COMPANY LAW ESSAY

“You have been invited to give a lecture to a group of institutional investment managers on the role and responsibilities of non-executive directors in public companies in the United Kingdom. The title of the lecture is: “Non-executive directors in the UK, their responsibilities and the extent to which they protect the interests of shareholders.” You have been informed that in particular the managers will be interested in the following:

a) **The nature of the responsibilities of non-executive directors.**
b) **Their potential liability to the company under the law.**
c) **Their enhanced responsibilities under the Combined Code of Corporate Governance.**
d) **Whether, in practice, non-executive directors are efficient in monitoring management.**
e) **Whether the role of non-executive director should be abolished and we should look for other ways in which to improve corporate governance within the company.”**

In order to discuss whether non-executive directors are effective in protecting the interests of shareholders, we must first examine the nature of their role and responsibilities and the liabilities they face. After a detailed discussion of whether or not they are effective, alternative methods of protecting shareholders will be considered. The question of whether non-executive directors should be abolished will then be addressed.

Non-executive directors are generally part-time members of a board of directors, and are usually executives from other companies. Their role is to be an independent presence on the board, to uphold the interests of shareholders and to curb the excesses of the managing executive directors.

There is no statutory definition of a non-executive director. However, the law recognizes that a company cannot perform its own acts as an artificial person and must be managed by directors (*Ferguson v Wilson* (1866) LR 2 Ch App 77). Under s. 282, Companies Act 1985, every private company must have at least one director, and every public company at least two. A director is defined under s. 741(1) simply as “anyone occupying the position of director”.

The idea of non-executive directors (NEDs) was promoted by the Cadbury Committee in their report published in 1992. This report was commissioned by the Financial Reporting Council and London Stock Exchange after the collapse of several large corporations – such as Polly Peck and the Robert Maxwell Group – due to managerial irregularities even though they were given healthy audit reports. These failures were blamed on poor corporate governance, which the Cadbury Report defined as “the system by which companies are directed and controlled” [FN 1]. The Committee sought to improve corporate governance and make directors more accountable to shareholders. To achieve this aim, the Committee aimed to strengthen the role of NEDs in UK listed companies. The report created a voluntary Code of Best Practice, backed up with the requirement that all UK listed companies should comply with the Code, or explain why they have not in their annual reports [FN 2].

The Cadbury Report states that NEDs should bring their independent judgement to bear on issues of strategy, performance, appointments and standards of conduct [FN 3]. Therefore they are expected both to monitor executives and contribute to corporate strategy, working as part of a unified board for the benefit of the company as a whole. Non-executive directors are to be appointed by the board [FN 4] for specific periods with no automatic re-appointment once their term has expired [FN 5] and they are expected to be free of any business or financial connection with the company [FN 6], although it is for the board as a whole to decide who is “independent” [FN 7].

All boards are required to form Audit Committees to review the scope and results of internal and external audits of the company [FN 8]. These should be composed exclusively of NEDs [FN 9] with a majority of those being “independent” [FN 10]. They should meet three times a year.

Executives’ pay is to be subject to recommendations made by a Remuneration Committee made up mainly of NEDs [FN 11].

The Code sets no minimum number for NEDs, but states that there should be enough to carry “significant weight” on board discussions [FN 12]. The Code also states that it is “highly desirable” if NEDs are formally trained, but this is not a requirement [FN 13].

The Code is a ‘soft law’ in that breaches do not incur criminal or civil penalties. It is a voluntary code of self-regulation. Theoretically, companies who comply with the Code will inspire more confidence in shareholders and as a result will do better than companies which do not.

However, NEDs may incur liability under statute and common law.

Under statute, the Company Directors Disqualification Act 1986 allows UK courts to review the way a director has conducted a company’s affairs and disqualify them from being a director if they are unfit to hold office. Those who breach disqualification orders may incur criminal penalties. Similarly, under ss.11 and 13, Companies Act 1985, it is an offence for an undischarged bankrupt to act as a director or be concerned in the management of a company. These then are sanctions for incompetent or improper conduct by all directors.

The common law recognizes that directors owe a company a duty of care. However, the law is inconsistent as to whether there is any difference between executives and NEDs.

In *Re City Equitable Fire Insurance Co. Ltd* [1925] 1 Ch 407, the court held that directors are subject to a duty of care and skill to their company. They must act honestly and in good faith in the company's best interests. In *Dorchester Finance Co. Ltd v Stebbing* [1989] B.C.L.C. 498, the court held that NEDs are subject to the same standard of care as executive directors. The court applied s.214(4), Insolvency Act 1986. This Act states the standard of care required of a director is that of

> …a reasonably diligent person having both – a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and b) the general knowledge, skill and experience that a director has.

Also, in *Bishopsgate Investment Management Ltd v Maxwell* [1993] B.C.C. 120, the court took into account "how the particular company's business is organised and the part which the director could reasonably have been expected to play".

The test is therefore both subjective and objective, so courts should consider the different 'functions' carried out by a NED.

However, in *Equitable Life Assurance Society v Bowley* [2004] 1 B.C.L.C. 180, the company sued its own NEDs, who appealed using s.727, Companies Act 1985 as a defence. This measure relieves NEDs from liability for breaches of duty or negligence if, in the courts opinion, they acted honestly and reasonably and ought fairly to be excused. However, this requires lengthy and incredibly costly court action. The Equitable Life case is one of the most expensive civil suits in history, involving years of legal action. Therefore this is not an attractive safeguard for NEDs. It is foreseeable that many people will be dissuaded from becoming NEDs because of this increased risk of liability.

Under ss. 19 and 20, Companies (Audit, Investigations and Community Enterprise) Act 2004, companies can indemnify directors from legal proceedings. However, this is not a right a director can demand, nor will it protect him if he loses, or against criminal proceedings or actions by regulatory bodies. The Companies Act 2006, s.211, will allow companies to provide insurance, but again this is not a right directors can demand. Therefore the law makes little allowance for the disadvantaged position of NEDs.

The courts have also been inconsistent as to how much they demand of NEDs.

In *Re Barings (no. 5)* [1999] 1 B.C.L.C. 433, the court allowed a director who had been disqualified from a company to continue to act as a director on three other companies' boards on the condition that he remained a NED. The court noted that there had been no suggestion of any dishonesty or impropriety on his part that would have made it necessary to protect the public from him. However, a lapse of judgement by a NED is just as potentially damaging as that of an executive director. For instance, it was just such a lapse of judgement by NEDs on an audit committee that led to the collapse of Enron.

Yet, in *Ginora Investments v James Capel Ltd* (1995), unreported [FN 14], the court said that NEDs could not plead ignorance of the law or lack of business experience, as all directors of public listed companies are presumed to have sufficient business acumen. This is to protect their shareholders.

Moreover, in *Re Landhurst Leasing Plc* [1999] 1 B.C.L.C. 286, the court placed the onus of monitoring directors' remuneration on the NEDs as opposed to the executive directors. The court said that "this is quintessentially a matter which the non-executive directors could have raised…and it may be said they should have done so".

This puts the law on a level footing with the responsibilities set out in the Combined Code. However, it illustrates how the courts have not applied these duties consistently.

A new statutory duty of care will be provided in s.156, Companies Act 2006, which states that directors must have regard to "(a) the likely consequences of any decision in…the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact…on the community and the environment, (e) the desirability of…maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company".

This duty adopts the pluralist model of a company, which sees a corporation as an institution which operates for the benefit of many stakeholders, not just shareholders, and this will have to borne in mind in future court decisions.

After the Cadbury Report, the Greenbury Committee examined directors' remuneration [FN 15]. It recommended that executive directors should not be able to decide their own pay and advised this be done by independent Remuneration Committees. However, this was ineffective, as NEDs' "independence" was decided by the board itself, undermining the Remuneration Committee's objectivity.

Subsequently, the Hampel Report reviewed the Greenbury and Cadbury recommendations [FN 16], and the Higgs Review examined the role of NEDs [FN 17]. Together they produced the current Revised Combined Code of Corporate Governance.

The Code now says that at least fifty percent of the board should be "independent" NEDs (Provision A.3.2). A concession is made for smaller companies who need only have two independent NEDs on their Remuneration, Nomination and Audit Committees (Provisions A.3.2, B.2.1, C.3.1).

The Higgs Review laid out a test for NEDs' "independence". Provision A.3.1 now lists seven factors that could compromise a NED's character and judgement. These are: being an employee of the company in the last five years; having a business relationship with the company in the last three years; receiving money from the company other than a director's fee, for example share-option schemes; having close family ties with the company's directors, advisors or senior employees; having cross-directorships (where directors serve as NEDs on each others' boards) or any other significant links through involvement with other companies; representing a significant shareholder; or serving on the board for over nine years. Non-executive directors may serve longer than nine years, but if they do, they will no longer be considered “independent” (Provisions A.7.2, A.3.1).

The Code creates a Senior Independent Non-Executive Director, other than the Chairman or CEO, who provides an alternative channel of communication for shareholders (Provision A.1.3). The Senior Independent NED must be available to shareholders so that they can raise concerns they feel have not been addressed by the board. The Senior Independent NED must also attend a sufficient number of meetings to familiarise themselves with shareholder concerns (Provision D.1.1).

Provision A.4.1 recommends Nomination Committees made up of a majority of independent NEDs to make recommendations to the board on the appointment of new directors. The provision states that this should be a “rigorous, formal and transparent procedure”.

Remuneration Committees should be composed exclusively of “independent” NEDs (Provision B.2.2).

Non-executive directors should be prohibited from having share options, unless they have been given prior shareholder approval (Provision B.1.3). However, they can be paid in shares.

Audit Committees should have at least three “independent” NEDs, one of whom must have “recent and relevant financial experience” (Provision C.3.1).

The Higgs Review recommends that NEDs receive “comprehensive, formal and tailored induction” and “continually update their skills and knowledge to enable them to fulfil their role”. In order to address concerns that NEDs were not spending enough time with the company, they are now sent a letter of appointment setting out the time commitments expected of them and they must also disclose their other commitments (Provision A.4.4). The leading case in this area was *The Marquis of Bute’s Case* [1892] 2 Ch 100. Here, a NED attended only one board meeting in forty years, yet the court held that this in itself was not a breach of any duty of care. Therefore

Higgs's recommendations will require a change in the law.

The Higgs Review was commissioned in response to the collapse of Enron, a holding company with many subsidiary companies. The directors of Enron moved money around these subsidiaries, so each subsidiary's financial statement showed that the company was doing well. However, the company collapsed with massive losses that neither the auditors nor the NEDs had detected. Therefore, in this case, the NEDs failed the shareholders, despite making up the majority of the board.

Since then, the Combined Code has sought to strengthen the role of NEDs by defining "independence", enhancing the role of the Senior NED, strengthening the independence of Nomination, Remuneration and Audit Committees, and introducing the "whistle blowing" Provision, C.3.4. This provision states that staff should be able to raise concerns over financial reporting irregularities to the Audit Committee in confidence. All these provisions are designed to prevent another Enron.

However, there are important factors which limit the effectiveness of NEDs.

NEDs are part time and are paid a small fee, but their duties are time consuming. Marconi and Cable & Wireless, two companies which also suffered collapse, both had NEDs. However, these were chairmen with multiple roles in other FTSE 100 companies. This reduced the amount of time they could spend in their roles as NEDs. Yet the Code does not put a limit on the number of other directorships a person can hold.

The monitoring function of NEDs may cause conflict with the rest of the board. For instance, Provision A.6 of the Combined Code allows for a performance review of management by NEDs. This may make working together on corporate strategy uncomfortable. The role of the Senior NED to be available to shareholders also has the potential to damage relationships of openness with executives and chairmen.

Non-executive directors can face crippling liabilities. Despite their disadvantaged position, their duty of care is generally the same as that of executives. Also, s.727, Companies Act 1985 requires them to go to court to seek the court's opinion on whether they have a defence. As in Equitable Life's case, this can be incredibly costly. Yet, despite this, they have no right to insurance or indemnification from the company. While ss. 156–161 of the Companies Act 2006 should clarify their roles, it will not aid their protection.

Non-executive directors' skills and training are generally worse than those of executives. Higgs found that two thirds of the NEDs surveyed had received no formal training. The Penrose Report into Equitable Life also concluded that Equitable Life's NEDs "had insufficient knowledge and skills to provide an effective challenge in critical areas" [FN 18]. This is mirrored in the collapse of Marconi. The company had a corporate strategy that meant they were selling proven businesses and buying ones that were not performing well. The NEDs should have re-examined this strategy. This shows their lack of business expertise.

However, whereas Marconi had good corporate governance but a poor corporate strategy – hence its failures were discovered quickly, Enron had a bad corporate strategy and poor corporate governance. Hence the results of its mismanagement were kept hidden for years [FN 19]. This shows that NEDs can make a positive contribution to the company despite lack of skills and expertise.

Non-executive directors are not accountable to anyone. Despite the "independence" test, Remuneration Committees are no guarantee of objectivity when it comes to setting executives' salaries. The board is not bound by the Remuneration Committee's recommendations [FN 20], and as NEDs are executives in other companies, it is in their interest to push up salary levels throughout the business sector.

The Code also ignores the relationship between NEDs and shareholders – a key issue in corporate governance. Yet, apart from recommending a Senior NED be available to listen to their concerns, the Code does nothing to hold NEDs accountable to shareholders.

In law, directors do not owe any duty of care to investors. In *Foss v Harbottle* (1843) 2 Hare.

461, the court held that where a wrong is done to a company, the proper plaintiff is the company itself. Also, an individual shareholder cannot bring an action on the company's behalf.

The case of Shell highlights this lack of accountability to investors. Shell overestimated its own oil reserves, thereby increasing its share prices. It was found that, despite having sixteen NEDs, they failed to identify this in financial statements. A key criticism was the role of the Group Reserves Auditor, who was part time, had limited resources, little training, and no real authority over those he was supposed to monitor [FN 21].

Therefore NEDs' effectiveness depends on the information they receive. Yet part of the problem in Enron's case was that the executives withheld information from the NEDs. Some executives may do this to keep their competitive edge secret from those NEDs who are executives in other companies.

Even so, it was found in Shell's case that exaggerating its oil reserves did not amount to "market abuse" under s.118(2)(b), Financial Services and Markets Act 2000, as these failings were purely internal. This was despite the directors' duty to keep themselves well informed (Combined Code A.4).

In Equitable Life's case, the company was able to bring an action against its NEDs. However, in Shell's case, the company actually benefited from the failures of its NEDs. Therefore there was no possibility of legal action against them to hold them accountable to shareholders.

This creates problems of enforcement against NEDs. The Combined Code is not legally binding. UK listed companies must merely "comply or explain" in their annual reports. Therefore they could choose to ignore the Code and get rid of NEDs altogether, as long as they explain why they have done so.

NEDs also have no powers of enforcement against executives. Their only sanction is to resign and give formal reasons for doing so.

Finally, the Higgs Review stresses that “it is important to establish a spirit of partnership and mutual respect on the unitary board” [FN 22]. However, NEDs are part time, lack influence and training, and their pay is unequal to executives. So any respect they get is undermined by these factors.

Therefore, although NEDs can help detect failures or irregularities of management, they are no guarantee against corporate malpractice, due to problems of enforcement against them and their own lack of power, training and expertise.

Are there, then, any alternative ways of improving corporate governance?

According to the idea of shareholder primacy, economic forces will control the behaviour of the executive directors of public companies. If shareholders learn that a director is not acting in their best interests, the company’s share prices will fall. However, this is unrealistic. The whole idea of a public company is that people can invest in it without having to be concerned in its management. Also, the widespread ownership of shares means that no shareholder can effectively control its directors. This is known as the “separation of ownership and control”.

However, the recent rise of large institutional investors has increased their ability to influence company policy. Institutional investors such as the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) control around seventy percent of the shares in all UK listed companies [FN 23]. This should at least give them some influence over directors of companies they hold shares in.

Under s.303, Companies Act 1985, members can even remove a director from office by ordinary resolution. However, the company may still have to pay the director compensation. This may be substantial if they are on a fixed-term contract.

However, several factors prevent institutional investors from acting together. The range and number of companies they hold shares in can make it difficult and costly to actively participate in all of them. There may be competition between different institutional investors. This prevents them from acting collectively.

Despite this, institutional investors are encouraged to be the watchdog of the Combined Code: "Institutional shareholders have a responsibility to make considered use of their votes" (Provision C.1). Yet the rule in *Foss v Harbottle* makes it difficult for shareholders to bring actions against directors. The result is that the formal power of large investors to influence management is limited to the way they vote at the company's Annual General Meeting (AGM).

Private shareholders own only twenty percent of shares in UK listed companies, so their influence is comparatively small. However, the increased use of technology, such as electronic voting, could give them a bigger say at AGMs and in company policy.

Another means of making directors more accountable to shareholders is the Operating and Financial Review (OFR). The OFR provides a narrative of the company's past, present and future performance. However, the OFR was abolished under s.257, Companies Act 1985. Bringing the OFR back would empower shareholders with valuable information on how the company is managed.

Therefore, in order to be effective in improving corporate governance, institutional investors must become more active in using formal channels to influence the directors of the companies in which they hold shares. However, for the reasons discussed, this seems unlikely to happen overnight. Therefore legislation seems the best solution to empower them with a formal remedy against directors who mismanage companies.

In Europe, many companies employ a two-tier board system. This consists of a management board of executive directors, responsible for running the company on a day-to-day basis, and a supervisory board of NEDs, responsible for monitoring the management board. In Germany, the principle of co-determination means that employee representatives sit on the supervisory boards of large firms, giving more stakeholders a say in corporate governance. Directors are not allowed to be members of both boards.

However, the two-tier system has several disadvantages when compared to the UK system of a unitary board. The two-tier system creates large, unwieldy boards. Employee representatives often lack managerial expertise, and their presence limits confidentiality between employees and management. This can prevent any effective sharing of information. In turn, supervisors become too removed from management to influence company policy. For example, Shell was an Anglo-Dutch company which had both board structures. Yet the unitary English board and the two-tier Dutch board both failed to address their financial reporting problems. In all, the UK unitary board system seems a better option.

In the USA, the Sarbanes-Oxley Act 2002 created criteria for the independence of NEDs and requires companies to have Compensation Committees and Audit Committees which are entirely made up of NEDs. This mirrors the position of the UK's Combined Code. It also created criminal penalties for directors who sign off inaccurate financial reports. This secures their compliance with the Act.

The Act allows for bonus payments to reward managers who sustain long-term growth, and financial penalties for inaccurate accounting. This independent monitoring of directors provides shareholders with a remedy against unruly executives.

Critics say the US approach stresses the monitoring functions of NEDs to prevent fraud, whereas the UK Combined Code encourages a spirit of partnership between executives and NEDs to improve profitability [FN 24]. However, legislation would clarify the role of NEDs and provide a useful legal reference point for duty of care cases. It could also give NEDs much-needed powers of enforcement against executive directors. Criminal penalties are also needed to ensure compliance with any new Act and to give it proper legal force.

There are advantages to having NEDs. They bring independent judgement and a wider perspective to boardroom discussions. They enhance a company's reputation, both by reassuring shareholders that the company is managed properly, and because many NEDs are successful executives in other companies. They also give shareholders and employees a way of raising concerns in confidence about managers.

However, many potential NEDs will be put off by the increased risk of liability, particularly since the Equitable Life case. Therefore, to improve the profile and quality of NEDs, there should be a professional regulatory body to oversee their activities. This could provide support and training, vet potential NEDs, monitor their performance and educate companies about corporate governance. The Company Law Review in 2001 recommended such an institution.

In conclusion, NEDs can undoubtedly improve corporate governance and help protect shareholder interests. Therefore there is no reason to abolish them. However, on their own they are no guarantee against corporate mismanagement. They suffer from poor powers of enforcement, a high risk of liability and poor training. Legislation is also needed to provide shareholders and NEDs alike with enforcement powers against directors, and to subject directors to greater public scrutiny. Professional regulation can also play a vital role in producing NEDS who are effective, accountable and skilled enough to perform what is a very challenging role. All these solutions could then be part of a combined approach to improve corporate governance.

[FN 1] CADBURY et al. *Report of the Committee on the Financial Aspects of Corporate Governance.* London: Gee & Co. 1992 (‘the Cadbury Report’)

[FN 2] paras 3.7–3.9

[FN 3] para 4.8

[FN 4] para 4.13

[FN 5] para 4.14

[FN 6] para 4.9

[FN 7] para 4.12

[FN 8] para 4.1

[FN 9] para 4.33

[FN 10] para 4.9

[FN 11] para 4.6

[FN 12] para 4.8

[FN 13] paras 4.15–4.16

[FN 14] see FN 20

[FN 15] GREENBURY et al. *Directors’ Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury.* London: Gee & Co. 1995 (‘the Greenbury Report’)

[FN 16] HAMPEL et al. *Report of the Committee on Corporate Governance*. London: Gee & Co. 1998 ('the Hampel Report')

[FN 17] HIGGS, D. *Review of the role and effectiveness of non-executive directors*. London: DTI. 2003 ('the Higgs Review')

[FN 18] PENROSE. *Report of the Equitable Life Inquiry*, March 8 2004, H.C. 290

[FN 19] KEENAN, J. Corporate Governance in UK/USA Boardrooms, *Corporate Governance*, 2004, **12** (April) pp. 172–176

[FN 20] Hampel Report s.4 para 4.12

[FN 21] BURBRIDGE, P. "How can you be sure of Shell?" Is Corporate Governance better served by Unitary or Two-Tier Boards?, *International Energy Law and Taxation Review,* 2005.

[FN 22] Higgs Review para 6.3

[FN 23] paras 15.2–15.3

[FN 24] WATTS, S. et al. Revised Combined Code: Better Corporate Governance? *Practical Law for Companies*, 2003 (October) pp. 29–41.

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