Chapter 5 – Directors

Ethos plc is a major, international graphic design company. One of Ethos’ directors, Mike, is in extreme financial difficulty and is close to having to declare himself bankrupt (which would make him ineligible to act as a director of Ethos). Accordingly, to prevent this, the other directors of Ethos cause the company to lend Mike £15,000. The transaction is disclosed at a meeting of the directors and the directors unanimously agree to authorize the loan. Mike was present at this meeting, but did not vote on whether the loan should be made.

Ethos’ Articles of Association state that ‘Ethos plc may engage in any activity directly related, or incidental to, the carrying on of a graphic design business.’ The directors of Ethos cause the company to lend £5,000 to Ceri, who will then pay off the loan over a two-year period. Ceri is a major client of Ethos, but aside from this, she has no other links with the company or its directors. A number of Ethos’ members hear of the loan and argue that Ceri must repay the money immediately.

The board of Ethos discover that Asset Strip plc is considering a takeover bid of Ethos. Asset Strip plans to break up the various parts of Ethos and sell them off individually and to remove the company’s directors. Ethos is making a considerable profit and the directors genuinely believe that it would not be in the interests of the company or its members for Ethos to be taken over by Asset Strip. Accordingly, the directors cause the company to issue new shares to Sylvia - an existing member who is known to oppose the takeover - with the aim of preventing the takeover from succeeding.

Discuss whether or not Ethos or any of its directors have breached the law.

Introduction

- This problem question requires you to discuss the law relating to directors’ duties, with a strong focus on those transactions involving the company/directors that require shareholder approval. There are three principal issues to discuss:
  1. The validity of the £15,000 loan made to Mike by Ethos
  2. The validity of the £5,000 loan made to Ceri by Ethos
  3. Ethos’ response to the potential takeover bid.

£15,000 loan made to Mike

- The first issue to discuss is the £15,000 loan that Ethos has made to Mike. Initially, this appears to be a case involving the duty to declare an interest in a proposed transaction or arrangement, but recourse to this duty alone will not provide an accurate answer.
The CA 2006, s 177(1) provides that the duty to declare an interest in a proposed transaction or arrangement is not breached where the director discloses his interest to the company before the transaction is entered into. Under the 2006 Act, disclosure to the directors will suffice (although the company’s articles can require more exacting disclosure requirements). Accordingly, the board of Ethos has not breached this duty.

However, more exacting rules apply in relation to loans, quasi-loans and credit transactions. Where a company enters into such a transaction with one of its directors, mere disclosure is not enough. The CA 2006, s 197(1) provides that the company can only enter into such a transaction with a director if it first obtains approval from the general meeting via the passing of an ordinary resolution. The directors of Ethos have not obtained the approval of the general meeting. Accordingly, the directors have breached s 197(1). Two consequences follow:

1. the transaction is voidable at the Ethos’ instance.
2. irrespective of whether Ethos avoids the transaction, Mike will be liable to account to Ethos for any gains made, and is also liable to indemnify Ethos for any losses sustained, as a result of the loan.

£5,000 loan made to Ceri

The second issue to discuss is the £5,000 loan made to Ceri by Ethos. At first glance, it would appear that this situation involves a discussion of the duty to avoid a conflict of interest, or the duty to declare an interest in a proposed transaction. However, this is not the case, as the question makes clear that Ceri has no links with the company or its directors. Accordingly, no conflict exists.

You may think that the question concerns the rules relating to loans, quasi-loans and other credit transactions. However, those rules only apply to situations where the company makes a loan or quasi-loan to a director, or enters into a credit transaction with a director. As Ceri is not a director, these rules do not apply.

The relevant duty is the duty found in the CA 2006, s 171(a), which provides that the directors are under a duty to act in accordance with the company’s constitution. The Articles of Association form the most important part of the company’s constitution, so the directors are under a duty to act in accordance with it.

It is highly unlikely that providing a loan to a client will be regarded as ‘directly related, or incidental to, the carrying on of a graphic design business.’ Accordingly, it is likely that, in providing the loan to Ceri, the directors have acted ultra vires and have breached the duty found in s 171(a).

However, applying the CA 2006, s 39, the loan agreement itself will remain valid and cannot be set aside on the ground that it is ultra vires. Accordingly, where the directors engage in an act that is outside the scope of their powers under the company’s constitution, they will be in breach of duty, but the transaction will still bind the company. Therefore, Ceri will not need to pay the money back immediately, and the terms of the loan agreement will remain enforceable.
Response to takeover bid

- The third and final issue to discuss is the directors’ response to the potential takeover bid. The relevant duty to discuss here is the duty found in the CA 2006, s 171(b) which states that a director must only exercise powers for the purposes for which they are conferred. This duty is based on the common law ‘proper purpose’ doctrine and many of the cases decided under the common law remain relevant. The majority of the cases involving the proper exercise of directors’ powers, like our problem, concern the power of the directors to issue shares.

- Issuing shares in order to prevent Asset Strip from taking over Ethos could be regarded as a proper purpose, as the directors genuinely believe that the takeover would not be in the interests of the company or its shareholders. However, a side effect of preventing the takeover is that the directors retain control of the company, and the courts have repeatedly indicated that it is an improper purpose of power for directors to issue shares in order to keep themselves in office (e.g. Punt v Symons [1903]).

- In line with the approach outlined by the court in Howard Smith Ltd v Ampol Petroleum Ltd [1974], you should try to determine what is the dominant purpose. If the dominant purpose is proper, the exercise of power will be valid, notwithstanding that subservient improper purposes existed, and vice versa.

- The issue to determine here is what is the dominant purpose behind Ethos issuing the shares. If the dominant purpose is for the directors to keep themselves in office, then the exercise of their power will be improper and the duty will be breached. However, based on what we are told, it would appear that the dominant motivation behind the issuing of shares is to prevent the takeover.

- There is no legal principle that states that the directors cannot act in order to prevent a takeover from succeeding. However, in most cases, directors acting in such a way will have difficulty establishing that they are not acting in such a way in order to maintain themselves in office.

- Despite this, several judges have stated that directors who exercise their powers in order to prevent a takeover may not necessarily breach the duty contained in s 171(b). For example, see Megarry VC’s comments in Cayne v Global Natural Resources plc [1982], where he stated that directors who act to defeat a takeover bid might be doing so for perfectly proper reasons.

- If Megarry VC’s view is regarded as correct, then it could be argued that the directors of Ethos have not breached the proper purpose. However, the law in this area is unclear and Megarry VC’s view has not been accepted by some members of the judiciary (see e.g. Hoffmann J (as he then was) in Re a Company (No 005136 of 1986) [1987]).