

## Draft clauses on directors' liability – TUC Comments May 2006

The TUC welcomes the opportunity to offer brief comment on the draft clauses on directors' liability published by the Government on 3<sup>rd</sup> May 2006.

The draft clauses on directors' liability are an important part of the Government's attempt to forge a consensus on the issue of business narrative reporting, following the decision late last year to abolish the OFR<sup>1</sup>. The draft clauses aim to address the concerns raised by business representatives about the liability of directors for, in particular, forward-looking reporting.

The TUC shares the aim of achieving frank and open reporting by directors. However, we also wish to ensure that directors approach narrative reports with an appropriate degree of rigour. On the one hand, proposals on directors' liability need give directors protection if statements made in good faith and after reasonable care and diligence has been taken later turn out to be wrong. On the other, they need to establish that due care and diligence must be taken in the preparation of narrative reports. The TUC does not believe that the Government's current draft strikes the right balance between these two aims.

Balance  
not  
right.

There is an important issue of the coverage of the liability clauses. We understand that the anxiety about directors' liability expressed by business organisations relates specifically to forward-looking reports. Clearly, forward-looking reports are distinct in that, unlike backward-looking report, they are by their very nature unverifiable at the time of writing. The TUC agrees that where forward-looking reports are made in good faith and are based on a reasonable assessment of relevant and sufficient evidence, directors should not be liable if, subsequently, events prove their predictions to be wrong.

This is not, however, the case for reports about a company's performance in the past. In compiling backward-looking reports, directors do not need to make predictions, and, other than in very rare circumstances, should be able to ensure that statements they make are accurate. While directors will need to make judgments about what to include in narrative reports, readers should be able to count on the accuracy of the material included, while understanding that interpretation and selection are a matter for directors' judgment.

This distinction is not reflected in the Government's approach to liability. The draft clauses cover a wide range of reports – directors' reports, remuneration reports, summary financial statements and disclosures made under the Transparency Obligations Directive, all of which are subject to the same approach.

According to the draft clauses, for a director to be liable for producing untrue or misleading statements, two conditions must be fulfilled: firstly, the company must have suffered loss as a result for relying on the report; and secondly, the director must either have known the statement was untrue or misleading or have known an

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<sup>1</sup> For the TUC's views on the abolition of the OFR and the future of business narrative reporting, see *Business Narrative Reporting - TUC Comments*, TUC, March 2006

omission to be dishonest concealment, or have been reckless as to whether a statement was untrue or misleading.

The situation where a director willfully makes an untrue or misleading statement, either through inclusion of inaccurate material or an omission, is dealt with by these clauses. However, other than in such extreme cases, for a director to be liable for an inaccurate statement s/he must have been 'reckless' as to its accuracy. There is no requirement for a director to take due care and diligence in compiling the reports. To prove that a director has been reckless in his or her behaviour is a very high bar that will only be reached in fairly extreme situations. The gap between the high standards of practice that should be expected of company directors in their approach to company reporting and 'reckless' behaviour is too large, providing very little incentive for directors to take their responsibilities on reporting seriously. The TUC believes that being 'reckless' is too high a bar to set for the liability of directors for their reports.

Bar = reckless  
not action  
due (prep)  
care, skill  
+ diligence

This would be somewhat less problematic if the coverage of these draft clauses was limited to forward-looking reports. However, as has already been noted, they cover a wide range of reports, on which investors and stakeholders need to rely for decisions about their involvement with the company. It is particularly inappropriate for such a low level of care to be required for reports where there is really very little excuse for inaccurate or incomplete reports.

duty to shareholders  
where loss  
→ negligence

The TUC is particularly concerned about the potential impact of these draft clauses on the quality of business reviews. The Government has made it clear that it is not recommending statutory reporting standards for business reviews. This would mean that clause 395 in the Company Law Reform Bill would be the only guidance that directors, investors and others would have as to what should be included in business reviews. A lack of clear standards or guidance on what is expected of directors in their business reviews would make it still harder to establish whether or not a director had been reckless in its compilation. In contrast, the prescribed content of a disclosure such as the directors' remuneration report is much more detailed, making it much easier to show whether a report is deficient than would be the case for a business review. Similarly, the audit regime is considerably weaker for business reviews than for other disclosures, again making it harder for investors and stakeholders to establish whether a report is deficient in contents.

protect from negligent misstatement  
~~misstatement~~  
or omission

It should be noted that even where a report is clearly deficient, proving that this results directly from an individual director's 'reckless' behaviour may prove difficult, thus reducing the potential for any meaningful enforcement of directors' liability for the quality of their reports.

→ negligence

weak for protects of reports

In addition to having acted recklessly, for a director to be liable for deficient reports, the company must have suffered loss as a result of the report and the director is liable only to the company for the contents of reports. This raises questions about how other affected individuals or organisations are able to achieve compensation if they have relied upon inaccurate or incomplete reports to inform their dealings with the company. The TUC believes that it is essential that that the right of other natural or legal persons to hold the company to account if they have relied on inaccurate or

↳ liability beyond shareholders

misleading information published by the company is assured, and would welcome reassurance on this point.

In addition, it is not clear how 'the company' would enforce a director's liability for a deficient report, and whether this is something that individual shareholders would be able to pursue or whether only the shareholders as collectively represented either through majority support for a shareholder resolution or through a decision of the board of directors would be able to take action against an individual director. Where action against an individual director is warranted, it is clearly essential that 'the company' is in a position to reach a decision to take the appropriate action without a conflict of interests being created, as could be the case for the board of directors.

Other than in a situation where a third party has sued the company and been awarded compensation because of deficient company reporting that the third party has relied upon, it is not clear how the company would assess whether it has suffered loss as a result of deficient reporting. There may be many instances where low quality reporting deters investors from investing in the company; but as such considerations would not usually be made public, this would be very difficult to prove. Equally, potential employees may be deterred, or existing employees may leave, but this information is unlikely to be accessible to 'the company'. The draft clauses do not appear to allow for any assumption that poor reporting will reduce company value, but appear to require proof of a concrete loss suffered by the company. This is not satisfactory. The Government has argued that high quality reporting adds value to companies. Companies should be able to rely on an assumption that low quality reporting will reduce company value in enforcing directors' liability for their reports.

poor reports  
reduces  
value/  
growth  
in  
value  
not-  
required

not as a  
result of  
reports  
not actions  
reported on  
misleading  
reports

→ ↑ transparency  
↑ investor confidence in what is said ⇒ ↑ liquidity

### Conclusion

Taking all these points together, the TUC believes that the draft clauses on directors' liability do not give directors a sufficient incentive to act responsibly in the compilation of their reports or to ensure that they take due care and diligence to ensure that their reports are accurate and complete. We are particularly concerned about the potential impact on the quality of business reviews, for which there are no reporting standards, and for which the Government has announced that it does not intend to produce statutory reporting standards.

We believe that an amendment should be inserted that makes it clear that directors are required to take due care and diligence in compiling their reports. We also believe that it is essential that a reporting standard for business reviews be established (after full consultation with all interested parties).

In addition, consideration should be given to limiting the draft clauses on liability to forward-looking information, so that the other aspects of reporting are unaffected.

Finally, the conditions relating to the enforcement of directors' liability for their statements must be clarified, and the points raised above on the nature of the loss suffered, how third parties gain compensation if they have relied on inaccurate reports and how 'the company' acts to enforce directors' liability for statements must be addressed.