



# Corporate governance - Risks and solutions

## The Issues

The role of corporate governance in business has been highlighted for public and private companies by the aftermath of spectacular collapses of US corporations, which themselves followed earlier scandals in the UK. Regulation in major countries has been tightened. In the UK, the Cadbury, Greenbury and Hampel reports have been drawn together with the Higgs report into the Combined Code launched in 2003.

The result of this for individual non-executive directors has been to bring home to them the risks that they face on a personal level as a result of their positions. This was highlighted by the summer 2003 Legal Director Taylor Wessing Benchmark Survey, whose findings included

- Nearly half of non-executive directors said that they had considered giving up their role as non-executive directors after the Enron collapse

- More than half of non-executives said that their concern over their personal liabilities had increased after the Enron collapse

These findings indicate the depth of concern that exists amongst non-executive directors. Since executive directors face the same or similar liabilities as non-executives, the concerns of all directors are likely to be of the same order.

This is an issue that needs to be addressed by public and private companies alike to safeguard their talent at board level.

## Addressing the Issues

Taylor Wessing LLP's experienced lawyers help clients understand the corporate governance issues facing them, the personal risks that arise out of failures in corporate governance and the solutions that can be used to manage those risks.

## Corporate Governance

Since the early 1990's corporate governance has received ever increasing prominence. The initial spur for this in the UK was a series of spectacular corporate collapses. This resulted in the Cadbury Report being commissioned and subsequently the Greenbury Report and Hampel Report, which were combined to produce the Combined Code, a set of rules designed to improve corporate governance with which fully listed companies are expected to comply or explain why they have not done so.

In the wake of even more spectacular corporate collapses in the US and UK in the last 3 years the Higgs Report was commissioned in the UK to make recommendations regarding the role of non-executive directors in promoting good corporate governance within listed companies. That report resulted in changes to the Combined Code.

The relevance of these reports and the Combined Code to non-listed companies is that, absent legislation setting out the obligations of directors and what constitutes good corporate governance, they provide very good guidance as to what is regarded as best practice for the governance of a company's affairs.

Why is corporate governance important? Because when a company makes a decision, whether by its shareholders, its Board or one of its executives, it must be through a process which complies with good corporate governance and balances the interests of the company as a whole with those of its shareholders and employees. In particular, the process must withstand scrutiny after the event when, as may happen, the decision that was taken proves not to have been the best commercial decision. The aim of good corporate governance is to ensure that the decision making process contains sufficient checks and balances to withstand scrutiny made with the benefit of hindsight.

Those ultimately responsible for ensuring a company complies with good corporate governance are the Board of Directors. However, for the executive directors this responsibility may well conflict with their obligations to make commercial decisions to develop a company's business. Accordingly, much of this responsibility will fall on the non-executive directors. However, although executive and non-executive directors may be carrying out different roles in a company, they are all responsible if something goes wrong.

When former non-executive directors of Equitable Life unsuccessfully sought to have the company's claims against them dismissed in the Autumn of 2003, Mr Justice Langley endorsed the following summary of the obligations of a director:-

- Directors have a duty to acquire sufficient knowledge of a company's business to enable them properly to discharge their duties as a director.
- Even though directors are entitled to delegate particular functions to management and trust in their competence and integrity to a reasonable extent, they are not absolved from a duty to supervise the discharge of the delegated function.
- The extent of the duty to supervise and whether it has been discharged depends on the facts of each case including the director's role in the management of the company.

The last point can have the effect of imposing a greater duty of care on the executive directors, but non-executive directors should not fulfil or rather fail to fulfil their roles on assumption that they owe a lesser duty of care! The Judge in Equitable Life emphasised in this context that this was an area in which the law is developing.

Historically there has been a lack of clarity regarding the responsibilities of non-executive directors. The Higgs Report aimed to provide clarity stating that non-executive directors must:

- Constructively challenge and help develop proposals on strategy.
- Scrutinise the performance of management in meeting agreed goals and objectives.
- Monitor the reporting of performance.
- Satisfy themselves on the integrity of financial information and that financial controls and systems risk management are robust and defensible.
- Determine appropriate levels of executive directors remuneration and have a prime role in appointing and, where necessary, removing executive directors, and in succession planning.

Even if there are no non-executive directors on the board, the executive directors should attempt to balance the interests of the Company, the employees and the shareholders when they make their commercial decisions.

The need for a company to comply with the principles of good corporate governance is nothing new but the consequences of

failure mean that ignorance is no longer bliss.

## Directors' Risks

Failures in corporate governance expose companies and their directors to civil and criminal liabilities: it is those incidents where the checks and balances of good corporate governance have failed, where the decisions that are most likely to produce that exposure are liable to be taken.

As Mr Justice Langley emphasised in Equitable Life, directors' responsibilities to their company and to third parties is an area of law that is developing. It is a time of uncertainty for directors. Until further guidance is provided, directors face challenges that push at the edges of established law and have to act in a manner that reduces the risks to them.

Even the criminal law is evolving in this area: the failure of the existing law to secure convictions following major disasters has led to a review by the government. That review is likely to lead to new statutory offences of reckless killing or killing by gross negligence, aimed at individuals within an organisation bearing primary responsibility.

Existing areas of personal criminal liability for directors include the money laundering regime, the insolvency law and competition law, leaving aside the obvious areas of the Theft Act, Health & Safety at Work regulation, consumer legislation and intellectual property infringement.

In the context of civil claims, directors may find themselves defending claims from third parties (such as franchisees or those subscribing for shares on misrepresentation claims) or from their own company. Directors may not anticipate claims by their own companies, particularly if they also own the shares. But control of companies can change, either following a share purchase or insolvency, for example; and the ability of companies to claim in respect of matters that transpired at least 6 years before can lead to unexpected claims by the company itself.

The existence of an indemnity in the Articles of Equitable Life against costs of proceedings against directors did not persuade the court at the interim stage in Equitable Life to order such an indemnity. Further, the power granted by s727 Companies Act 1985 to excuse a director from liability for his negligent acts or other breaches of duty if he has acted honestly and reasonably and the court considers that he ought fairly to be excused that

liability, was found by Mr Justice Langley in Equitable Life to be a power that should only be exercised prior to a full trial in a "quite exceptional case".

The result is that directors face the prospect of the defence of claims up to trial without an indemnity on costs and without knowing whether or not the additional defence available to them under the Companies Act will prevail.

### Managing the Risks

Risk management is an important aspect of corporate governance. In determining whether a Board has fulfilled its duties towards a company, shareholders are likely to require the company to maintain adequate insurance cover for the risks to which it is subject, from environmental liabilities to property damage.

In addition, although the Board of a company will no doubt aspire to maintain requisite standards, there may be occasions when the Board, or an individual director, falls short of those standards. In such circumstances, one of the questions the Board or director will be asking is whether

the risk of such failure was adequately considered and whether steps were taken to avoid or manage the risk.

One of the main ways in which risk to a company and its directors can be managed is by obtaining adequate insurance cover, in particular cover for Directors & Officers liabilities (D&O cover). There has been increased uptake of this cover in recent years, in the wake of corporate scandals that have resulted in sizeable claims against directors. At the same time, however, insurers have responded by increasing premiums (by as much as 500%) and reducing the scope of the D&O cover. As a result, Boards are facing the dilemma of trying to maintain cover that is effective, as part of its efforts to attract and retain the right talent at board level, whilst limiting the cost to the company.

Boards can no longer afford to renew insurance each year without a full consideration of available cover, considering in advance what steps they can put in place to make their business more attractive to insurers, and carrying out the necessary balancing exercise.

The latest failures in corporate governance continue to attract comment from many quarters and there remain high profile actions in progress, such as Equitable Life. The final decisions in these cases and their consequences will become clearer in the future but the Courts have accepted that corporate governance is a developing area. In addition, the Combined Code has only recently come into force and it is yet to be seen whether it will cause a sea change in corporate practices and attitudes. What is certain is that directors must be acutely aware of the need to maintain the highest possible standards of corporate governance.

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