

**EXTRACTS FROM COMPANY LAW COMMITTEE MEMORANDUM 401
RESPONSE TO COMPANY LAW REVIEW CONSULTATION DOCUMENT 5
DEVELOPING THE FRAMEWORK – AUGUST 2000**

Chapter 3

Corporate Governance: Directors and Officers

General

We recognise that the conclusions of research undertaken by the Law Commissions and the Institute of Directors that, in many cases, directors are not sufficiently aware of their general duties and we support moves to increase that awareness. The question is by what means that objective should be achieved. We agree that the options are (a) education, through the use of non-statutory codes and guidance together with greater public debate (as has been achieved through the corporate governance debate over the last ten years) or (b) codification of the duties in statute.

In the past, this Committee has opposed the introduction of a statutory statement of directors' duties. As a matter of principle, we continue to do so for the fundamental reasons summarised below. Our preference continues to be for the law (which is, by necessity, complex) to be made more accessible by non-statutory means - for example, by providing directors with an officially recognised, but non-statutory, summary of their duties. We recognise, having had the benefit of a meeting with members of the Review team, that there are difficulties standing in the way of such an approach, although we do not believe these difficulties are insurmountable. Similarly, we are not convinced that our preferred solution would prevent the Review from delivering its objectives in relation to encouraging a more "enlightened" approach by directors in the exercise of their duties.

We accept, with some reluctance, that codification of directors' duties is the likely outcome of the Review. If so, it is crucial that:

- the relationship between the statutory code and the common law is clearly and explicitly spelled out in the legislation, and that it is expressed to be subject to judicial interpretation;
- shareholders are able to override the code, so as to impose different duties on their directors - whether generally in the articles of association or, in relation to specific situations, by special resolution;
- amendment of the code should be possible (after full consultation) by statutory instrument, given the present defects in our parliamentary process which make it almost impossible to secure the passage of technical primary legislation in a timely manner.

Arguments against codification

The Committee's opposition to codification is well known. It is based on the following, strongly held, views. We understand that the law in this area is perceived to be complex and inaccessible. However, as a matter of principle, we remain unconvinced that codification will in practice be helpful to either professional or lay users. The law must be flexible enough, and broad enough in scope, to cater for companies in a great variety of circumstances and situations. As a result, it is necessarily complex. It cannot be encapsulated in a simple statement which is sufficiently clear to satisfy the goal of accessibility, while being comprehensive enough to give a satisfactory degree of certainty. Inevitably (as is the case with the trial draft) there will be gaps in its coverage and issues with which it does not deal. We understand that where other common law jurisdictions, such as Australia, have sought to introduce codification of this area of the law there has been a need to introduce substantial amendments to the legislation to deal with problems which have later emerged in practice. We are reluctant to embark on a similar process, even with the benefit of their experience and believe that such experience illustrates our concern that codification will, in practice, add to rather than reduce the uncertainty and consequent cost to business.

A statutory statement will also be much less flexible than the current law. Not only are the courts at present able to develop the law as business practice and expectations change, but shareholders are also able to override certain aspects of the law to reduce (or increase) the burden of duty on their directors.

A statutory statement will be subject to judicial interpretation and, to meet shareholder objectives, shareholders must continue to be free to relax or alter its terms. Judicial interpretation will, over time, overlay it with a gloss of case law which is not readily available to the lay user. While we sympathise with directors' desire to have a comprehensible statement of their duties, this gloss is in our view a necessary shortcoming of a statutory statement, which its proponents must recognise and accept.

Further, any statutory statement is bound (as does the trial draft) to express the law using new language which has not been used in the courts and will, therefore, introduce uncertainty as to the law where no such uncertainty exists at present. There will, therefore, be a cost to industry in introducing a statutory code both in terms of litigation to obtain judicial interpretation of its wording and also in terms of the need for professional advice as to the impact of the code on existing practice. Proponents of a statutory code must be satisfied that its benefits are sufficient to justify such new costs.

We are concerned that by seeking to codify the law in this area and to present to the directors a simple statement which purports to set out their duties, directors will be misled into believing they no longer need to seek advice on the issue, possibly with serious consequences.

Faced with a statutory code, many companies may exclude it. It may appear intimidating and cumbersome. It may also appear to require boards to consider many elements which appear to them to be irrelevant. Alternatively, boards may evade their proper responsibilities of management by delegating the decision to shareholders in awkward cases. This would defeat the purpose of the operation. A non-statutory code of guidance would not have the same provocative effect. Indeed it could not be overridden. No doubt listed and large companies would not exclude a statutory code. But the multitude of other companies might well be tempted to do so. The purpose of having a code is largely directed to such companies.

The statement

We note that drafting comments on the text of the trial draft are not sought (paragraph 3.38). However, given our reservations about the feasibility of encapsulating the law in a useful statement, we feel it is important that we put at least some comments of this nature forward at this stage and therefore do so later in this paper. Our comments also illustrate the scope for misunderstanding, and differences of view, over what particular forms of words are intended to achieve. It will be extremely important that Parliamentary Counsel is given very clear instructions about the extent to which the law is to be summarised, but not changed, and the extent to which (if any) change is intended. To the extent scope for uncertainty remains (and although very much as a last resort), clarification in the form of a Ministerial statement when the Bill is introduced will be welcome. It should, in our view, be made clear in particular (as we believe to be the case) that there is no intention to impose higher or more onerous duties on directors than at present and, where appropriate, the statement is not intended to change the existing law.

We also assume that the preamble to the statement will make absolutely clear its relationship to other laws (common and statutory) which apply to directors and will include signposts to other sources of duties, including insolvency legislation. It will be essential for there to be adequate consultation when a full draft is produced.

Remedies

We note that the Consultation Document does not deal with the question of remedies for breach of the statement. Until it is clear how and by whom a breach of duty will be actionable, it is difficult to comment fully on the duty itself. We would, though, be extremely concerned if it were proposed to give direct rights against the directors to particular groups of “stakeholder” (such as creditors or employees) where no rights currently exist. It should be made absolutely clear in the legislation itself that only those who are currently entitled to take action for breach - ie the company (directly or, in limited circumstances, by a shareholder bringing a derivative action) or a liquidator - will be able to do so under the new law.

Is it intended that the remedies for breach of duty will be the same as those for breach of the provisions which ultimately replace Part X? Will the remedies be spelled out in the legislation - or will they be left to the common law (so that, for example, where a duty is expressed to be fiduciary, the normal remedies for breach of fiduciary duty under the common law will be assumed to apply)? We understand that a separate working group is to consider remedies - will these issues be considered by that working group, or by the Corporate Governance working group?

In our submission to the Law Commission, we suggested the introduction of a “universal” civil remedy for breaches of Part X (which could extend to breaches of any statutory statement of directors’ duties). This should:

- (a) make provision for the voidability of any transaction involved, probably along the lines of section 322(1) and (2) (although we recommend that the exception in section 322(2)(b) be extended to cover any rights acquired in the circumstances described, including by a party to the transaction (for example, by a party to a transaction in respect of which there had been a breach of section 317, where the third party was unaware of the director’s interest and/or the failure to disclose));
- (b) render the director in breach liable to account for any profit made; and
- (c) render that director and any other director knowingly involved in the breach liable to indemnify the company (or, in appropriate cases - such as section 314 - shareholders) for any loss suffered as a result of the breach.

Legislative structure

We have mixed views about the appropriate legislative vehicle for a statutory statement of directors’ duties, whether or not comprehensive. As a general rule, we are not in favour of dealing with fundamental legal concepts, such as this, by statutory instrument. However, given the uncertainty which, in our view, the statement will cause and the likely need for it to be amended, we recommend that the statement, whether it is originally established in primary or secondary legislation, is expressly capable of amendment by secondary legislation (after full consultation).

Question 3.25 **Should the monitoring responsibilities of NEDs be set out in legislation?**

No. The “monitoring” function, to the extent it currently exists, has largely arisen out of the initiatives in corporate governance of the 1990s (Cadbury, Greenbury, Hampel, and Turnbull) although we recognise that these initiatives are limited to companies whose shares are listed (but note Cadbury’s recommendation – quoted in the Consultation Document at para. 3.113 – that unlisted companies should also aim to meet the requirements of the Cadbury Code). The principal advantages of such codes are, as the Consultation Document points out: (i) that they are flexible, so that while they are a good way of spreading good practice, companies are not bound to apply practices which are inappropriate to their circumstances; and (ii) they can be updated easily, to reflect changing economic circumstances and business practices, a characteristic that legislation does not possess. If the best practice codes are modified in future, then it is possible that there will be automatic modifications to the “monitoring” role of non-executive directors. A legislative formula could result in inherent contradictions between the two systems.

Question 3.26 **Should the monitoring responsibilities of NEDs be more clearly defined in a code of practice than is currently the case, and if so how?**

No. Because the “monitoring” role largely arises from the best practice codes, it may be expected automatically to evolve (see answer above to Question 3.25).

Question 3.27 **Do you agree that it is not desirable to require NEDs to report to shareholders on the quality of the company’s management?**

We agree. Indeed, a requirement for NEDs to report on the quality of the company’s management could be divisive (counter to the nature of the unitary board) and even lead to bland wording being used in reports that would convey nothing of use or value to the reader.

Question 3.28 **Should the monitoring responsibilities of the board as a whole be set out in legislation?**

No.

Question 3.29 **If you favour answers which would identify functions in law for NEDs, how should NEDs be defined?**

Not applicable.

Question 3.30 **Should boards be required to contain a majority of NEDs?**

No. The resource/availability issue would make this a practical impossibility for all companies. The lack of suitably qualified individuals could lead to “bad” appointments being made, simply to meet the requirements. We are strongly of the view that “The quality required is a state of mind and character and relevant experience” (see Consultation Document, para. 3.148).

Question 3.31 **Should boards be required to contain a majority of “independent” NEDs? If so how should “independence” be defined?**

No. We do, however, think that the directors’ report should disclose, in relation to all non-executive directors, whether they are “independent” (this is a slight modification to requirements currently found in the Combined Code providing that non-executive directors considered by the board to be independent should be identified as such in the annual report). It will then be for the shareholders to judge whether the position of any particular director is appropriate. We think this would be satisfactory when combined with the greater disclosure of the directors’ relevant experience for which we have argued in our answer to Question 3.21 above.

The difficulty is in defining what the test should be. This is a problem wrestled with by both Cadbury and Hampel, neither of which reached any definitive conclusion, preferring in the end to leave the matter to the board. Cadbury referred to non-executive directors being “independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment”. While we share the concern expressed in para 3.150 of the Consultation Document that “it is arguable that whether NEDs are in fact independent is not sufficiently clear to outsiders”, we think there are insuperable difficulties in the

way of defining “independence” with any greater precision than did Cadbury. Attempts have been made to give meaning to the Cadbury definition, by specifying factors which should be considered in applying the test. For example, in 1999 the National Association of Pension Funds and the Association of British Insurers developed a formulation of “independence”. They stated:

“...we start with the assumption that [the director] is independent unless, in relation to the company:

- He was formerly an executive.
- He is, or has been, paid by the Company in any capacity other than as an NED.
- He represents a trading partner or is connected to a company or partnership (or was prior to his retirement) which does business with the company.
- New appointees selected other than by a formal process.
- He has been a NED for nine years - i.e. we allow three 3 year terms.
- He is closely related to an executive director.
- He has been awarded share options, performance related pay or is a member of the Company’s pension fund.
- Represents a controlling or significant shareholder.
- He has cross directorships with any executive director.
- The company, for whatever reason, says he is not independent.”

The Committee considers that these factors, helpful though they may be, raise a number of difficulties in themselves. For example, the nature and types of relationship for the purposes of the sixth bullet point are unspecified, leading no doubt to inconsistency in the application of this test, and the same can be said of the eighth bullet point, relating to the definition of “significant shareholder”. Moreover, the Committee does not consider that merely because a non-executive director has served more than nine years, that this renders him or her not independent. It is the quality of the individual that counts and the extent to which he or she exercises independent judgement in Board deliberations as well as ensuring that he or she has the necessary tools to do the job. In that latter regard, two significant matters arose out of Cadbury: the first was a recommendation that Boards

should adopt a procedure for directors to take independent professional advice at the expense of the company. The second was a recommendation that all directors should have access to the advice and services of the company secretary. These recommendations have found their way into the Combined Code (paragraphs A.1.3 and A.1.4) and if adopted by most listed companies (the evidence is that the first is certainly being followed by most listed companies) should provide real support to directors in discharging their duties with an independent spirit of mind. It should not be forgotten, of course, that directors always retain the ultimate sanction of resignation and there are some cases where this sanction has been used to considerable effect. A recent case where a non-executive director resigned after only two months, apparently because of concerns over the corporate governance of his company, led to a substantial fall in the market price of that company's shares.

It should be clear from our response that we would oppose any rule prohibiting the appointment of directors who are not independent. Shareholders should have the opportunity to decide the matter in all such cases.

Question 3.32 **If the answer to either Question 3.30 or 3.31 is yes, should the requirement apply to all listed companies, or just listed companies above a certain size threshold? If the latter, what should the threshold be?**

Not applicable

Question 3.33 **Should the requirements addressed in Questions 3.30 – 3.32 be contained in legislation, or a code of practice?**

This is an area in which we prefer codes of practice to legislation.

Question 3.34 **Should NEDs be appointed by a nomination committee consisting entirely of independent NEDs? If so, should this be statutory or a code requirement?**

We do not support this option. There must be considerable benefit to the board from the fact that candidates for appointment as non-executive directors have been selected after a process that involves consideration by both the executive and non-executive elements on the board. It has to be remembered that the unitary board, which the Steering

Group favours, as well as the absence in law of any definition of non-executive directors as distinct from executive directors, largely reflects the collegiate approach adopted to corporate management in the UK, some of the benefits of which are espoused in para. 3.140 of the Consultation Document. It seems to us highly artificial to exclude the Chief Executive from involvement in the selection process and we think that whatever any statute might prescribe on the matter is likely to be overridden in practice: it is most unlikely that a chairman would not consult (and obtain the agreement of) the Chief Executive before allowing the nominations committee to propose the appointment of any specified individual as a non-executive director. A failure to do so is likely to erode the confidence of the Chief Executive (and other executive directors) in the Chairman and other members of the board.

Question 3.35 **Should it be required that in notices of resolutions to appoint or confirm NEDs specified links with the company and other factors that might compromise independence should be disclosed? If so, what should be specified and should this be statutory or a code requirement?**

Yes. The board should state whether, in its opinion, the director is regarded as independent in terms of the test espoused by Cadbury. This requirement could be set out in a code of practice.

Question 3.36 **Should companies be required by legislation or rules to have a separate chairman and chief executive?**

We do not favour prescription here. It must be a matter for shareholders, having regard to the particular circumstances of the company. But we do think that companies (other than private companies) should explain to shareholders their reasons for combining the roles of Chairman and Chief Executive where that is the case. Some members do feel that the roles of Chairman and Chief Executive should not be combined and a compromise may be for a requirement, where the roles are combined, for the board to identify a senior independent non-executive director to whom shareholders can voice concerns (a large number of listed companies are declining to identify a senior non-executive director as recommended in the Combined Code –

paragraph A.2.1, but it would seem to have merit where the Chairman and Chief Executive roles are combined).

Question 3.37 **Should the chairman be required by legislation or rules to be a NED, or even an independent NED?**

No

Question 3.38 **Do you support the current Code regime for securing compliance with the norms adopted for board organisation and the operation of NEDs, and do you believe that the disclosure regime should continue to reply on the annual report, or would you favour some other mechanism such as legislation? Do you have views on the inter-operation of Combined Code disclosure and disclosure in the new OFR (chapter 5 below).**

We support the current regime of disclosure based around the annual report.

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Title: EXTRACT FROM COMPANY LAW COMMITTEE
MEMORANDUM 401
Subject:
Author: Law Society
Keywords:
Comments:
Creation Date: 07/10/2002 11:22
Change Number: 2
Last Saved On: 07/10/2002 11:22
Last Saved By: camassey
Total Editing Time: 0 Minutes
Last Printed On: 11/10/2002 10:00
As of Last Complete Printing
Number of Pages: 10
Number of Words: 3,195 (approx.)
Number of Characters: 18,217 (approx.)