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**The Enforcement of
Directors' Duties in
Britain and Germany**

**A Comparative Study
with Particular Reference
to Large Companies**

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Introduction

The problem underlying the subject of this book

The enforcement of directors' duties poses a number of difficult questions. The fundamental issue relates to the company's separate legal personality. This complicates the enforcement of directors' duties because as an artificial legal entity the company needs human agents to act on its behalf. There are two main organs through which the company may act, namely the shareholders in general meeting and the board of directors. The power to initiate and control litigation in the company's name is normally vested in the board. This, however, causes a major difficulty where a claim of the company is against some or all of the directors. Since directors' duties are owed to the company, the board (or a part of it) will face a significant conflict of interest, whenever some or all of the directors breach their duties.

This conflict of interest is the starting point for the analysis in this book. It demonstrates that the issue underlying this book is in essence a result of the separate legal personality of companies. If the power to initiate litigation against wrongdoing directors were exclusively vested in the board, it seems at least questionable whether all claims in the company's interests would be brought. The board's decision is potentially tainted as the wrongdoers are part of the decision-making process and are likely to pursue their personal interests rather than the interests of the company. Therefore, when it is alleged that directors have breached their duties, the board as a whole is an unsuitable decision-maker and the following question arises: Who should decide whether it is in the company's interests to initiate litigation against the alleged wrongdoers?¹ This issue will be referred

1 A separate issue is who should subsequently control the litigation. It is important to note that the decision right and the control right may be vested in different persons or bodies.

to as the litigation decision in this book. There are a number of reasons why litigation against wrongdoing directors, even if meritorious and successful, may not be in the interests of the company. The litigation decision involves a commercial judgment based on an assessment of the risks, expenses and possible benefits of an action and may be regarded as an investment decision for the company. The question of who should take the decision is therefore of great significance.

In British² company law the famous rule in *Foss v Harbottle*³ provides that the majority of shareholders in general meeting normally ought to take the decision on litigation against wrongdoing directors. There is, however, an exception to this complex rule, which allows an individual shareholder in highly restricted circumstances to take the litigation decision and to enforce the company's claim by means of a derivative action. The present law governing the enforcement of directors' duties is inaccessible, complex and fraught with inconsistencies. Claims initiated by the shareholders against wrongdoing directors are rare.⁴ It seems difficult to believe that the present legal regime produces the optimal amount of litigation. It is, of course, difficult to say what level would be optimal. For the purposes of this book it will be assumed, however, that the optimal amount of litigation against wrongdoing directors is the amount that would be brought by an adequately informed and disinterested body of persons after a thorough assessment of the interests of the company. The analysis in this book also assumes that the duties of directors and the

2 In this book the terms Britain and British rather than England and English will be used. If there are differences in the law between England, Scotland and Wales, the law referred to is the one applicable in England. The rule in *Foss v Harbottle* and the exceptions to it are part of Scots law. However, the Scottish procedure relating to the rule and its exceptions is different from English law. See G. Morse (principal ed), *Palmer's Company Law* (London: Sweet & Maxwell, 25th edn, 1992), 8.817.

3 (1843) 2 Hare 461.

4 For recent cases involving derivative actions, see, for example, *Bracken Partners Ltd v Gutteridge* [2003] 2 BCLC 84; *Qayoumi v Oakhouse Property Holdings plc* [2003] 1 BCLC 352; *Konamenini v Rolls Royce Industrial Power (India) Ltd* [2002] 1 WLR 1269; *Knight v Frost* [1999] 1 BCLC 364.

credible threat of liability claims against directors for violation of these duties are an important element of a corporate governance system. This seems to be the prevailing view in major jurisdictions. It is not surprising, therefore, that the problem underlying this book is topical. Indeed, in both Britain and Germany the discussion in the recent past about the reform of company law has embraced the law regarding the enforcement of directors' duties.

The scope of the book

This book is in essence a work on corporate legal theory with a significant comparative element. Therefore, it is necessary to concentrate on the key principles and mechanisms relating to the enforcement of directors' duties. A discussion in a broader context, including the substance of directors' duties, other (personal) shareholder remedies and remedies against directors where a company is in liquidation, is not possible in the limited space. Moreover, it is appreciated that there is a variety of social and market forces that operate to hold directors accountable. Clearly, directors' duties and their enforcement are just one element of a web of control mechanisms in a corporate governance system.

There are three important limits on the scope of this book. First of all, the analysis in this book focuses on large companies with a great number of shareholders (widely held shares) as opposed to small and medium companies with a limited number of shareholders (closely held shares). The size characteristic refers not primarily to the economic significance of a company but to the number of shareholders involved. The group of large companies includes but is not limited to the companies that are listed at the stock exchange or other markets. It is assumed that in large companies there is generally a separation of ownership and control. The focus on large companies may seem questionable given that the rule in *Foss v Harbottle*, which governs the enforcement of directors' duties in British law, was set out at a time when companies and their shareholders did not resemble

today's large companies. Indeed, many of the cases dealing with the rule in *Foss v Harbottle* concern small and medium companies that were controlled or 'owned' by the wrongdoing directors as shareholders. Such control is, of course, unlikely in large companies. Clearly, the application of a rule developed at a time when companies were generally very different from modern large companies is problematic. This difficulty has not been sufficiently recognised in the literature. To expose this problem and to make a reform proposal that is tailored to the needs of at least one subset of companies, it seemed helpful to focus on large companies. Moreover, the enforcement of directors' duties appears to be of particular significance in large companies, because shareholders in smaller companies have other remedies at their disposal, such as petitions under section 459 CA 1985, which are not generally available or of use to shareholders in large companies.

Second, although the substantive formulation of the duties of directors may have an impact on the amount of litigation, an analysis of the substance of directors' duties is outside the scope of this book. For the purpose of the analysis, it will generally be assumed that a director has breached a duty, that the shareholders in general meeting have not ratified the breach and that the company thus has a valid cause of action against the wrongdoer. Third, this book focuses on corporate claims based on breaches of directors' duties. Since directors' duties are owed to the company, any breach of these duties is a violation of the company's rights and provides the company with a cause of action. The analysis in this book is concerned with the enforcement of directors' duties and therefore with the company's claims against directors. It does not deal with shareholders' claims against the directors or the company. Thus, actions based on personal rights are generally outside the scope of this book. This is the reason why the analysis of the rule in *Foss v Harbottle* will be limited to its limb applying to wrongs done to the company.⁵

The discussion of German company law is even more focused on the mechanisms for the enforcement of claims against directors. Most

5 Regarding the two limbs of the rule in *Foss v Harbottle*, see Chapter 2, section 2.1.1.

significantly, the analysis is limited to the provisions of the law applicable to Aktiengesellschaften (public limited companies), namely the Aktiengesetz (AktG). In the two-tier board system of Aktiengesellschaften, the Aufsichtsrat (supervisory board) asserts the company's claims against members of the Vorstand (management board) and the Vorstand brings actions in the company's name against members of the Aufsichtsrat. The Aktiengesetz does not provide for a derivative action by shareholders. However, § 147 AktG⁶ provides a number of mechanisms available to shareholders with regard to the enforcement of the company's claims based on breaches of the duties of members of the administrative organs. Following the approach taken in respect of British law, the analysis of the Aktiengesetz is limited to corporate claims for compensation of damages against members of the administrative organs.

The structure of the book

The rule in *Foss v Harbottle*, which in essence determines who may enforce directors' duties in what circumstances, has been vigorously criticised for many years. Following proposals by the Law Commission,⁷ which were broadly adopted and recommended by the Company Law Review (CLR),⁸ a reform of the current law regarding the enforcement of directors' duties seems a distinct possibility. Somewhat surprisingly, the government did not deal with the CLR's recommendations in respect of the enforcement of directors' duties in its first White Paper⁹ on the proposed company law reform. However, although there is further delay with regard to the proposed company

6 All references to 'paragraphs' in this book are to the Aktiengesetz, unless otherwise indicated.

7 Law Commission, *Shareholder Remedies* (Consultation Paper No 142, 1996); Law Commission, *Shareholder Remedies* (Report No 246, 1997).

8 See DTI, *Modern Company Law for a Competitive Economy: Final Report, Volume I* (July, 2001), 7.46–7.51.

9 *Modernising Company Law* (Cm 5553-I).

law reform,¹⁰ a new Companies Act, which will implement the CLR's recommendations, is expected in the near future.

This book takes a step back. It starts from the underlying problem and contemplates the whole range of alternative approaches to address the difficult question of who should decide whether it is in the company's interests to initiate litigation against an alleged wrongdoer. This involves an analysis of the theoretical basis of each approach and an evaluation of the strengths and weaknesses of different decision-makers.

Throughout this book a theoretical framework, which is set out in Chapter 1, will be utilised. This framework is partly based on a forthcoming book¹¹ of the International Faculty for Corporate Law and Securities Market Law.¹² The approach underlying the International Faculty's work has been adapted and expanded for the particular problem analysed in this book. The resulting framework consists of the main legal strategies that may be utilised to deal with the problem underlying the enforcement of directors' duties, namely the board's conflict of interest regarding the litigation decision. The application of the theoretical framework for the analysis, assessment and comparison of four models of the enforcement of directors' duties forms the main part of the book. Drawing on the findings in the main body of the book, the final part outlines an alternative reform proposal for the enforcement of directors' duties in large companies.

This book is comprised of eight chapters. Chapter 1 starts from the board's conflict of interest in respect of the litigation decision and sets out the theoretical framework, which consists of a number of legal strategies to deal with this problem. The principles underlying the enforcement of directors' duties in British law are the subject of Chapter 2. The derivative action in British company law is discussed in Chapter 3. The analysis in this chapter focuses on the three modern

10 See FT, 11 July 2003, p. 4; FT, 10 July 2003, p. 1.

11 R. Kraakman et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: Oxford University Press, 2004).

12 The members of the International Faculty for Corporate Law and Securities Market Law are: R. Kraakman, P. L. Davies, H. Hansmann, G. Hertig, K. J. Hopt, H. Kanda, E. B. Rock.

standing requirements for such actions. In Chapter 4, Vinelott J's decision in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*¹³ is analysed. His Lordship's judgment may be regarded as a proposal to reform the rule in *Foss v Harbottle* and provides the basis of what will be referred to as Vinelott J's model in this book. The Law Commission's proposal or model to reform the derivative action, which forms the basis of the recommendations that emerged from the CLR in this area, is analysed in Chapter 5. The subject of Chapter 6 is the enforcement of the company's claims against members of the Vorstand and the Aufsichtsrat in Aktiengesellschaften. The approach taken in the Aktiengesetz to deal with the problem underlying this book will be referred to as the German model. Chapter 7 highlights the main choices a jurisdiction has to make when deciding what strategies to adopt in respect of the litigation decision. Drawing on the findings in this book, a proposal for the reform of the law regarding the enforcement of directors' duties in large companies is presented. The book is concluded in Chapter 8 with some comparative remarks and an attempt to pinpoint the factors that influence the choice of legal strategies to address the problem with the enforcement of directors' duties. Finally, the impact of the pressures of the globalisation of capital and product markets on the development of company law systems is briefly considered.

13 [1981] Ch 257.

