

## Review of the Role and Effectiveness of Non-Executive Directors

### **Submission by Giles Ridley**

1. This memorandum is submitted in response to the Consultation Paper dated 7<sup>th</sup> June 2002.

The views expressed below are based on my experience:-

- (i) as a former partner of Slaughter and May and in that role an adviser to many public and private companies, both UK and non-UK; and
- (ii) as a former chairman of the Business Organisations Committee of the International Bar Association in which role I conducted several debates on this area with the benefit of comparative input from lawyers from many jurisdictions.

The opinions and conclusions contained in this memorandum are my own and should not be attributed in any way to the various organisations with which I am now or have in the past been associated. I have had the advantage of seeing the paper being submitted by Hugh Stevenson, now my Chairman at Equitas, where I am General Counsel.

2. I am supportive of the much expanded role of the non-executive as the right answer to holding the reins between shareholders (and increasingly other stakeholders) and executive management.
3. Attracting the right calibre of person to be non-executives then becomes critical and society does itself no service if it does not put in place the right framework for this to happen.
4. The current framework of rights and liabilities has not really changed, barring tinkering, since 1929, long before the Cadbury concept of a non-executive had even been conceived. It is high time for change – and I would like to concentrate in this paper on the issue of the fair limitation of directors' liabilities.
5. It is probably now only of only historical interest why the 1929 Companies Act which followed the Greene Committee introduced such a draconian ban on companies indemnifying their directors except within very narrow limits. It was probably a function of the outrage felt at the (ironically named) City Equitable Fire Insurance scandal which had led to the Greene Committee's appointment. In a sense it did not matter because, however much lawyers warned about directors' potential

liabilities at prospectus meetings, in practice British directors did not get sued.

6. Now British directors are getting sued, and effective/reasonably priced insurance is becoming hard to find. So we have to get it right.
7. What is the right answer:-
  - (i) full exemption – ie to allow directors wholly to indemnify themselves at the company's expense;
  - (ii) full liability - ie if directors are negligent, even without dishonesty, they should always be liable to the full extent of their personal fortunes, save to the extent that they/the company can get effective insurance;
  - (iii) proportionate liability – ie they should be liable – but only, in any case not involving dishonesty, to an extent in some way proportionate to their relationship to the company (perhaps measured as some multiple of their fees)?
8. I believe that the proportionate liability approach is right. Proportionality is of course a topical concept in the context of modern Human Rights law. Interestingly, it was the answer apparently reached by the American Law Institute when they looked at the same issue in the US in the 1980's after cases like Smith and Van Gorkum had created a similar problem for US directors – see the attached article by Robert B Titus in the Western New England Law Review Vol II Issue I 1989 (with apologies for annotations). As quoted on p.5, "most fundamentally, a ceiling [of liability] is justified on the grounds of fairness, because the potential liability in cases where the ceiling could apply could otherwise be excessive in relation to the nature of the defendant's culpability and the economic benefits expected from serving the corporation. Second, economic logic suggests that a ceiling would reduce the pressures on directors to act in a risk-averse manner...[Third], such a limitation may serve to reduce the cost of insurance.." The article surveys the various different ways in which US states allow exemption. Note that the ALI approach mandates a minimum level of liability which may not be contracted out of by bye-law amendment (contra the approach in Virginia where contracting out in practice followed).
9. So I would argue not for mere tinkering amendments to s.310 but for a wholesale revision which would allow companies to indemnify directors (and critically to pay up front the costs of defending claims against them) except for:-
  - (i) cases of dishonesty (see below);

- (ii) a "floor" below which, if liability is established, they should always pay themselves - bearing some proportionate relationship perhaps to the fees they earn in a year.
10. I use the word "dishonesty" as a generic term for the area beyond which the exemption should not lie. It has the advantage of simplicity of application for the courts and boards. The ALI advocated a more complex test based around "knowing" or "conscious" breach. It is noteworthy that recent amendments to the Canadian Business Corporations Act (s 124) allow a Canadian company fully to indemnify a director (without a minimum floor) provided the director "acted honestly and in good faith with a view to the best interests of the [company] ..and in the case of a [criminal penalty or the like] had reasonable grounds for believing [the relevant conduct] lawful".
  11. What are the arguments against the approach? Some would say that directors need to have their minds concentrated by the personal threat to their fortunes if they get it wrong. This somewhat immature-seeming approach is easily countered (if it needs to be – I would imagine most non-executives would see the reputational risk as sufficient) by selecting a sufficiently high floor. I would not suggest that 1 times the annual fee would necessarily meet the bill; 5 times undoubtedly would. Somewhere in between might.
  12. At a lower level some say Parliament would never vote to "let directors off the hook". Even accepting that level of debate, society (and every citizen with his pension fund investments etc) is in danger of cutting its own throat. Through supporting the Cadbury/Common Code process it is putting all its trust in non-executive directors and in the same breath denying a fair framework in which good non-executives will be prepared to take on the job. Why should someone take on the role for a FTSE100 company for £50,000 pa and, as a result of a single act of negligence without any dishonesty, risk losing their life savings? As a pensioner, once I understood the issue, I know how I would vote.

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