 45) will argue that without the discipline of the threat of hostile takeover, boards of directors become, in practice, unaccountable. It is certainly true that alternative channels for corporate governance would need strengthening and developing, including both the engagement of long-term shareholders and the representation of workers.

18. The argument of this submission so far has been for the minimum recognition of intrinsic employee membership necessary to enable directors to pursue wider corporate purpose. A powerful case can be made for going much further in terms of worker participation in corporate governance and management, not least in terms of worker motivation and productivity. This would involve the solution of a number of complex issues, including the reconciliation of one vote per employee with one vote per share, perhaps through separate meetings as with different classes of share. A decision on a recommended takeover should probably be made by secret ballot. An ultimate goal might be the introduction of co-determination along the lines of the German model. All this would require a gradual and incremental change of UK industrial culture and practice.

19. The concept of deemed employee membership adds a new ingredient to the debate over worker representation. It provides legal recognition of the human association which produces goods and services and serves customers and wider society. It provides grounds in terms of the well-established legal principles of association for participation in governance. From membership follows accountability, including general meetings and the election of directors.

20. The duty of a director elected by workers would be to the company, as in the case of any other director. With the above suggested clarification of the meaning of success of the company as relating to the business enterprise, the Board could be unified in pursuit of this objective, in the creation of value for the community as a whole. There would be no more conflict of interest between the interests of workers and of the company than exists in the case of executive directors. Under this proposed regime, excessive pay awards would be as unlikely for workers as for executives; present

problems with executive pay reflect the current understanding of success in terms of shareholder value.

21. The role of the trade union is complementary. The duty of a trade union is to its members, not to the company. Worker directors should not be directly appointed by trade unions yet neither should trade union officials or members be disqualified from holding office as a director, any more than shareholder representatives. The trade union could play a key role in negotiation with the company in those areas, such as terms and conditions of employment, where worker directors experience a conflict of interest. Furthermore they could play a role similar to that of a political party in relation to members of Parliament, such as in the training and nomination of candidates for election to the Board.

*25 October 2016*

**Reference**

Company Law Review Steering Group [CLR] (1999) *Modern Company Law for a competitive economy: the strategic framework*, London: Department of Trade and Industry, URN 99/654.