Should the Director's Obligation to Consider Creditor Interests When Companies are Insolvent be Wider and Include Other Stakeholders?

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ABSTRACT

In many common law jurisdictions directors are subject to an obligation to consider the interests of their companies' creditors when companies are insolvent or close to insolvency. This obligation is part of the directors' duty to act in the best interests of their company and is not a standalone duty. Much has been written about this obligation, but the paper addresses an issue that has not been previously broached. It investigates whether the interests of stakeholders other than creditors should also be taken into account when a company is insolvent but has not entered some formal insolvency regime, such as liquidation. Hitherto, the literature has examined whether the interests of stakeholders in general should be considered by directors along with those of shareholders in solvent companies. After explaining the main elements of the obligation to creditors, the paper examines the rights many say stakeholders should have in companies and then considers whether stakeholders should be entitled to have their interests considered by directors when a company is insolvent. Finally, the paper identifies and analyses the problems that exist with requiring consideration of the interests of stakeholders and examines some of the options that could be employed to address these problems.

Keywords: *directors' duties, insolvent companies, stakeholders, balancing, enforcement*

INTRODUCTION

In a significant number of jurisdictions, particularly in European civil law jurisdictions,[2] directors must file insolvency proceedings within a certain period of their company becoming insolvent, or else they could be held liable personally for losses sustained by their company and its creditors. In most common law jurisdictions, there is no obligation on the directors to file proceedings if their company becomes insolvent. The directors are not liable merely for trading on where their company is insolvent. Some boards will effectively file insolvency proceedings by taking their companies into administration, liquidation or some other insolvency proceeding because they believe that it is appropriate, but they are not required to do so. Nevertheless, if directors continue to trade the company's business while the company is insolvent, they might be liable. For instance, directors might be liable for: wrongful trading in the UK;[3] insolvent trading in Australia;[4] reckless trading in Ireland,[5] New

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[2] For instance, Insolvency Code, s.69(2) (Austria) and Insolvency Law, art. 21(g) (Poland).
[3] Insolvency Act 1986, s.214 (UK).
[4] Corporations Act 2001, s.588G (Aust)
[5] Companies Act 2014, s.610 (Ireland).

Zealand[6] and South Africa.[7] Besides these possible liabilities, directors in many common law countries could be liable when their company is insolvent for breaching a specific obligation that relates to the company's creditors. This obligation precipitates a shift in the nature of the responsibility of the directors; they have to take into account the interests of their companies' creditors when their company is insolvent (or even when bordering on insolvency or in the vicinity of insolvency) as part of their duties. This shift does not entail a shift in the one to whom directors owe their duties. The directors continue to owe their duties to the company even when it is insolvent, but the shift that occurs involves a change of focus to at least include consideration of the interests of creditors.[8]

Before insolvency occurs, the approach in most Anglo-American jurisdictions is that the directors are to engage in shareholder primacy,[9] that is exercising their powers and duties in order to benefit the shareholders alone, but they are often allowed, or, as is the case in some jurisdictions, such as the UK,[10] compelled to consider the interests of stakeholders, other than shareholders, in discharging their duty to act in the best interests of the company. However, as mentioned above, there is a shift when insolvency occurs, in that directors must consider creditor interests either in conjunction with shareholder interests or as their paramount consideration. The reason for the shift from a focus on shareholders to creditors is that, it is said by some decisions, the interests of the company have in reality become the interests of creditors.[11] The shareholders are the owners of the residual value of the company when it is solvent (the residual owners being those whose wealth directly rises or falls with changes in the value of the company[12]), but when a company is insolvent the shareholders' interests are of no value and the directors are effectively playing with the creditors' money,[13] as any further losses could lead to the liquidation of the company in which creditors (excepting, perhaps, the secured creditors) will not receive full payment. Thus, the creditors are regarded, when insolvency occurs, as the major stakeholders in the

6 Companies Act 1993, s.135 (NZ).

7 Companies Act 2008, s.22 (South Arica).

8 While it has been held at times in the United States that directors owe a direct duty to creditors, this has not been the case in the rest of the common law world There have been cases where this kind of duty was referred to, such as *Winkworth v Edward Baron Development Co Ltd* ([1986] 1 W.L.R. 1512; [1987] 1 All E.R. 114 and *Jeffree v NCSC* (1989) 7 A.C.L.C. 556, but it has not been embraced, and a number of cases have clearly manifested a view that that approach is wrong, such as *Yukong Lines Ltd of Korea v Rendsburg Investments Corporation* [1998] B.C.C. 870; *Spies v The Queen* [2000] HCA 43, (2000) 201 C.L.R. 603, (2000) 173 A.L.R. 529; *Bilta (UK) Ltd (in liq) v Nazir (No 2)* [2015] UKSC 23, [2016] A.C. 1; [2015] 2 W.L.R. 1168, [125] and [126]; *BTI 2014 LLC v Sequana SA* ("Sequana") [2022] UKSC 25, [2022] 3 W.L.R. 709, [2023] B.C.C. 32, [11], [205].

9 Also known variously as "shareholder value" or "shareholder value maximisation."

10 See Companies Act 2006, s.172(1) (UK).

11 For instance, see *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 A.C.L.C. 215; *Brady v Brady* (1988) 3 B.C.C. 535, 552

12 D. Baird, "The initiation problem in bankruptcy" (1991) 11 *International Review of Law and Economics* 223, 228-229; S. Gilson, and M. Vetsuypens, "Credit Control in Financially Distressed Firms: Empirical Evidence" (1994) 72 *Washington University Law Quarterly* 1005, 1006. This seems to be what was being said in *Brady v Brady* (1988) 3 B.C.C. 535.

13 R. Millner, "What Does it Mean for Directors of Financially Troubled Corporations to Have Fiduciary Duties to Creditors?" (2000) 9 *Journal of Bankruptcy Law and Practice* 201, 207; R Hartman, "Situation Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals" (1993) 50 *Washington and Lee Law Review* 1761, 1771; R. Lipson, "Directors" Duties to Creditors: Volition, Cognition, Exit and the Financially Distressed Corporation" (2003) 50 *University of California at Los Angeles Law Review* 1189, 1212.

company.[14] The consequence of all of this is that the directors have an obligation not to sacrifice creditor interests.[15] The obligation effectively provides "the greatest protection at the time of the greatest risk, and, by changing what the board can reasonably justify as being in the corporate interest"[16] and prevents misuse of the corporate power to incur liabilities.

The shift that occurs on insolvency is a shift from total focus on shareholders to consideration of creditors, and this does not include consideration of other stakeholders of the company. Much has been written about the obligation to consider the interests of all stakeholders in companies, but this paper addresses an issue that has not been previously broached. The literature has focused on stakeholder interests in solvent companies. What this paper investigates is whether the interests of stakeholders, as well as creditors, should be taken into account when a company is insolvent but has not entered some formal insolvency regime, such as liquidation. It does this because when a company is insolvent s.172(1) of the UK's Companies Act 2006 ("the Act") does require directors to have consideration for certain stakeholder-like interests, such as the interests of employees[17] and it might be thought odd that the same requirement is not mandated when a company is insolvent and when the interests of one stakeholder, creditors, must be considered. Furthermore, the issue might be said to be of greater relevance now that the European Union, in its Directive on Preventive Restructuring Frameworks[18] provides in Article 19 that "where there is a likelihood of insolvency, directors, have due regard, as a minimum, to…the interests of creditors, equity holders and *other stakeholders*." (author's emphasis)

"Insolvency" means, in this paper, where a company either is unable to pay its debts as they fall due (cash flow insolvency) or its liabilities outweigh its assets (balance sheet insolvency). The paper is structured as follows. First, the paper considers the obligation that is owed in respect of creditor interests. Secondly, there is a discussion of stakeholders, who they are and what has been argued in relation to their interests in companies. This is followed by an examination of the arguments that could be formulated to support the view that directors should take into account not only creditors but other stakeholders when their company is insolvent. Fourthly, the paper identifies and analyses the problems that exist with requiring consideration of the interests of a broader range of stakeholders during insolvency as well as examining some of the options that could be employed to address the problems. Finally, there are some concluding comments.

The paper focuses on whether there should be a change in the nature of the fiduciary duty owed by directors rather than more broadly providing for other forms of stakeholder protection. It does this because while a change in the nature of the duty would be somewhat revolutionary it might be argued that it would be far less so than the introduction of broader protections given the policy underpinning company law principles in the UK and elsewhere which has indicated a willingness to provide only limited protection in the company legislation for stakeholders.

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14 *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 A.C.L.C. 215, 221.
15 *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 A.C.L.C. 215, 221.
16 Ross Grantham, "The Judicial Extension of Directors' Duties to Creditors" [1991] JBL 1, 15.
17 Section 172(1)(b) (UK).
18 Official Journal of the European Union, L 172, 2019/1023

At the outset it should be emphasised that the common law does not impose a duty on directors to creditors. The obligation considered here is an aspect of the duty, or what can be seen as a modification of the duty, to act in the best interests of the company.[19] Effectively, the duty of the directors is to act in the best interests of the company and when a company is insolvent an element of this duty is that creditors' interest must be taken into account. Thus, the paper refers to the requirement to consider creditor interests when insolvency occurs as "the obligation."

THE OBLIGATION (TO CREDITORS)

Much has been written on the subject of the obligation[20] and the paper will not rehearse the development of the obligation save to address the main issues in order to provide the necessary context for the issue that has been posed by the paper. The obligation owes its genesis to the obiter comments of Mason J of the High Court of Australia in *Walker v Wimborne*.[21] His Honour said (with the concurrence of Barwick CJ) that:

> In this respect it should be emphasised that the directors of a company in discharging their duty to the company must take into account the interests of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them... [a creditor's] interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent.[22]

Subsequently, this dictum was taken forward in the 1980s in, amongst others, the New Zealand case of *Nicholson v Permakraft (NZ) Ltd*[23] and the Australian decision of *Kinsela v Russell Kinsela Pty Ltd ("Kinsela")*.[24] *Kinsela* was approved of by many Commonwealth cases, including by the English Court of Appeal in the first UK case that really considered the obligation as providing the basis for proceedings against directors, namely *Liquidator of West Mercia Safetywear Ltd v Dodd*.[25] The obligation has been considered and applied over

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19 See *Sequana* [2022] UKSC 25, [2022] 3 W.L.R. 709, [2023] B.C.C. 32.

20 The literature is too voluminous to cite, but the following are examples of it which discuss the development of the obligation and the issues pertaining to it: C. Riley, "Directors' duties and the interests of creditors" (1989) 10 Co Law 87; D. D. Prentice, "Creditor's Interests and Director's Duties" (1990) 10 OJLS 265; S. Worthington, "Directors' Duties, Creditors' Rights and Shareholder Intervention" (1991) 18 MULR 121; R. Grantham, "The Judicial Extension of Directors' Duties to Creditors" [1991] JBL 1; D. Wishart, "Models and Theories of Directors' Duties to Creditors" (1991) 14 NZULR 323; J. Ziegel, "Creditors as Corporate Stakeholders : The Quiet Revolution – An Anglo-Canadian Perspective" (1993) 43 University of Toronto Law Journal 511; A. Keay, *Company Directors' Responsibilities to Creditors,* Routledge-Cavendish, 2007; A. Keay, "Directors' Duties and Creditors' Interests" (2014) 130 LQR 443; K. van Zwieten, "Director Liability in Insolvency and Its Vicinity" (2018) 38 OJLS 382; R. Teele Langford and I. Ramsay, "The contours of the 'creditors' interests' duty'' (2021) 21 JCLS 85.

21 (1976) 137 C.L.R. 1, (1976) 3 A.C.L.R. 529.

22 (1976) 137 C.L.R. 1, 6-7, (1976) 3 A.C.L.R. 529, 531.

23 (1985) 3 A.C.L.C. 453.

24 (1986) 4 A.C.L.C. 215.

25 [1988] 4 B.C.C. 30

a number of years in many Commonwealth jurisdictions as well as in Ireland and Hong Kong. The authorities have held that directors have, as part of their duty to act in the best interests of the company, the obligation to consider the interests of their company's creditors when their company was insolvent[26] (or close to insolvency[27]). It now appears to be an inveterate part of the law of many jurisdictions.[28]

There have been two major questions in relation to the obligation that have been the subject of a great amount of debate and commentary. The first is: when is the obligation triggered?[29] It is accepted by the case law in all jurisdictions, and therefore, not an issue for this paper, that it is triggered when a company is insolvent.[30] The bigger issue with the obligation has been: at what time before insolvency does the obligation arise? This has led to the construction of a plethora of formulae from courts across the world.[31] We will not explore that issue here given the issue that has been posed; we are concerned with companies that are actually insolvent, but which have not entered some formal insolvency regime.

The second issue is how the directors are to act when subject to the obligation. Here there is no conformity among court decisions. The vast preponderance of English authority has held that when a company is insolvent the creditors' interests are paramount.[32] This corpus of authority includes obiter comments made by the English Court of Appeal in *BTI 2014 LLC v Sequana S.A.*[33] The Irish Supreme Court in *Re Frederick Inns Ltd*[34] seemed also to adopt the paramountcy approach. However, the U.K. Supreme Court in an appeal in *BTI 2014 LLC v*

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[26] The number of authorities is voluminous. The following are some examples: *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 A.C.L.C. 215; *Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch), [2003] B.C.C. 885; *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* [2008] WASC 239; *Bti 2014 Llc v Sequana SA* [2016] EWHC 1686, [2017] 1 B.C.L.C. 453.

[27] Most of the cases reflect the situation where the company has been insolvent and so while it has occupied practitioners and academics at one point before insolvency was the obligation triggered it has not been a major issue in deciding cases. However, the decision of the English Court of Appeal in *BTI 2014 LLC v Sequana S.A.* [2019] EWCA Civ 119, [2019] 2 All E.R. 784, [2019] B.C.C. 631, [2019] 1 B.C.L.C. 347, did consider it, but the comments of the leading judgment (of David Richards LJ) were obiter.

[28] See, for instance, the comments of the UK Supreme Court *Sequana* [2022] UKSC 25, [2022] 3 W.L.R. 709, [2023] B.C.C. 32, [76], [138], [151], [207].

[29] For instance, see A. Keay, "The Director's Duty to Take into account the Creditors' Interests: When is it Triggered?" (2001) 25 MULR 315; R. Teele Langford and I. Ramsay, "The contours of the 'creditors' interests' duty'" (2021) 21 JCLS 85.

[30] For instance, see *Kinsela* (1986) 4 A.C.L.C. 215; *Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch), [2003] B.C.C. 885; *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* [2008] WASC 239.

[31] In *Re Termite Resources NL* [2019] FCA 354, [202]-[203], White J of the Australian Federal Court listed the various approaches.

[32] For instance, see *Re Pantone 485 Ltd* [2002] 1 B.C.L.C. 266, [69]; *Colin Gwyer v London Wharf (Limehouse) Ltd* [2002] EWHC 2748 (Ch); [2003] 2 B.C.L.C. 153, [74]; *Re Capitol Films Ltd (in administration)* [2010] EWHC 2240 (Ch); [2011] 2 B.C.L.C. 359, [49]; *Re Oxford Pharmaceuticals Ltd* [2009] EWHC 1753 (Ch); [2010] B.C.C. 838, [92]; *Roberts v Frohlich* [2011] EWHC 257 (Ch); [2012] B.C.C. 407; [2011] 2 B.C.L.C. 625, [85]; *Re HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch), [92]. This can be regarded as meaning creditors' interests are given priority over other interests: Rosemary Teele Langford and Ian Ramsay, "The contours of the 'creditors' interests' duty'' (2021) 21 JCLS 85. This appears to accord with s.172(3) (UK).

[33] [2019] EWCA Civ 119, [2019] 2 All E.R. 784, [2019] BCC 631, [2019] 1 B.C.L.C. 347.

[34] [1993] I.E.S.C. 1, [47].

Sequana S.A.S ("Sequana")[35] was not as definitive, for it said that until a company is insolvent or insolvent liquidation or administration is inevitable directors must consider the interests of shareholders as well as creditors, but even when insolvency occurs the creditors' interests will not necessarily take over but they *may* do so.[36] "Paramount" means something that is more important than anything else,[37] so we can conclude that the creditors' interests are to be seen as pre-eminent. Thus, this would suggest that directors must put the interests of creditors before any other concern or interest, including those of the shareholders. Whereas the position in Australia is that the directors must consider the interests of both shareholders and creditors, even when the company is insolvent, which is consistent with what Mason J said in *Walker v Wimborne*.[38] In, arguably, Australia's most celebrated (and certainly longest) case on the issue, *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)*,[39] Owen J rejected the notion of creditor paramountcy. His Honour thought that a creditor paramountcy rule would mean that the law would be getting dangerously close to replacing the duty to act in the interests of the company with a duty to act in the interests of the creditors.[40] More recently, the approach in *Bell Group* was followed in *Re Termite Resources NL*[41] but the judge did say that the closer a company got to insolvency the greater weight should be given to the interests of creditors.[42] The conclusion we can draw from the cases is that when insolvency occurs the interests of creditors are to be taken into account and possibly along with those of the shareholders.

Before completing this part, we need to acknowledge that a number of commentators have criticised the development of the law.[43] It is outside the ambit of the paper to engage in an analysis of the points that have been made by critics of the obligation. However, identifying them might be useful in addressing the question posed by the paper. The following arguments have been propounded against the obligation's existence, many of which have been made when considering the appropriateness of a duty owed by directors to creditors (the position in the U.S.A. at times), and which is not the situation elsewhere, but we will apply the arguments to the obligation. First, according to the Delaware Chancery Court (and some commentators[44]) there is no need to have an obligation as creditors are protected by strong covenants, liens on assets, and other negotiated contractual protections, the implied covenant of good faith and fair dealing, and the law of fraudulent conveyance.[45] Secondly, creditors could cost the risk of the company's insolvency and allow for it in the loan

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35 [2022] UKSC 25, [2022] 3 W.L.R. 709, [2023] B.C.C. 32.

36 [2022] UKSC 25, [2022] 3 W.L.R. 709, [2023] B.C.C. 32, [11], [50], [77], [164], [172], [190], [247], [290].

37 J Pearsall, *New Oxford Dictionary of English* (OUP, 2001), 1346.

38 (1976) 137 C.L.R. 1, (1976) 3 A.C.L.R. 529.

39 [2008] WASC 239, [4438]-[4439].

40 [2008] WASC 239, [4438]-[4439].

41 *Re Termite Resources NL* [2019] FCA 354.

42 *Re Termite Resources NL* [2019] FCA 354, [208].

43 For instance, see H. Hu and J. Westbrook, "Abolition of the Corporate Duty to Creditors" (2007) 107 Colum L R 1321; K. Hayne, "Directors' Duties and a Company's Creditors" (2014) 38 MULR 795, 811-812; S. Worthington, "Directors' Duties, Creditors' Rights and Shareholder Intervention" (1991) 18 MULR 121.

44 For example, S. Rousseau, "The Duties of Directors of Financially Distressed Corporations: A Quebec Perspective of the Peoples Case" (2003) 39 CBLJ 368, 382; B. Adler and M. Kahan, "The Technology of Creditor Protection" (2013) 161 U Pa L R 1773, 1775.

45 *North American Catholic Educational Programming Foundation Inc v Gheewalla*, 930 A. 2d 92, 100 (Holland J) (Del, 2007). The implied covenant of good faith and fair dealing does not apply in many jurisdictions.

agreement.[46] Thirdly, creditors could demand personal guarantees from the directors. Fourthly, a creditor has the power to petition for the company's winding up, if it is insolvent.[47] Fifthly, some courts have said that the creditors assume proprietary-like interests in the company when the company is insolvent, and it has been submitted that this is not possible.[48] Nevertheless, it is submitted that all of the protections mentioned above are, like contracts, incomplete, and may be fraught with problems.[49]

It is contended that the law is now so ingrained in the law of many legal systems that it is too late to ditch it, especially given the fact that it has been recognised by several appellate courts around the world,[50] even if its exact scope is not as clear as one might like. We also have legislation condoning the obligation in both the UK, with s.172(3) of the Companies Act 2006, and Ireland, with s.224A of the Companies Act 2014.[51] Also, as mentioned at the outset, the EU has provided in a directive that directors must have regard for the interests of creditors (and others) when their company is likely to be insolvent.

STAKEHOLDERS

Before tackling the main issue in this paper, it is necessary to provide some discussion of stakeholders and the arguments that have developed in support of their interests being considered by directors. The following discussion makes no distinction between solvent and insolvent companies, although the literature has not considered the role and rights of stakeholders in insolvent companies, at least outside of insolvency regimes such as liquidation, administration or, in the United States, Chapter 11 bankruptcy.

Companies, and particularly large companies, may have many stakeholders. Whilst there is no universally acceptable definition of a stakeholder in this context, and there has been a significant amount of debate on the subject, we can say that it is someone or some entity that has a stake in a company. They are people who contribute to the company in some way. A stake "is an asserted or real interest, claim or right, whether legal or moral, or an ownership share in an undertaking."[52] While it is possible to say that companies can have a large range of stakeholders, the most common stakeholders identified in the literature are employees, creditors, suppliers, customers, the local community and the environment.[53]

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46 Richard Posner, "The Rights of Creditors of Affiliated Corporations" (1976) 43 U Chi LR 499.

47 Insolvency Act 1986, s 122 (UK).

48 For instance, K. Hayne, "Directors' Duties and a Company's Creditors" (2014) 38 MULR 795, 811-812; S. Worthington, "Directors' Duties, Creditors' Rights and Shareholder Intervention" (1991) 18 MULR 121, 140-141.

49 For instance, obtaining a winding-up order can be very difficult in some situations.

50 For example, the UK Supreme Court in *Bilta (UK) Ltd (in liq) v Nazir (No 2)* [2015] UKSC 23, [2016] A.C. 1; [2015] 2 W.L.R. 1168 and *Sequana* [2022] UKSC 25, [2022] UKSC 25, [2022] 3 W.L.R. 709, [2023] B.C.C. 32; the High Court of Australia in *Spies v The Queen* [2000] HCA 43, (2000) 201 C.L.R. 603; the New Zealand Court of Appeal in *Nicholson v Permakraft (NZ) Ltd* (1985) 3 A.C.L.C. 453; the New South Wales Court of Appeal in *Kinsela* (1986) 4 A.C.L.C. 215, 223; (1986) 10 A.C.L.R. 395 and *Kalls Enterprises Pty Ltd (In Liquidation) v Baloglow* [2007] NSWCA 191.

51 Amended by the European Union (Preventive Restructuring) Regulations 2022 (SI 380/2022).

52 L. Ryan, "The Evolution of Stakeholder Management: Challenges and Potential Conflicts" (1990) 3 *International Journal of Value Based Management* 105, 108.

53 A. Keay, "Stakeholder Theory: Has it Got What it Takes?" (2010) 9 *Richmond Journal of Global Law and Business* 249, 257.

The championing of the notion of stakeholders having more of a say in, and receiving greater benefit from, a company has led to the development of what is known as "stakeholder theory." The theory provides that stakeholders are inherently valuable to the company and as a result they should be treated as such in the management of the affairs of the company.[54] It is a theory that is often seen as standing in opposition to shareholder primacy (also known as shareholder value) theory that holds that a company should be managed for the ultimate benefit of the shareholders of the company alone. Stakeholder theory asserts that shareholders are merely one of many competing and diverse groups that have an interest in the affairs of a company. This approach, in general terms, is founded on the notion that an inclusive approach towards all contributors is, from a social, economic and political perspective, valuable; the theory focuses on fostering the full potential of all contributors. The ideal in stakeholderism is that "all parties work together for a common goal and obtain shared benefits, 'opting in' to the business's project,"[55] and all those who contribute critical resources to the company should benefit. The essence of the theory is that companies are to be managed for the benefit of, and accountable to, all stakeholders.[56]

Stakeholder theory maintains that, as a consequence of its tenets, it is necessary for the directors of companies to balance the interests of all[57] stakeholders in coming to any decisions with the aim of making the company a place where stakeholder interests can be maximised in due course.[58] Directors are obliged to ask: what will stakeholders feel about the decision that we are contemplating? They then to consider which stakeholders warrant or require greater consideration.[59]

Like many creditors, most stakeholders are vulnerable when a company is insolvent. For instance, employees might be concerned that they will not get paid outstanding wages and leave entitlements and are probably even more concerned that they will lose their jobs, and suppliers might be concerned that they will lose a major (or even sole) customer, while customers might not be able to enforce any breaches of warranty given by the company. While creditors are primarily concerned that they get the money which they are owed (or as much as possible), the primary concern of other stakeholders is that the company will remain in business. It is possible, as with the obligation to creditors, to point to actions that stakeholders can take to protect themselves. For instance, workers can go on strike, but while this might be of some value when a company is solvent, it is not so likely to help them if the company is insolvent. In fact, such action could precipitate the (premature) closure of the business.

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[54] S. Reynolds, F. Schultz and D. Hekman, "Stakeholder Theory and Managerial Decision-Making: Constraints and Implications of Balancing Stakeholder Interests" (2006) 64 *Journal of Business Ethics* 285, 293.

[55] J. Dean, *Directing Public Companies*, (Cavendish, 2001), 94.

[56] W. Hutton, *The State We're In* (Jonathan Cape, 1995).

[57] Some might restrict it to "main" stakeholders. For example, J. Plender, "Giving People a Stake in the Future" (1998) 31 *Long Range Planning* 211, 214.

[58] R. E. Freeman and R. Phillips, "Stakeholder Theory: A Libertarian Defense" (2002) 12 *Business Ethics Quarterly* 331, 333.

[59] R. Mitchell, B. Agle and D. Wood, "Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts" (1997) 22 *Academy of Management Review* 853, 855.

While the stakeholder theory has developed rapidly as far as its influence and even, it would appear, its application is concerned,[60] and it is highly respected by many, there are a number of criticisms of the theory. In general terms the theory has been said to be "naive, superficial and unrealistic."[61] One trenchant critic has said that the theory is "deeply dangerous and wholly unjustified"[62] on the basis that it "undermines private property, denies agents' duties to principals, and destroys wealth."[63]

INTERESTS OF STAKEHOLDERS IN INSOLVENCY

Creditors are one kind of stakeholder, but what about the other stakeholders, should their interests be considered when a company is insolvent? While an obligation to take creditors' interests into account might well ensure that directors do not engage in outrageous and even unreasonable risk-taking during times of insolvency, and this also will assist in protecting other stakeholders, it is possible that there will be a divergence of interests between creditors and other stakeholders in a time of insolvency.[64] At the outset we should say that some of the arguments made against the existence of the obligation to creditors may apply to stakeholders. This is not surprising as these protections are based on contract and the arguments of contractarians that all one needs is contract. However, those views are, generally, anathema to many who argue for stakeholder rights.

As mentioned in the last section, the notion behind stakeholder theory is that stakeholder groups, as well as shareholders, have a claim on the company's property and profits as they contributed to the capital of the company;[65] like shareholders they have risked their investment in the company. The point is often made that stakeholders make firm-specific investments in the company. For instance, employees may make an investment in companies by undergoing specialised training that might not be able to be used elsewhere in other employment, and suppliers might acquire specialist machinery to enable them to supply the company with particular kinds of products, and this machinery is not able to be used on any other contracts that they hold or hope to obtain in the future.

It might be argued that stakeholders are unable to negotiate contracts, certainly on an even footing, with companies; they are often vulnerable and there is inequality of bargaining power. So, a normative foundation for providing protection for stakeholders in insolvency is that it makes sure that their legitimate expectations, and particularly those that are beyond

60 P. Ireland, "Corporate Governance, Stakeholding, and the Company: Towards a Less Degenerate Capitalism" (1996) 23 *Journal of Law and Society* 287, 296.

61 C. Stoney and D. Winstanley, "Stakeholder Confusion or Utopia? Mapping the Conceptual Terrain" (2001) 38 *Journal of Management Studies* 600, 606.

62 E. Sternberg, "The Defects of Stakeholder Theory" (1997) 5 *Corporate Governance: An International Review* 3, 6.

63 E. Sternberg, "The Defects of Stakeholder Theory" (1997) 5 *Corporate Governance: An International Review* 3, 9.

64 D. Skeel, "Creditors' Ball: The 'New' New Corporate Governance in Chapter 11" (2003) 152 U Pa L Rev 917, 923; J. Ellias and R. Stark, "Bankruptcy Hardball" (2020) 108 *California Law Review* 745, 748,

65 R. Karmel, "Implications of the Stakeholder Model" (1993) 61 *George Washington Law Review* 1156, 1171.

the terms of any contract, are fulfilled.[66] When stakeholders get involved with a company then it might be argued that the directors impliedly promise to consider the interests of the stakeholders.

It has been asserted that: "[T]he economic and social purpose of the corporation is to create and distribute wealth and value to all its primary stakeholder groups, without favoring one group at the expense of others."[67] This comment is usually directed at challenging shareholder value/primacy theory, but it could be equally directed at creditors' interests attracting paramountcy of attention when a company is insolvent. Donaldson and Preston have said that "each group of stakeholders merits consideration for its own sake and not merely because of its ability to further the interests of some group, such as shareowners."[68]

Requiring directors to focus on creditor interests, to the exclusion of others, is contrary to stakeholder theory which posits the equality of all stakeholders in that they all have intrinsic value, and all are entitled morally to be considered in the management of the company's affairs and to be considered concurrently.[69]

There are some indications that stakeholders might have a case. In the New Zealand Court of Appeal decision in *Nicholson v Permakraft (NZ) Ltd*[70] Cooke J said that: "The duties of directors are owed to the company. On the facts of particular cases this may require the directors to consider *inter alia* the interests of creditors."[71] (my emphasis) This indicates that there were interests other than the creditors which might be taken into account. Now his Honour might have been thinking of shareholders, but he does not say this explicitly. However, as the judge did not elaborate on what he meant, it does not provide a strong argument that the judge was contemplating stakeholders other than creditors. In an English decision, *Re Welfab Engineers Ltd,*[72] and discussed in detail shortly, the judge seemed to enable directors in an insolvency situation to consider the interests of other stakeholders provided that they did not prejudice the interests of the creditors. As far back as 1991 Grantham implied the need to consider the interests of stakeholders other than creditors in some situations.[73] He said that the interests of the ones who have the residual interest, the creditors in insolvency, will be dominant but we must admit "the possibility that in some circumstances the combined weight of other interested groups may prevail."[74]

One leading argument in favour of stakeholders' interests in general being taken into account by directors is based on fairness, which is at the heart of stakeholder theory.

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66 W. Leung, "The Inadequacy of Shareholder Primacy: A Proposed Corporate Regime that Recognizes Non-Shareholder Interests" (1997) 30 *Columbia Journal of Law and Social Problems* 589, 622. Also, see David Wishart, "Models and Theories of Directors' Duties to Creditors" (1991) 14 NZULR 323, 354.

67 M. Clarkson, "A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance" (1995) 20 *Academy Management Review* 92, 112

68 T. Donaldson and L. Preston, "The Stakeholder Theory for the Corporation: Concepts, Evidence, Implications" (1995) 20 *Academy Management Review* 65, 67.

69 R. Mitchell, "Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts" (1997) 22 *Academy Management Review* 853, 862.

70 [1985] 1 N.Z.L.R. 242.

71 [1985] 1 N.Z.L.R. 242, 249

72 [1990] B.C.C. 600.

73 R. Grantham, "The Judicial Extension of Directors' Duties to Creditors" [1991] JBL 1.

74 R. Grantham, "The Judicial Extension of Directors' Duties to Creditors" [1991] JBL 1, 14.

Certainly, this might be seen as one of the rationales lying behind the judicial acceptance of the fact that the obligation is designed to protect creditors.[75] The undoubted problem with fairness is that it can be a slippery concept, and it is incapable of precise definition.[76] Nevertheless, the courts have accepted fairness as underlying several concepts and principles in law. For instance, the courts have said that fairness is at the essence of the rule in Ex parte James,[77] which is a rule that requires officeholders of insolvent estates, because they are officers of the court, to act honourably and fairly.

It might be argued that fairness in the context of the paper could involve the concept of reasonable and legitimate expectations,[78] which is, in essence, a contract-based idea, the object of which is to fill in the gaps in a contractual relationship. It involves asking what reasonable parties would have wanted to have included in their contract had they thought about the issue.[79] It has been argued that it is fair that a creditor's reasonable expectations at the time of extending credit are fulfilled.[80] It would be reasonable and legitimate for creditors to expect directors not to do some things, such as transferring assets at an undervalue, and to do other things, such as taking creditor interests into account at a time when the company is in financial distress because if the actions of the directors do not do so it is likely that the creditors will be prejudiced.[81] If these expectations are not fulfilled, then creditors can reasonably expect that directors would be held responsible.[82] This chimes with the comments in a leading text on company directors[83] which say that doing something that may adversely affect the payment of creditors prejudices the creditors' expectation to be paid in full. This statement was approved of in a Scottish case involving a claim that directors had failed to consider creditors' interest and were in breach of s.172(3) of the UK's Companies Act 2006, *Joint Liquidators of CS Properties (Sales) Ltd,*[84] and it has been put forward as a policy in Canada underpinning the duty to consider the interests of creditors in light of the Canadian Supreme Court's decision in *People's Department Store Inc v Wise*.[85] It also accords with what Sealy said:

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75 For instance, see *Joint Liquidators of CS Properties (Sales) Ltd* [2018] CSOH 24, [154] and referring to S. Mortimore (ed), *Company Directors: Duties, Liabilities and Remedies* (3rd ed, OUP, 2017).

76 L. Mitchell, "Fairness and Trust in Corporate Law" (1993) 43 *Duke Law Journal* 425, 451.

77 For instance, see *Re Clark* [1975] 1 W.L.R. 559, 563; *Re Mark One (Oxford Street) plc* 2000] 1 B.C.L.C. 462; *Lomas v Burlington Loan Management Ltd* [2015] EWHC 2270 (Ch), [2015] B.P.I.R. 1162, [180].

78 It is a concept that is regularly considered in cases brought under oppression provisions, such as s 994 of the Companies Act 2006 (UK) and s.232 of the Corporations Act (Aust), claiming that a company's affairs have been conducted in an unfairly prejudicial or oppressive way.

79 L. Mitchell, "The Fairness Rights of Bondholders" (1990) 65 *New York University Law Review* 1165, 1225.

80 A. Keay, "Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors" (2003) 66 MLR 665, 679-680.

81 A. Keay, "Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors" (2003) 66 MLR 665, 679.

82 A. Keay, "Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors" (2003) 66 MLR 665, 680.

83 S. Mortimore (ed), *Company Directors: Duties, Liabilities and Remedies* (3rd ed, OUP, 2017).

84 [2018] CSOH 24, [154].

85 [2004] SCC 68, (2004) 244 DLR (4th) 564. See, B. Morgan and H. Underwood, "Directors' Liability to Creditors on a Corporation's Insolvency in Light of the Dylex and Peoples Department Stores Litigation" (2004) 39 CBLJ 336, 338.

> What the law has to ensure is that the risks which that company elects to embrace fall within the range of legitimate business risks, consistently with the expectations of all those interests are at stake, creditors and members alike.[86]

It might be argued that other stakeholders also have certain reasonable expectations when becoming involved with the company. These expectations are likely to differ depending on the relevant stakeholder.

A second aspect of fairness is that many stakeholders are not able to obtain protection for a number of reasons, such as lack of bargaining power, ignorance or insufficient funds to pay necessary costs (e.g. legal costs). Infrequently contractual arrangements are entered into between parties of equal strength. Several scholars have reported from their research that contracts involving stakeholders are not complete and not perfectly priced.[87] A reason given for consideration of creditor interests is that "that the level of risk upon which credit was calculated and extended by creditors has changed"[88] and some stakeholders could argue something similar in relation to their position. For example, workers accept posts in the company on the basis that the company was going to continue to trade responsibly. Also, many stakeholders will not have express, or any, contractual arrangements with the company. Thus, they are unable to rely on contractual terms.

In jurisdictions which require directors to take stakeholder interests into account when their company is solvent why should not this be the case when the company is insolvent? For instance, in the UK, while s.172(1) of the Companies Act 2006 provides that the directors must promote the interests of the company for the benefit of the company, they must also consider the interests of a broad range of stakeholders, set out in s 172(1)(a)-(f), however, on insolvency, according to s.172(3) the s.172(1) duty is subject to the obligation that provides that creditor interests have to be taken into account and no mention is made of other stakeholders. This appears to suggest that the directors no longer have to consider the interests of other stakeholders, and thus stakeholders are worse off in insolvency. If this is the case, then we might be seeing the virtual replacement of shareholder primacy/value that applies in solvency with creditor primacy/value in insolvency.

Are the interests of creditors subject to greater threat than the interests of other stakeholders and, therefore deserving of more/specific protection? The answer is that it will depend. Certainly, the present obligation is likely to provide stakeholders other than creditors more protection than they would have if the obligation did not exist. The obligation is likely to contribute to: controlling "asset siphoning and preferential payments to insider (owner-manager) creditors in closely held firms";[89] creating "appropriate

86 L. S. Sealy, "Directors' 'Wider Responsibilities' – Problems Conceptual, Practical and Procedural" (1989) 15 *Monash University Law Review* 164, 181

87 J. Fisch, "Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy" (2006) 31 J Corp L 637.

88 A. Keay, "The Shifting of Directors' Duties in the Vicinity of Insolvency" (2015) 24 *International Insolvency Review* 140, 145.

89 K. van Zwieten, "Director Liability in Insolvency and Its Vicinity" (2018) 38 OJLS 382, 390, note 50, citing P. Davies, "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency" (2006) 7 *EBOR* 301, 303, and T. Bachner, *Creditor Protection*, (CUP, 2009), 22.

incentives for early action through the use of restructuring negotiations or reorganization";[90] better monitoring of companies' financial health.[91] Besides benefiting creditors, it could also indirectly protect other stakeholders and perhaps provide compensation for the ex ante vulnerability of such stakeholders. However, there will be some actions taken to benefit creditors that might not benefit other stakeholders. It is likely that there will be divergence between interests in some situations. It might, for example, benefit creditors (and other stakeholders) if the company made some workers redundant as there will be a cost saving. Clearly, this is not in the interests of those workers and the local community.

It might be argued that it is unfair for creditors to be the focus of the obligation as some of those who might benefit from it have already been able to protect themselves by contract,[92] whereas many stakeholders are unable to do so. Of course, it must not be forgotten that some stakeholders to whom this part has made reference will also be creditors. For instance, employees will be owed outstanding pay and leave entitlements and some customers may have paid deposits to companies for goods that are in the process of being manufactured or obtained.

One case that might provide us with an instance of directors taking into account the interests of stakeholders is the decision of Hoffmann J in *Re Welfab Engineers Ltd,*[93] which was mentioned earlier. In this case the directors of a company that might well have been insolvent - it certainly was close to insolvency if not technically insolvent - were seeking to sell the company's business. Their aim was to ensure that it continued, and the jobs of the workforce were retained. The directors offered for sale the company's freehold premises, equipment and work in progress ("the business"). The directors never really considered the possibility of any sale which would not either allow the company to continue in business or involve the sale of the business as a going concern. The directors declined an offer for the business in the sum of £125,000 and instead accepted an offer for £110,000. There were some suggestions that if the business had been marketed properly then a sale price of nearer £145,000 might have been possible but the judge did not think more than £125,000 was obtainable. The directors accepted the offer of £110,000 because the purchaser agreed to maintain the business as a going concern and to keep all the workers, including the directors, in their jobs. The company entered liquidation and the liquidator sued the directors on the basis that the business was sold at an undervalue and consequently the directors breached their fiduciary duties. Importantly the liquidators argued that the directors should have realised the company's assets to the best advantage of creditors, and they did not.[94] The liquidators' case was that the directors acted improperly because they gave priority to the preservation of the business and the jobs of the employees, including themselves over and above the interests of the creditors.

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90 UNCITRAL Legislative Guide, para 7.

91 A. Keay, "Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors" (2003) 66 MLR 665, 686.

92 H. Anderson, "Creditors' Rights of Recovery: Economic Theory, Corporate Jurisprudence and the Role of Fairness" (2006) 30 MULR 1.

93 [1990] B.C.C. 600.

94 [1990] B.C.C. 600, 604.

Hoffmann J ruled against the liquidators. He did so on the basis that the difference between the offers of £125,000 and £110,000 might well have not been £15,000 as the deals were subject to imponderables. The judge believed that the directors made an honest attempt at selling the business and this, together with the background pressures on them, meant that they were not in breach. While the decision seems to support the view that directors should take a wide view of the interests involved in the company, Hoffmann J did say that: "Of course the directors are not entitled to sell the business to save their jobs and those of other employees on terms which would clearly leave the creditors in a worse position than on a liquidation."[95] We might draw from this that stakeholder interests might be taken into account by directors, but they must not trump those of the creditors. Thus, it is difficult to read the case as supporting the notion that all stakeholder interests should always be considered by the directors.

Although not developed in any way, Lady Arden JSC said recently in *Sequana*[96] interests in a company are not limited to shareholders and creditors and this becomes relevant once the creditors' interests cease to be aligned with those of shareholders. However, the majority of the judges opined that while creditors cannot be said to obtain a proprietary interest in the company when it is insolvent, they do assume an economic interest in the company. Can the same view be applied to other stakeholders? Well, "yes" and "no." it might be argued, for instance, that those workers who have taken time to obtain qualifications and/or experience that relates peculiarly to the company's business and those suppliers who have set up their business in a particular way in order to supply the company (which is their only or primary customer) with goods do assume an economic interest in the company, but other stakeholders might not be able to make such claims.

There appears to exist arguments in favour of directors having to take stakeholders other than creditors into account in insolvency, but, as many ask as far as stakeholder theory is concerned, is it workable?

THE PROBLEMS WITH REQUIRING CONSIDERATION OF STAKEHOLDERS

Just as there is when a company is solvent, there is a lot to be said for requiring consideration of all stakeholder interests when a company is insolvent. Nevertheless, there are, it is submitted, major problems with requiring directors to have to take account of all stakeholder interests when their company is insolvent.

Identifying Stakeholders

The first, and this is one that is common with solvent companies, is: determining who is a stakeholder. There were 28 different definitions of "stakeholder" proposed between 1963 and 1995,[97] and some commentators have divided stakeholders into categories to try and make stakeholder theory more workable, yet no definition has received wide acclaim. Perhaps the most popular definition was that provided by R. Edward Freeman: parties who

95 [1990] B.C.C. 600.
96 [2022] UKSC 25, [293].
97 R. Mitchell, B. Agle and D. Wood, "Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts" (1997) 22 *Academy of Management Review* 853, 855.

can affect or are affected by a company's decisions.[98] However, this is very broad and may be seen as vague. Therefore, if directors must consider the interests of all stakeholders, it is not clear on whom the directors are to focus.

The Balancing Issue

The second problem is how will directors act if they have to take all stakeholder interests into account when exercising their duties? Stakeholder theorists assert that directors should balance the various interests; balancing is a critical aspect of the theory. Superficially balancing is an attractive way to proceed as it suggests rational, fair and careful thinking while considering the interests of several stakeholders. Nevertheless, stakeholder management involves, in the words of adherents to the theory, "a neverending task of balancing and integrating multiple relationships and multiple objectives,"[99] which suggests that it is never possible to achieve a result. Thus, the primary argument that is mounted against the stakeholder approach is that the requirement that directors have to balance the interests of all stakeholders means they are faced with an impossible task.[100]

There are several problems with balancing. First, and this repeats the issue raised in the last section: how do directors ascertain who are stakeholders to be considered in a fair balancing of interests and claims? Secondly, how do directors determine how they are to address the needs of divergent groups of stakeholders.[101] How can directors know what stakeholders consider as a benefit or what they see as within their interests?[102] Admittedly under the present law, directors will have to balance the interests of different creditors, but if one admits to consideration all stakeholders the difficulty that the directors have is multiplied.

A third issue is: what does balancing actually entail? Does it mean embracing compromise or taking such action that enables the interests of stakeholders to coincide?[103] The former might not be acceptable to many stakeholders, and might leave some disenchanted, and the latter does not, for the most part, appear to be possible. Fourthly, and related to the last point is that it is difficult for directors to know what is the basis on which they are to balance interests. It is not possible to provide directors with any specific guidance in conducting a balance, and how the various interests are to inform their decision-making.[104] There are no standards devised for assigning relative weight to the interests of the stakeholders involved and no criteria for solving problems.[105] The upshot is that directors are presented with

98 R. E. Freeman, *Strategic Management: A Stakeholder Approach,* (Pitman/Ballinger, 1984), 97.

99 R. E. Freeman and J. McVea, "A stakeholder approach to strategic management" in M. Hitt, R. E. Freeman and J. Harrison (eds), *Handbook of Strategic Management*, (Blackwell Publishing, 2001), 194.

100 The difficulty of doing so is demonstrated in B. Shenfield, *Company Boards*, (George Allen and Unwin, 1971), Chapter 7.

101 W. Leung, "The Inadequacy of Shareholder Primacy: A Proposed Corporate Regime that Recognizes Non-Shareholder Interests" (1997) 30 *Columbia Journal of Law and Social Problems* 589, 621.

102 E. Sternberg, "The Defects of Stakeholder Theory" (1997) 5 *Corporate Governance: An International Review* 3, 4.

103 B. Shenfield, *Company Boards*, (George Allen and Unwin, 1971), 149.

104 A. Sundram, and A. Inkpen, "The Corporate Objective Revisited" 15 *Organization Science* 350, 353; M. Jensen, "Value Maximisation, Stakeholder Theory, and the Corporate Objective Function" (2001) 7 *European Financial Management* 297, 305.

105 T. Donaldson, *The Ethics of International Business* (OUP, 1989), 45.

"standardless discretion."[106] Balancing is made difficult by the fact that stakeholders will usually have conflicting claims, and each one will be subject to the opportunistic actions of other stakeholders.[107] This complicates any balancing that is undertaken. A vague requirement that the expectations of stakeholders are to be taken into account does not provide any guidance whatsoever but leaves the directors none the wiser and perhaps even confused.[108] Even with the best will in the world and acting in good faith, it would be very difficult for directors to know what the best interests of individual stakeholders are. This is exacerbated by the fact that stakeholders in a company will be continually changing, and the expectations of existing ones could be revised. The concern is that confronted with all of this, decision-making could be paralysed at a critical time in the life of the company. For instance, what if a course of action will benefit A, B and C, but not D and E? Another equally efficient course of action will benefit constituencies A, D and E, but not B and C. What do the directors do? How do the directors decide which of the two actions should be taken?[109]

A response to this could be that directors are professionals who are accustomed to balancing issues. Arguably, this has to be done when a company is solvent. For example, s.172(1) of the Act demands that stakeholders' interests must be considered by directors in exercising their duty under this provision and in doing so there is some evidence that directors have to balance the interests of the relevant stakeholders.[110] Nevertheless, it still does not seem to make a director's task easier.

The Lack of Enforceable Accountability

Embracing the inclusion of stakeholders other than creditors within the obligation would run into the "too many masters problem." This provides (in the context of a company) that where a director is required to serve and consider the interests of many parties, it enables the director to engage in self-dealing or shirking because he or she is not really accountable to anyone. Any action which the director takes can be excused by the director on the basis that what the director was doing was to benefit a particular stakeholder as the director felt that that was the most appropriate course of action to take.[111] The problem is that, "[a]dvocates of traditional stakeholder theory...hand managers [directors] a theory that makes purposeful decisions impossible. And, with no way to keep score, stakeholder theory forces managers to be unaccountable for the very actions through which they were to be

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106 L. Mitchell, "A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes" (1992) 70 Texas LR 579, 589

107 M. Blair and L. Stout in "A Team Production Theory of Corporate Law" (1999) 85 Va L R 247, 276-287.

108 M. Jensen, "Value Maximisation, Stakeholder Theory, and the Corporate Objective Function" (2001) 7 *European Financial Management* 297, 301. Judges who have to consider this issue in relation to claims made that a company's affairs have been conducted oppressively or in an unfairly prejudicial manner (in, for example, the UK (s.994 of the Companies Act 2006); Canada (s.241 of the Canada Business Corporations Act 1985); Australia (s.232 of the Corporations Act 2001) often find it onerous.

109 Based on an example in Andrew Keay, "Stakeholder Theory: Has it Got What it Takes?" (2010) 9 *Richmond Journal of Global Law and Business* 249, 298-299.

110 See *Re Phoenix Contracts (Leicester) Ltd (sub nom: Shepherd v Phoenix Contracts (Leicester) Ltd*) [2010] EWHC 2375 (Ch), [103].

111 See, F. Easterbrook and D. Fischel, *The Economic Structure of Company Law* (Harvard University Press, 1991), 38

evaluated."[112] It is likely that, "[a]ll but the most egregious self-serving managerial behaviour will doubtless serve the interests of *some* stakeholder(s) and work against the interests of others,"[113] and hence they can mount a credible defence in relation to what they have done.

Parkinson recognised the enforcement problem when he said that placing a duty on directors to balance conflicting interests would:

> [P]resent the courts with a near-impossible task...not only would the court need to assess the likely impact on each group of a contested business policy, in both the short and the long term, but also it would have to evaluate the policy in accordance with a theory which stipulated when one set of interests should prevail over the others.[114]

Directors would be able to assert that following balancing, they made a decision to benefit stakeholders X and Y, and the fact that this decision just happened to benefit or protect themselves was coincidental, and it is difficult to challenge what the directors decided to do.[115]

There might be three possible ripostes from the adherents of stakeholder theory. First, the view expressed in the last paragraph is a cynical way of viewing things and that directors as professionals will be concerned to retain their reputation and integrity and will refrain from acting opportunistically or engaging in shirking. Stakeholderism holds that we have to rely upon the trustworthiness of the directors. Blair and Stout, amongst others, point out there is ample evidence from behavioural theory of people acting altruistically and sacrificing selfish interests to achieve a result that benefits others, and this is consistent with ethical behaviour.[116] The problem with this point is that while it may apply to directors of medium to large companies, that may not necessarily be the case with small companies and particularly those which are owner/managed. The jurisprudence provides many instances of directors of small private companies who have acted opportunistically during a period of insolvency.[117]

The second riposte might be that a judge should be able, if the evidence is clear and solid, to determine what directors were really doing. Although it is clear that it is the subjective view

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112 L. Donaldson, "The stakeholder revolution and the Clarkson principles" (2002) 12 *Business Ethics Quarterly* 107 and quoted in F. Robins, "Why corporate social responsibility should be popularised but not imposed" (2007) 8 *Corporate Governance* 330, 333.

113 A. M. Marcoux, "Balancing Act" in J. DesJardins and J. McCall (eds) *Contemporary Issues in Business Ethics*, (4th ed, Wadsworth, 2000), 97.

114 *Corporate Power and Responsibility* (Clarendon Press, 1993), 86.

115 A. Keay, "Stakeholder Theory: Has it Got What it Takes?" (2010) 9 *Richmond Journal of Global Law and Business* 249, 284

116 M. Blair and L. Stout, "Director Accountability and the Mediating Role of the Corporate Board" (2001) 79 Wash U L Q 403.

117 For example, see *Kinsela* (1986) 4 A.C.L.C. 215, 223, (1986) 10 A.C.L.R. 395; *Liquidator of West Mercia Safetywear v Dodd* (1988) 4 B.C.C. 30; *GHLM Trading Ltd v Maroo* [2012] EWHC 61 (Ch); *Re HLC Environmental Projects Ltd (in liq)* [2013] EWHC 2876 (Ch); *Ball v Hughes* [2017] EWHC 3228 (Ch); *Joint Liquidators of CS Properties (Sales) Ltd* [2018] CSOH 24.

of the directors that is critical in determining whether or not they have in fact breached their duty to act in good faith in the best interests of the company, case law indicates that judges do not have to accept a director's assertion provided in evidence that he or she acted in good faith in the best interests of the company, and in light of the circumstances surrounding the alleged breach, it is permissible for a judge not to believe directors when they state that they were acting in good faith for the benefit of the company.[118]

Thirdly, balancing is part and parcel of being a director. Some management specialists have even said that managing competing interests is a primary function of management,[119] and the balancing of diverse interests might be said to be within directors' abilities.[120] It has been contended that it is not unmanageable or unreasonable for persons occupying positions like directors, to make allocative decisions. Yet this, again, probably applies only to professional directors of large companies, which are only a small portion of companies.

The Enforcement Issue

Introduction

The fourth, and perhaps the primary hurdle, certainly from a legal perspective, for those advocating a wider obligation is that such a wider obligation could not be enforced under present law. There is no avenue in place which permits stakeholders to bring legal proceedings against the directors who are in breach so that there would have to be a change of law. In fact, even creditors have no power to bring proceedings against miscreant directors as the obligation is an element of a duty which is owed to the company. Only the company may bring proceedings. Nearly all actions that have been initiated for breach have seen the liquidator of the company bring the proceedings on behalf of the company.

Most legal systems allow shareholders to bring derivative proceedings on behalf of the company against directors when the directors are in breach[121] but, in general, there is no power vested in any other stakeholders to bring such proceedings. There are limited exceptions. For instance, in South Africa a registered trade union that represents employees of a company may bring derivative proceedings.[122] Other jurisdictions have legislation giving courts wide discretionary power as to who may bring proceedings. Section 238(d) of the Canada Business Corporations Act 1985 includes amongst those who may make applications, "any other person who, in the discretion of a court, is a proper person to make

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118 See, for example, *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch. 62, [1969] 3 All E.R. 1185; *Extrasure Travel Insurance Ltd v Scattergood* [2003] 1 B.C.L.C. 598; *Breitenfeld UK Ltd v Harrison* [2015] EWHC 399 (Ch).

119 H. Ansoff, *Implanting Strategic Management* (Prentice-Hall, 1984) and referred to in J. Harrison and R. E. Freeman, "Stakeholders, Social Responsibility and Performance: Empirical Evidence and Theoretical Perspectives" (1999) 42 *Academy of Management Journal* 479, 479. Management commentators have asserted that directors are in effect to act as referees between two stakeholder groups (M. Aoki, *The Co-operative Game Theory of the Firm* (Oxford, 1984).

120 UK Department of Trade and Industry Report *Company Law Reform*, 1973 Cmnd 5391, [55]-[59]; *Unocal Corporation v Mesa Petroleum Corporation* 493 A. 2d 946 (Del, 1985).

121 For instance, see Companies Act 2006, s.261; Corporations Act 2001 (Aust), s.236, Companies Act 2008 (South Africa), s.165.

122 Companies Act 2008, s.165(2)(c) (South Africa).

an application." In a similar vein, s 216A(1)(c) of the Singaporean Companies Act provides that the range of persons who can apply for a derivative action includes "any other person who, in the discretion of the Court, is a proper person." In Canada it must be demonstrated that the applicant has a legitimate interest in the manner in which the company is being run or has a direct financial interest in how directors are managing the company's affairs.[123] Potentially a provision of the ilk of the Singaporean or Canadian provisions would allow a wide range of persons to initiate actions.

Options

To introduce a power into legislation to permit stakeholders to bring derivative actions in relation to solvent companies might be very difficult, especially given the fact that most jurisdictions which have provided for a creditor focus during a period of insolvency, remain shareholder-centred and suspicious of granting stakeholders power. Having said that, legislation dealing with companies that are insolvent might be more likely than where a company is solvent, given the fact that there is a shift from shareholders to creditors in insolvency. There appear to be three avenues that might be followed.

Initiating Derivative Proceedings

The first option that might be embraced is that legislation could permit a wide range of people to bring derivative proceedings. In the light of the difficulty of identifying those who are stakeholders, it would not be easy if the legislation merely referred to "stakeholder." Another way to proceed is to include in legislation that specific and primary stakeholders, like employees, have the right to instigate derivative action. The downside with this is, arguably, that it discriminates against stakeholders who are not included. A further approach is to provide that a court, in its unfettered discretion, may grant leave to a person who it believes is an appropriate person, to bring proceedings. For instance, the South African Companies Act 2008 provides that leave may be granted by a court where it is satisfied that it is necessary or expedient to grant leave in order to protect a legal right of that person.[124] The Canadian and Singaporean provisions, mentioned above, are also representative of this approach.

An advantage of introducing this process for a broader class of stakeholder is that there would be more potential claimants instituting a derivative action if directors breach their obligation to stakeholders. It is possible that some stakeholders will have either more resources or more information than other shareholders. Stakeholders might also form a loose coalition to bring proceedings.

Whichever of the avenues were embraced it is probable that the legislature would provide that the leave of the court would have to be obtained in order either to continue derivative proceedings or initiate such proceedings, which is the extant position in many

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123 *Hordo*; *Jacobs Farms Ltd v Jacobs* [1992] OJ No 813, 12-14, and referred to by J. Sarra, "Taking the Corporation Past the 'Plimsoll Line' – Director and Officer Liability When the Corporations Founders" (2001) 10 *International Insolvency Review* 229, 240.

124 Section 165(2)(d) (South Africa).

jurisdictions.[125] To obtain such leave the applicant would have to establish that the company was insolvent.

It must not be forgotten that even if a derivative action could be instituted by a stakeholder in insolvency, any award of damages for breach would not go to the stakeholder bringing proceedings or the whole group of stakeholders; it would be paid to the company. This might benefit the stakeholders indirectly, for instance either it could prevent directors denuding the company of assets and hastening its demise or see an inflow of cash (a damages award) which enables the company to extricate itself from its insolvent position, but it might not provide any assistance at all. Of course, it might not be possible to establish any loss in an action against the directors and even if it could, the directors might well be impecunious.

Oppression Proceedings

Another option might be to state in legislation that stakeholders, like shareholders, may bring proceedings for oppression[126] or, as it is referred to in some jurisdictions like the UK, unfairly prejudicial conduct.[127] That is, the affairs of the company have been conducted in a manner that has oppressed or is oppressing the applicant. If this were done the avenues that are likely to be available mirror those discussed above in relation to derivative proceedings. The Canada Business Corporations Act 1985 has a provision which permits a court to grant relief in an oppression action to a wider range of people than shareholders. It is provided in s.241(2) that the range included are creditors, security holders, directors and officers. This is not, however, as broad a range of people as stakeholder theorists would like to see. The problem is, as discussed above in relation to derivative actions, it is difficult to draft a wider provision unless it is one that is similar to the third possibility considered in relation to derivative actions, that is the court is given power to give leave to a party whom it believes is an appropriate person to bring proceedings. This would mean that the court would act as a filter to ensure that anyone who wishes to commence proceedings has a chance of establishing oppression. The concern with this kind of provision is that stakeholders will have little idea of knowing whether they would have a chance of obtaining leave.

With the oppression action option there are two concerns. First, it is going to be frequently the case that it will not be easy to assess if the interests of any claimant stakeholder have been prejudiced, and even then, it may well be difficult to quantify the extent of the loss. Secondly, a legislature might be hesitant to enact a provision as an award of damages would be paid to the claimant and that could mean that other stakeholders would be prejudiced as the miscreant director would have no, or at least fewer, funds to pay any other disgruntled stakeholders as well as paying out creditors.

Further Concerns with the Options

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125 For instance, in England and Wales and Northern Ireland leave must be secured to be able to continue derivative proceedings already commenced (Companies Act 2006, s.261) whereas in Scotland leave of the court must be obtained in order to initiate proceedings (Companies Act 2006, s.266).

126 For instance, Corporations Act 2001, s.232 (Australia); Companies Act 2008 (South Africa), s.163.

127 Companies Act 2006, s.994 (UK).

There are two further issues with either of the options that need to be identified. First, any application would have to be heard speedily if it is likely to be of any benefit as things can happen quickly when a company is insolvent. This involves creating court time and that is never an easy thing to do. Secondly, the kinds of proceedings discussed above could be cumbersome and certainly relatively expensive in terms of legal costs.

CONCLUSION

It is well-established in many common law jurisdictions that directors are required to consider the interests of the creditors of their companies when insolvency occurs. This paper has explored whether this obligation imposed on directors could be extended to all the stakeholders of a company.

There are some significant arguments to support the argument that the interests of all stakeholders should have to be considered by directors when their company is insolvent. Instances of such arguments considered in the paper are, first, why should creditors benefit at the potential expense of other stakeholders. Secondly, there is a normative case for stakeholders being included based on fairness, that is, it is unfair that the interests of non-creditor stakeholders should be excluded when directors are making decisions.

However, it is contended in the paper that just as there are some notable difficulties in implementing stakeholder theory in the law, namely ensuring that directors have consideration for the interests of all stakeholders, when companies are solvent, there are many problems in implementing such an approach in relation of insolvent companies. In relation to this latter respect, the problems, identified and discussed in this paper, are: it is difficult to identify who are stakeholders and consequently whose interests directors need to take into account; the interests of stakeholders diverge and thus it is not easy for directors to balance divergent interests of stakeholders, particularly when a company is insolvent; directors would not be able to be held to account for what they had done or not done because they would be able, in many situations, to submit that their actions did take account of all interests and it would be difficult to evaluate this assertion given the breadth of stakeholders involved, and this is especially the case when directors engage in carefully covering their tracks; whilst not impossible, it would be very difficult to implement inclusion of a provision in law which enabled stakeholders to enforce breaches of the obligation by directors. The last point was explained in detail, and it was contended that there are inherent problems in stakeholders being given the power either to initiate derivative proceedings or oppression-type proceedings against directors of the company.

Finally, even if it were possible to implement in law stakeholder rights when a company is insolvent, it might well be of limited assistance to individual stakeholders or stakeholders as a whole because: stakeholders might not know about a company's insolvent or what the directors are aiming to do before they are able to initiate proceedings; the initiation of derivative or oppression proceedings could be expensive; and the benefits would flow to the company as an entity. Like the implementation of stakeholder theory in company law generally, the requirement of directors having to consider the interests of all stakeholders in insolvency might be seen as impracticable.