

*Reimagining the role, duties and liabilities of non-executive directors in 2020; 15 Years of the Companies Act 2006 and the pathway to the UK Corporate Governance Code 2018. Part One: a prelude to the current approach*

Article

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Reimagining the Role, Duties and Liabilities of Non-Executive Directors in 2020; 15 Years of the Companies Act 2006 and the Pathway to the UK Corporate Governance Code 2018. Part One: A Prelude to the Current Approach.

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## **Introduction**

The extent to which, if at all, Non-Executive Directors (NED) and Shadow Directors (SD) owe duties and liabilities to a company under English law has been the subject of rigorous debate between lawyers for many years. In contrast, the duties and liabilities of Executive Directors (ED) under English law were quite well defined. The Companies Act 2006 put those same duties and liabilities on a statutory footing and to an extent rendered the distinction between the two types of directors redundant. Therefore, the ED and NED are subject to the same duties, and caselaw demonstrates that SDs duties and liabilities are limited. The role of the NED, in corporate governance terms, has been strengthened by various reviews and iterations of the UK Corporate Governance Code. Embedding enlightened shareholder value in the codified director duties as part of a new Companies Act was a popular recommendation that was adopted in the 2006 statute by the UK government.<sup>4</sup> Part one of this duo of articles explores the clarity in the application of director duties in the 15 years since the 2006 statute came into force, highlighting the rationale that underpins the changing role of the NED leading up to the new Corporate Governance Code as at 2018. Part two explores the impact of the new code itself.

## The Role of Company Directors in the United Kingdom

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<sup>4</sup> House of Commons Trade and Industry Committee. The White Paper on Modernising Company Law. 2003. CM 5553-I. London: HMSO. Pp.7 – 8.

Before considering the issues, in English law, regarding the duties and liabilities of the various types of company directors and whether the statutorisation of these has been successful we start by defining the director types that are the subject of this research.

### Executive Directors (ED)

Part 10A of the Companies Act 2006 deals with directors. Whilst the provisions set out some of the requirements i.e. appointment, minimum age and residence (etc.), and the duties they do not define the 'director', a matter that will be discussed in more depth later given its expansion in the application of the law to both EDs, SDs and NEDs. Section 250 of the Companies Act 2006 states that a director 'includes any person occupying the position of director, by whatever name called.' In short, these are the person(s) responsible for the management of a company set up in accordance with English Law.<sup>5</sup>

### Shadow Directors (SD)

Section 251 of the CA 2006, as amended by the Small Business, Enterprise and Employment Act 2015 (SBEEA), provides that a shadow director is 'a person in accordance with whose directions or instructions the directors of the company are accustomed to act.'<sup>6</sup> SDs may not wish to be identified as directors for a number of reasons; they may for instance be disqualified.<sup>7</sup> In *Re Hydrodam (Corby Ltd)*<sup>8</sup> Millet J described

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<sup>5</sup> It is salient to note that the directors of charities are known as 'trustees', that said they are also subject to the Companies Act 2006 and the relevant duties but are also subject to Charity Law and other regulation. For an interesting cross-jurisdictional comparison on directors' duties see: Ma, F. (2014). Director's Duties in China: The Corporate Opportunity Doctrine. *The Company Lawyer*, 35(11), 340-346. [Accessed 29 April 2020].

<sup>6</sup> Sections 90(3) and 164(3)(g)(iii) of the Small Business, Enterprise and Employment Act 2015 (SBEEA) amended s.251(2) of the Companies Act 2006. Subsection (2) provides that a 'person is not to be regarded as a shadow director by reason only that the directors act ... (a) on advice given by that person in a professional capacity; (b) in accordance with instructions, a direction, guidance or advice given by that person in the exercise of a function conferred by or under an enactment; (c) in accordance with guidance or advice given by that person in that person's capacity as a Minister of the Crown (within the meaning of the Ministers of the Crown Act 1975) ... (3) A body corporate is not to be regarded as a shadow director of any of its subsidiary companies for the purposes of ... Chapter 2 (general duties of directors) ... by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions.' Note also: Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business. BIS/13/959. This is a discussion paper by the Department of Business, Innovation and Skills (BIS) from July 2013, it focusses on proposals to reform company law in the United Kingdom so that those in actual control of a company could be properly held to account. The paper discusses the control exercised by nominee directors but not SDs.

<sup>7</sup> Disqualification of directors may take place under the Company Directors Disqualification Act 1996 and may be for a variety of reasons i.e. misconduct (s.2 – 5A), unfitness (s.6 – 8), wrongful trading (s.10) and competition infringements (s.9A).

SDs as 'He [who] lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself.'<sup>9</sup>

In the *Secretary of State for Trade and Industry v Deverell*,<sup>10</sup> Morritt, L. J. gave what is considered, in practise, to be the leading judicial analysis of shadow directors stressing that '... interpretation [of what amounts to shadow directorship] may depend on the statutory context (e.g. a stricter construction may be more appropriate in a criminal or quasi-criminal provision); that the purpose of the legislation is to identify those with 'real influence' in the corporate affairs of the company, or part of them; that advice (other than professional advice) is capable of coming within the phrase 'directions or instructions'; and that it is not necessary that the board should be reduced to a subservient role or surrender its discretion'.<sup>11</sup>

In *Ultraframe (UK) Ltd v Fielding* (2005)<sup>12</sup> the court held that SDs do not 'normally' owe duties. However, s.170(5) of the CA 2006 now provides that the 'general duties [of directors] apply to a shadow director of a company where and to the extent that they are capable of so applying.'<sup>13</sup> The offending terms 'where and to the extent that they are capable of so applying' has resulted in the application of those duties and liabilities being limited. It is salient to note that an individual can become a SDs even where his or her directions or instructions do not cover, all or most of the company's affairs or activities. The practical effect of the s.170(5) has been to limit the instances in which SD owes the company a fiduciary duty to the nature and extent of the directions or instructions given.

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<sup>8</sup> [1994] B.C.C. 161; [1994] 2 BCLC 180. In this case it was decided that liability for wrongful trading extended to de-facto, de-jure and shadow directors. It was also stated that a shadow director and de-facto director are mutually exclusive terms. Section 251(3) of the CA 2006 adopts the position from *Hydrodam* that directors of a parent company are not necessarily shadow directors of a subsidiary.

<sup>9</sup> *Ibid* note 8, *Hydrodam* at paragraph 163.

<sup>10</sup> [2001] Ch. 340.

<sup>11</sup> Palmer, F. B. and Morse, G. (2020). *Palmer's Company Law*. Volume 2. London, England: Sweet and Maxwell. See: Part 8, chapter 8.217. [Accessed 09 May 2020].

<sup>12</sup> [2005] EWHC 2506 (Ch). Note, this case fell within the Companies Act 1985, in particular matters related to s.741(2). See also: *Yukong Line of Korea Ltd v Rendsburg Corp Investments of Liberia Inc* [1998] 1 WLR 294, here the SD was a de-facto director and therefore the consideration of SD duties and liabilities must be set against that.

<sup>13</sup> Section 170(5) in its original form stated that 'the general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles so apply'. This was amended to its current form by the SBEEA 2015. The explanatory note to the 2015 Act reads; '603. At present the general duties of directors can only apply to shadow directors in the same way as the corresponding common law rules and equitable principles can. In future, the starting point for shadow directors will be that the general duties apply to them unless they are not capable of applying (removing the current restriction). This is achieved by replacing section 170(5) of the CA 2006. This change in default position is neither intended to preclude the courts from looking at the application of the duties on a case by case basis, nor from drawing on existing case law in any given case.'

Contrary to academic discourse<sup>14</sup> suggesting otherwise, the CA 2006 does not extend to them the full range of duties and obligations that are owed by both EDs and NEDs to SDs.

In contrast to *Ultraframe*, in *Vivendi SA v Richards* (2013)<sup>15</sup> it was held that they 'should owe duties ... at [the very] least to some degree'. The court clarified that the duty of loyalty (good faith) in what the SD considers to be the best interests of the company<sup>16</sup> will apply when he or she is giving directions or instructions, but also that this is a matter for the court to decide on the merits of each individual case.<sup>17</sup> Although the matter in *Vivendi* concerned de-jure directors the reasoning shed some light on how the courts approach the question of an SDs duties and the interpretation of s.170(5); any person that gives directions or instructions to a company's directors with the belief that they will act upon them can be said to have assumed responsibility for those affairs.

It is interesting to note that s.89(3) of SBEA 2015 allows for the '...prescribed general duties of directors to apply to shadow directors with such adaptations as may be prescribed; (b) for prescribed general duties of directors not to apply to shadow directors.' The duties may therefore be made applicable in an adapted form, and of course inapplicable, but there has been no move towards this to date.

*Standish v The Royal Bank of Scotland Plc*<sup>18</sup> demonstrates the current position in law, as at 2019, but there is still a lack of clarity. In this case the court has held that there must be a causal link between the factors that give rise to a shadow directorship (directions or instructions) and the alleged wrong or loss, only then will the SD have breached, in relation to that, his or her duty to the company.<sup>19</sup> For practical purposes is it advisable for SDs, per English law, to act in accordance with the same duties that are imposed upon a de-jure director.

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<sup>14</sup> Moore, C. (2016). Obligations in the shade: The application of fiduciary directors' duties to shadow directors. *Legal Studies*, 36(2), 326-353. See also: Witney, S. (2016). Duties owed by shadow directors: closing in on the puppet masters? *Journal of Business Law*. UK: Sweet and Maxwell.

<sup>15</sup> [2017] EWHC 1581 (Ch).

<sup>16</sup> *Smithton Limited v Naggar* [2013] EWHC 1961 (Ch). Note: other than in the instances discussed the definition of a shadow director in English Company Law is still unclear.

<sup>17</sup> There are a number of express requirements in the CA 2006 that state SDs will be liable in the same manner as de-jure directors i.e. director disqualification and declaration of interests in existing transactions.

<sup>18</sup> [2019] EWHC 3116 (Ch). See also: *ibid* *Smithton*, note 16.

<sup>19</sup> S89(2) of the Small Business, Enterprise and Employment Act 2015 allows the secretary to state to '...by regulations make provision about the application of the general duties of directors to shadow directors. [S.89](3) The regulations may, in particular, make provision, (a) for prescribed general duties of directors to apply to shadow directors with such adaptations as may be prescribed; (b) for prescribed general duties of directors not to apply to shadow directors.'

## Non-Executive Directors (NED)<sup>20</sup>

In summary, the role of the NED as at 2020 has been strengthened. They must provide leadership, be involved in strategic decision making including the review of management performance and reporting of the same. They should also help set a company's values and standards. The purpose is also to lend objective and constructive challenge and aid the development of strategy. NEDs are involved in determining the remuneration of the EDs and appointing or removing senior management as well as planning for succession. They contribute to the management of risk and should be satisfied with the accuracy of financial information and adequacy of financial controls; such matters will be discussed with reference to the UK Corporate Governance Code 2019 later in this article.

To be clear; following the CA 2006, owe the same legal duties to a company as an ED. Thus, the law treats them 'similarly as a matter of principle ... but the difference ... can be important in practise'.<sup>21</sup> NEDs tend not to have the extent of actual authority<sup>22</sup> in representing the company and are far more easily replaced than EDs. The latter have substantial implicit protection because they can claim compensation for loss of office that can prove very expensive for a company. EDs will also be expected to work to a higher standard (skill and care) and will have access to information that the NED may not be given. Therefore, the NED will have to do less to discharge his or her duties under the statute in comparison to an ED because of his or her position within the company, the organisation type and the fact that EDs have their duties set out in their respective contracts of service (employment). The question of the standard expected of a NED in law is discussed later.

## Corporate Governance<sup>23</sup> and The Growing Importance of the NED

The role of the NED has not been defined in law, and therefore prior to the extensive in-roads made by the Corporate Governance Codes (Codes) in relation to the role of the NED a company could dictate what it desired

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<sup>20</sup> The Higgs Report was commissioned by the Department of Trade and Industry to review the role of NEDs within the corporate governance framework. Higgs, D. (2003). Review of the role and effectiveness of non-executive directors. London: DTI. See: <http://www.ecgi.org/codes/documents/higgsreport.pdf> [Accessed 07 May 2020].

<sup>21</sup> Ibid note 11, Palmer's Company Law at Part 8, chapter 8.2. It should also be noted that the Companies Act 1985 also made no distinction between EDs and NEDs.

<sup>22</sup> Note, s.40 of the CA 2006 allows directors to contract on a company's behalf without constitutional restriction. Where s.40 does not apply questions relating to whether a director has the power to do so is subject to the normal common law rules. See also: *The Royal British Bank v Turquand* (1856) 6 E. and B. 327, the rule 'Turquand's Rule' concerns an assumption by a person dealing with a company that there has been compliance with 'indoor management' rules i.e. the articles of association, this has generally become a synonym for the application of agency law to companies.

<sup>23</sup> The latest code, 2019, is applicable to all companies that have premium listing regardless of where they are incorporated.

him or her to do. The relationship was, and still is, governed or at worst left to the behest of the employment contract but there have been changes promoted by the Codes and, amongst other legislation, the Insolvency Act 1986 and the CA 2006.

#### Cadbury Report 1992<sup>24</sup>

In 1991, the accountancy profession, the Financial Reporting Council<sup>25</sup> and the Stock Exchange set up a committee to investigate the financial aspects of corporate governance in the United Kingdom. The committee, led by Sir Adrian Cadbury, published its report 'The Report of the Committee on the Financial Aspects of Corporate Governance' in 1992 noting that 'companies [with high] standards of corporate governance ... are the more likely to gain [investor] confidence ... and support for the development of their businesses'.<sup>26</sup> The Report highlighted that corporate governance is 'the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies.'<sup>27</sup>

Prior to Cadbury, theoretical studies have shown that NEDs have very little impact on the working of a Board of Directors<sup>28</sup> even where they have been given the responsibility to replace an ineffective Board<sup>29</sup> often because they have no actual stake in the proceedings.<sup>30</sup> The traditional role of the NED was perceived as being a 'token' one that was passive and created only to give credibility to a company board.<sup>31</sup>

The Cadbury Code of Best Practice, which was part of the Report, was based on accountability, integrity and openness, formed part of the

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<sup>24</sup> Cadbury, A. (1992). *The Committee on the Financial Aspects of Corporate Governance*. London: Gee and Co. Ltd. See also: Cadbury, A. (1990). *The Company Director*. London: Director Books; Cadbury, A. (2000). *The Corporate Governance Agenda*. *Corporate Governance*, Vol.8 (1), pp.7-15.

<sup>25</sup> The FRC is currently undertaking a project on the future of corporate reporting. The project is supported by an advisory group led by Paul Druckman. A key aim is to respond to a recommendation made by Sir John Kingman, that is to promote 'brevity, comprehensibility and usefulness in corporate reporting'. The FRC will, during 2020, publish its thought leadership paper on this project. Following Kingman's review of the FRC there is a proposal that it will transition into the Audit, Reporting and Governance Authority (ARGA). It is envisaged that ARGA will have a greater mandate, powers and of course operate under new leadership. See: Kingman, J. (2018). *Independent Review of the Financial Reporting Council*. UK: HMSO. At p.11.

<sup>26</sup> Ibid note 24, Cadbury at para 1.6 at p.11.

<sup>27</sup> Ibid note 24, Cadbury at para 2.5 at p.14.

<sup>28</sup> Demsetz, H. (1983). *The Structure of Ownership and the Theory of the Firm*. *Journal of Law and Economics* 25, 375-390. [Accessed 29 April 2020].

<sup>29</sup> Weisbach, M. (1988). *Outside Directors and CEO Turnover*. *Journal of Financial Economics* 20, 413-460. [Accessed 12 April 2020].

<sup>30</sup> Baum, L. and Byrne, J. A. (1986). *The Job Nobody Wants*. *Business Week* Editorial. September 8, 56. [Accessed 19 December 2019].

<sup>31</sup> Rubner, A. (1965). *The Ensnared Shareholder*. London: Macmillan.



Report. In terms of NEDs, the Report highlighted that, they had two important contributions to make 'as a consequence of their independence from executive responsibility' bringing a broader view an independent judgment to a company's activities namely; to review the performance of the board and executive directors and to take a lead where possible conflicts of interest arise.<sup>32</sup> The Code was important because the London Stock Exchange require all companies listed with it to declare in their respective annual statements whether they had complied or not throughout the particular financial year. Cadbury was the first to formally recommend independent oversight to at board level in the United Kingdom. Differences in interests between management and owners (shareholders) has often led to the liquidation of some otherwise profitable companies in the United Kingdom,<sup>33</sup> the injection of independent oversight or 'corporate conscience'<sup>34</sup> was also an attempt to mitigate this.<sup>35</sup> It is salient to state, that unlike the current position, that at that time NEDs being the custodians of corporate social responsibility was clearly not in the minds of Cadbury and others.<sup>36</sup> Some of the other issues NEDs were seen to resolve include the 'agency costs problem'; this remedied the failure of shareholders to effectively monitor the Board of Directors.<sup>37</sup> In short, the NED is put in place to monitor management on behalf of the shareholders; Baysinger and Butler (1985)<sup>38</sup> found a positive correlation in this respect. NEDs themselves have an incentive to ensure that the company performs well because it also affects their own standing

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<sup>32</sup> Ibid note 24, Cadbury at para 4.1 – 4.6 at pp.19 – 20.

<sup>33</sup> Laing, D. and Weir, M. (1999). Governance Structures, Size and Corporate Performance in UK Firms. *Management Decision* 37, 5, 457-464. See also: EQE review, 1994. EQE Review. (2002). Risk Management in the UK: A Board-level priority. [Online]. Available at: <https://www.eqe.com/publications/revf94/risk.html>

<sup>34</sup> Sweeney-Baird, M. The Role of the Non-Executive Director in Modern Corporate Governance. *The Company Lawyer* 2006, 27(3), 67-81, at p.6. [Accessed 29 December 2019].

<sup>35</sup> Hooghiemstra, R. and Van Manen, J. The Independence Paradox: (Im)Possibilities Facing Non-Executive Directors in the Netherlands. *Corporate Governance: An International Review*, Vol. 12, No. 3, pp. 314-324, July 2004. Also: Tan, C. H. Corporate Governance and Independent Directors. *Singapore Academy of Law Journal*, Vol. 15, p. 355, 2003. Note, NEDs may not wish to be connected to a failing company, see: Fama, E. F. and Jensen, M. C. (1983). Agency Problems and Residual Claims. *Journal of Law and Economics*. Chicago, 26, 2, 327-350. Poorly performing companies may seek NEDs to help steer them, see: Hermalin B. E. and Weisbach, M. S. (1989). The Determinants of Board Composition. *Rank Journal of Economics* 19, 95-112. [Accessed 02 April 2020].

<sup>36</sup> Henderson Global Investors. Governance for Corporate Responsibility: The Role of Non- executive Directors in Environmental, Social and Ethical Issues (A Discussion Paper). London: Henderson Global Investors, May 2003.

<sup>37</sup> Ibid note 35, Fama and Jensen. Note: Agency problems arise when a conflict of interest exists between the agent or management and the principal or the shareholders.

<sup>38</sup> Baysinger, B D. and Butler, H N. (1985). Anti-takeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation. *Virginia Law Review* Charlottesville, 71, 8, 1257. See also note 27, Demsetz.

as directors'.<sup>39</sup> The lack of incentives, expertise and time have often resulted a barrier to NEDs performing their duties effectively.<sup>40</sup>

### Greenbury Report 1995<sup>41</sup>

The Greenbury Committee was set up in January 1995 by the Confederation of British Industry<sup>42</sup> and chaired by Sir Richard Greenbury, who was at that time the Chairman and the CEO of Marks and Spencer. The report focuses on a particular issue in large public companies, the remuneration of directors;<sup>43</sup> accountability, transparency and enhancing performance.<sup>44</sup> The report went as far as to state, perhaps rather short-sightedly, that if this was achieved that the regulatory gaze need not be too far reaching.<sup>45</sup> Multiple reports, codes and reforms<sup>46</sup> later these are matters that still dominate the headlines, often for the wrong reasons as demonstrated by mass FTSE All-Share company shareholder dissent in opposition to ED pay packages in 2019.<sup>47</sup>

### Hampel Report 1998<sup>48</sup>

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<sup>39</sup> Ibid notes 28 and 29. See also: Ricardo-Campbell, R. (1983). Comments on the Structure of Ownership and Theory of the Firm. *Journal of Law and Economics*, 26, 391-394. [Accessed 20 April 2020].

<sup>40</sup> Lorsch, J. and MacIver, E. (1989). *Pawns or Potentates*, Boston: Harvard Business School Press.

<sup>41</sup> Greenbury, R. (1995). *Directors' Remuneration: Final Report (The Greenbury Report)*. This was the final report of of a study group chaired by Sir Robert Greenbury. Hansard provides some an interesting insight into some of the criticisms of Greenbury, see: Greenbury Report, HC Deb 17 July 1995 vol 263 cc1311-22. Available at: <https://api.parliament.uk/historic-hansard/commons/1995/jul/17/greenbury-report>. [Accessed 20 April 2020].

<sup>42</sup> The Confederation of British Industry or CBI is a business lobbying organization.

<sup>43</sup> Nakajima, C. Proposals for corporate governance reform and crack down on irresponsible business in the UK. *Comp. Law*. 2017, 38(3), 93-94.

<sup>44</sup> The link here was performance related pay, this was also the subject of recommendations in the Walker Review in 2009 – discussed later.

<sup>45</sup> Ibid note 41, Greenbury, at para.1.13. See also: Keay, A. Stewardship theory: is board accountability necessary? *Int. J.L.M.* 2017, 59(6), 1292-1314.

<sup>46</sup> For an interesting discussion on the move towards greater corporate social responsibility and director remuneration see; Ellerman, P., Rae, C, Sykes, G. and Ward, B. *All Together Now*. I.H.L. 2020, Win, 44-47.

<sup>47</sup> Harris, J. Shareholder dissent hit a quarter of FTSE all-share companies in 2019. *Comp. Law*. 2020, 41(5), 125. Analysis by the Investment Association published on 20.02.2020 showed that 158 FTSE All-Share companies were, in 2019, added to its Public Register. This tracks votes over 20% at an AGM or GM. Interestingly, just under 40 of those registered a resolution in 2018 and 62 in 2019 on the subject of remuneration packages, and the top investor concern related to the same. There was an increase of 30% increase in the number of FTSE 250 companies appearing for resolutions relating to remuneration.

<sup>48</sup> Hample, R. (1998). *Committee on Corporate Governance: Final Report. (The Hample Report)*. Gee Publishing Ltd. See also: Short, H. (1999). *Corporate governance: Cadbury, Greenbury and Hampel – A Review*. *Journal of Financial Regulation and Compliance*, Vol. 7 No. 1, pp. 57-67.

The Hampel Report formed the basis of the Combined Code on Corporate Governance in the UK.<sup>49</sup> Criticisms of Hampel included the fact that there were no lawyers involved,<sup>50</sup> it lacked proposal of a concrete model, it failed to acknowledge internal monitoring processes as essential elements of sound corporate governance and its overreliance on the Annual General Meeting<sup>51</sup> (AGM) as a conduit through which to effect organisational reform.<sup>52</sup> The subsequent trajectory of company law, related legislation i.e. the Insolvency Act 1986, the Company Directors Disqualification Act 1995 and the swathe of anti-money laundering or counter-terror finance initiatives along with the continual revisions to the Corporate Governance Codes in the United Kingdom demonstrates that behavioural change is seldom generated through self-regulation alone.

Hampel is part of holy trinity of Reports (Cadbury, Hampel and Higgs) that that have focused on a number of corporate governance concerns; effective leadership, communication including the flow of data and other management information, and generating stakeholder or ownership amongst all those linked to the organization i.e. employees, consumers, investors and suppliers etc.

Where Hampel was concerned it failed to suggest, in sufficient detail, a model of 'good' behaviour, flow of data and disclosure. Whilst the Report was published at a time when such models were at the stage of inception, Hampel missed a valuable opportunity to redefine stakeholder expectations. It also failed to acknowledge that the success of the AGM a form of corporate democracy relies on the sharing of relevant information, the importance that is placed upon it i.e. share ownership as investment or property may mean the holder is not engaged with the process or has relatively little interest in management matters, and the overall participation of stakeholders.<sup>53</sup> Whilst Hampel recognised the need for '[sufficient] controls to ensure ... compliance with laws and regulations'<sup>54</sup> it shied away from recommending enhancing internal monitoring mechanisms where there was an increased systemic risk or that posed to

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<sup>49</sup> FRC. The Combined Code on Corporate Governance. July 2003. London: Financial Reporting Council.

<sup>50</sup> This is a criticism that can be levied, perhaps more so by the legal fraternity, at Cadbury, Greenbury and Hampel.

<sup>51</sup> Stapledon, G. P. (1996). Institutional Shareholders and Corporate Governance. Oxford: Clarendon. See also: Hawley, J. P., Hoepner, A. G. F., Johnson, K. L., Sandberg, J. and Waitzer, E. J. (2014). Cambridge Handbook of Institutional Investment and Fiduciary Duty. UK: Cambridge University Press.

<sup>52</sup> For an interesting cross-jurisdictional (UK and the USA) critique of Hampel; Barnard, J. W. (1998). The Hampel Committee Report: A Transatlantic Critique. Popular Media, 61. USA: Sweet and Maxwell.

<sup>53</sup> For an interesting discussion on shareholder activism and its control in law through judicial intervention; see, Christie, A. L. and Liptrap, J. S. Mapping judicial reactions to shareholder activism in the UK. C.L.J. 2020, 79(1), 21-24. [Accessed 18 March 2020].

<sup>54</sup> Ibid note 48, Hampel at pp.51 – 54 at paras.6.10 – 6.15.

stakeholders. Again, current adverbs in regulatory compliance has proven this to be short-sighted.<sup>55</sup>

Cadbury<sup>56</sup> suggested that there should be a sufficient number of NEDs on a board, that they are independent or at least seen to be so, working together with the EDs demonstrating objectivity and independence of judgement where required.<sup>57</sup> In terms of the independence of NEDs, Hampel agreed suggesting that it is 'not practicable to lay down more precise criteria for independence ... it should be for the board to take a view on whether an individual director is independent in [this] sense.'<sup>58</sup> Whilst this seems logical it detracts from the issue of 'competence', an independent NED who is not competent may be perceived to be making an objective contribution but would in reality be far less impactful than an ED who is ethical in 'doing the right thing', is engaged and well informed. In this respect independence is reduced to mere 'tokenism' within the machinery that is the corporate democracy. Hampel suggested that there is a need, which still exists decades later and as demonstrated in this article, for the appointment process to ensure careful selection of NEDs, who themselves are subject to training and development, and review or replacement where appropriate, along with adequate compensation commensurate to the importance corporate governance places upon them.

Hampel, at para.3.3.,<sup>59</sup> also stated that NEDs should have '...common duties in the interests of the unity and cohesion of the board. Where the English courts are called upon to decide whether a director has fulfilled his or her duty, they have recently tended to take into account such factors as the position of the director concerned (e.g. whether he or she is a full time executive director or a non-executive director) and the type of company. We consider this to be a helpful recognition of the practical situation.' It seems that in law, as at 2020, this position has been fairly well maintained, the efficacy of which is discussed later in this article.

The Higgs Review (2003)<sup>60</sup>

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<sup>55</sup> Robinson, S., Altkemper, S. and Johal, Y. K. The regulatory FinTech Sandbox: A Global Overview. *Comp. & Risk* 2020, 9(1), 10-14. [Accessed 29 April 2020].

<sup>56</sup> Ibid note 24, Cadbury.

<sup>57</sup> Ibid see note 24, Cadbury at p.22, para.4.12. The report defined independence as 'apart from their directors' fees and shareholdings ... independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement'.

<sup>58</sup> Ibid note 48, Hampel at p.25 – 26, at para.3.9.

<sup>59</sup> Ibid note 48, Hampel at p.23, at paras.3.2 – 3.3.

<sup>60</sup> Higgs, D. (2003). Review of the role and effectiveness of non-executive directors. London: DTI. See also: McNulty, T., Roberts, J. and Stiles, P. (2003). Creating Accountability within the Board: The Work of the Effective Non-executive Director. London: DTI, Higgs Review; Tassell, T. Shareholders and business sing same tune overboard reforms. *Financial Times*, 24 July 2003, at p.5.

The review was a Treasury and Department of Trade and Industry initiative, led by Derek Higgs<sup>61</sup> and Sir Robert Smith, intended to amend the Combined Code with a profound effect on NEDs and Audit Committees; for the purist two of the most important corporate governance tools.<sup>62</sup> The focus of this review was to (a) ascertain the present state of affairs relating to NEDs i.e. independence level, the numbers of NEDs in use, their relationships with various stakeholders, and (b) create discourse in terms of enhancing their effectiveness which would lead to proposals for reform.<sup>63</sup> Perhaps underacknowledged, the fact is that some of the main contentions surrounding NEDs, as remedied in the CA 2006, owe themselves to this review. Higgs deduced that NEDs were 'largely invisible and poorly understood'.<sup>64</sup>

The recommendations in the Higgs Review related to; the Board and chairpersonship, NEDs, the independence of NEDs and a Senior Independent Director, appointment of directors, audit and remuneration, director liability and stakeholder relationships. What follows is a short summary of some of those.

#### The Board and Chairperson

Whilst the review recommended that at least 50% of the board, excluding the chairperson, should be made up of NEDs, it noted that a strong representation of EDs was also required. The Higgs Review failed to recommend that NEDs be restricted as to the number of appointments that they held, the impact of this on the NEDs ability to add value is obvious especially given many individuals are 'career NEDs'. The review did recommend that an ED should not become chairperson of a large organisation or have more than one non-executive directorship.

#### NEDs

The Higgs Review also recommended that the role of the NED should be defined in the Combined Code, in so doing it set out four aspects of it as; strategy, performance, risk and people. These were set out as follows:

'Strategy: Non-executive directors should constructively challenge and contribute to the development of strategy.'

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<sup>61</sup> This appointment was intended to demonstrate that the review was independent from government. See also: see Higgs, D. [2002] 11. Sweet & Maxwell's Company Law Newsletter 4.

<sup>62</sup> Perhaps this was a product of the time given the financial disasters that had occurred i.e. the Enron scandal and its subsequent collapse (2001) had caused much regulatory nervousness across the globe, see: Thomas, W. The Rise and Fall of Enron: When a company looks too good to be true, it usually is. Journal of Accountancy, April 2002. [Accessed 15 May 2020].

<sup>63</sup> Responses were received from over 250 organisations.

<sup>64</sup> Ibid note 60, Higgs at p.3.

Performance: Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.

Risk: Non-executive directors should satisfy themselves that financial information is accurate, and that financial controls and systems of risk management are robust and defensible.

People: Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management and in succession planning.<sup>65</sup>

The purpose behind this was to clarify the core elements of the role and to establish the 'spirit of partnership and mutual respect ... This requires the non-executive director to build recognition by executives of their contribution in order to promote openness and trust. Only then can non-executive directors contribute effectively. The key to non-executive director effectiveness lies as much in behaviours and relationships as in structures and processes.'<sup>66</sup>

#### Independence of NEDs

The review recommends a definition of NED independence be included in the Combined Code as '[a NED] is considered independent when the board determines that ... [he or she is] is independent in character and judgement and there are no relationships or circumstances which could affect, or appear to affect ... [his or her] judgement.'<sup>67</sup> In terms of the latter this would include less than five years in his or her previous employment or material connection with the company, less than three years since he or she had a material business relationship with the company, significant shareholding, additional remuneration, family ties with any of the company's main stakeholders i.e. directors or advisors, or has been on the board for ten years or more. The Higgs Review recommended that independent NEDs in its annual reports.

#### Audit and Remuneration

The review recommended that the remuneration committee should be made up of at least three members who should be NEDs. This committee

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<sup>65</sup> Ibid note 60, Higgs at p.27.

<sup>66</sup> Ibid note 60, Higgs at p.27 at para.6.3. Annex C, E and G of the Review provides guidance on the role, remuneration committee and due diligence for new board members.

<sup>67</sup> This was later revised in the Combined Code 2003, 2006 and 2008. The 2014 code states that there should be a balance between EDs and NEDs so that neither dominate the board and its decision making. The 2014 code also recognised that NEDs devote their time across organisations, in various roles, therefore they should avoid taking more than one NED-ship in any FTSE 100 company and the 2018 code does the same.

would set the remuneration for all EDs, senior executives and the chairperson. It was also recommended that the same NED should not be allowed to sit simultaneously on the audit,<sup>68</sup> remuneration and nomination committees, thus ensuring objectivity.

## NEDs and Liability as Directors

The Higgs Report focussed on the determination of liability of NEDs. Other than the recommendation of active case management and pre-litigation indemnification of costs and post-litigation calling to account where liable, the review does not adequately consider the formal application of director duties in law to NEDs, something that the Companies Act 2006, to some extent, later rectified.

The review set out the concerns of imposing liability on NEDs, specifically because the matters were raised post the Equitable Life and Ernst and Young<sup>69</sup> litigation. The case concerned breach of fiduciary duty and negligence, the duty of care and skill imposed on directors is one of the most important and is now covered by s.174 of the Companies Act 2006. This principles in terms of this duty were originally set out in *Re City Equitable Fire Insurance Co Ltd* by Romer, LJ. as ‘... in respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly’.<sup>70</sup> In the present case, nine of the fifteen directors being sued were NEDS. Langley, J. stated in this case that ‘[there exists] ... a considerable measure of agreement about the duty owed in law [to a company] by a non-executive director.’ He went on further to state that ‘It was no longer good law that directors might leave the conduct of the company’s business to competent management. Though section 727 [of the Companies Act 1985]<sup>71</sup> might give relief to directors who had been negligent, but who had nevertheless acted reasonably, summary relief in this case was inappropriate’.<sup>72</sup> Contrary to the suggestion of some commentators the increased liability of NEDs, in law, has not born out a reduction in NED recruitment levels. Perhaps this same risk has provided a greater incentive for higher levels of competence or at the least engagement to meet the requirements set out in law.

Higgs also discussed a contractual cap on liability, the creation of ‘proportional liability’ or to create a ‘business judgment’ defence. There

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<sup>68</sup> The Smith Report 2003, discussed later, focuses on Audit Committees. Thus, Higgs is consistent with Smith in this regard.

<sup>69</sup> [2003] EWHC 112 (Comm). See also: Barlow, J. Directors’ and Officers’ Liabilities through the Looking Glass. *Liability Risk and Insurance* - April 2004, LRI 164 (17).

<sup>70</sup> [1925] 1 Ch. 407.

<sup>71</sup> Section 1157 of the Companies Act 2006, see *supra*.

<sup>72</sup> See also: *Equitable Life Assurance Society v Hyman* [2000] UKHL 39.

was resounding support that the duties, in law, of EDs and NEDs should be the same – which the CA 2006 clearly reflects. Furthermore, there were concerns that a reduction or limitation in liability would render the NEDs careless which would undermine the ‘unitary-ness’ of the board.<sup>73</sup> The review concluded that the issue of greater potential liability was not having the detrimental effect on the recruitment of NEDs in large organisations, this argument reappeared in 1998 during the Company Law Review in terms of EDs,<sup>74</sup> even though there was a risk that the perception of higher risk could pose some issues.

The review also covered the adequacy of directors’ liability and indemnity insurance cover and the adverse impact on reputational risk, deficiencies that were then remedied by ss.233 of the CA 2006 (discussed later). It was also highlighted that there is a raft of additional legislation that applies to all directors; ‘health and safety, environmental law, competition ... companies and insolvency legislation ... obligations are imposed on the directors of a company as well as (or instead of) on the company itself. Some ... carry criminal sanctions, others may give rise to civil remedies in the hands of private third parties, insolvency practitioners or regulators.’<sup>75</sup>

It was noted<sup>76</sup> that the general duties owed by NEDs to the company including conduct and skill and care, have been set out in case law. The law was also set out as; the director will not be liable unless the company can show that he or she is in breach of the duty and that a loss has resulted. Section 727 of the Companies Act 1985 allows the court to give relief to a director if it believes that he or she acted honestly and reasonably in all the circumstances so that they should fairly be excused. In this review it was confirmed that the same duties applied to both EDs and NEDs but the ‘knowledge, skill and experience expected will vary between directors with different roles and responsibilities [i.e. finance or sales]’.<sup>77</sup> This hasn’t changed in the CA 2006, s.1157 replaced this provision on the same terms.

The issue for NEDs was knowing with certainty the extent of the duties they owe. The Higgs Review suggested<sup>78</sup> further guidance be provided to the Combined Code as an aid to the court when considering what could be reasonably expected from a NED in his or her position. This reflects the

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<sup>73</sup> Ibid note 60, Higgs at pp.63 – 66 at paras.14.1 – 14.20.

<sup>74</sup> Department of Trade and Industry. The Company Law Review Steering Group. (1999). *Modern Company Law for a Competitive Economy: The Strategic Framework*. UK: HMSO. Also: The House of Commons Trade and Industry Committee. (2003). *The White Paper on Modernising Company Law: Sixth Report of Session 2002–03*. UK: HMSO.

<sup>75</sup> Ibid note 60, Higgs at p.65 at para.14.14. It was also noted that the limitation of actions to the company and members derivative claims avoids speculative shareholder litigation.

<sup>76</sup> Ibid note 60, Higgs at p.62 at para.14.4.

<sup>77</sup> Ibid note 60, Higgs at p.63 at para.14.6.

<sup>78</sup> Ibid note 60, Higgs at p.63 at para.14.8.



position in law; the level of involvement, time devoted to company affairs is likely to be significantly less for a NED, the detailed knowledge and experience of the company's affairs required from a NED will be less than that expected from an ED, these are all matters taken into account when the question about the standard or skill and care and liability arises.

The schedule for annexation to the code, 'Guidance on the Liability of Non-executive Directors: Care, Skill and Diligence', stated the matters that could be taken into account '... in assessing the knowledge, skill and experience which may reasonably be expected of a non-executive director and therefore the care, skill and diligence that they may be expected to exercise ...

In this context, the following elements of the Code may also be particularly relevant. In order to enable directors to fulfil their duties, the Code states that:

- the contract or letter of appointment of the director should set out what is expected of them including the level of responsibility and time commitment ... ; and
- the chairman should provide sufficient, accurate, timely and clear information to board members to give them a fair and balanced understanding of relevant issues ...

Non-executive directors should themselves:

- undertake appropriate induction and, as needed, professional development ... ;
- make appropriate enquiries, and where necessary, take and follow appropriate professional advice ... ;
- where they have concerns, ensure that these are addressed by the board and to the extent that they are not resolved, ensure that they are recorded ... ; and
- give a statement of reasons to the board if they resign ...

It is up to each non-executive director to reach a view as to what is necessary in particular circumstances to comply with the duty of care, skill and diligence they owe as a director to the company.

In considering whether or not a person is in breach of that duty, a court would take into account all relevant circumstances. These may include having regard to the above where relevant to the issue of liability of a non-executive director.<sup>79</sup>

The extent of the duties a NED owes a company has been clarified by the CA 2006, much of the matters outline have found a place in the law.

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<sup>79</sup> Ibid note 60, Higgs, Annex A at p.92.

The Higgs Review also recommended that the company be able to indemnify a NED in advance against reasonable costs of having to defend proceedings without the need to establish prospects of success first. This would have created the requirement for repayment where the defence was unsuccessful. In addition, to provide NEDs with liability insurance prior to the appointment. Section 310 of the CA 1985 was amended by ss.1295 and 1300. The provision restricted the freedom of contract preventing the inclusion of any terms that tried to exempt any officer of a company, including NEDs, 'any liability which by virtue of any rule of law that would otherwise attach to him [or her] in respect of any negligence, default, breach of duty ... of which he [or she] may be guilty in relation to the company'.<sup>80</sup> The approach has begun to be circumvented by cost indemnities and indemnity insurance arrangements.<sup>81</sup>

Section 233 of the CA 2006 looked to clarify these issues. Sections s.309A – C of the CA 1985 were inserted into the CA 1985 by the Companies (Audit, Investigations and Community Enterprise) Act 2004 as a way to ameliorate the position of NEDs (and Eds). Section 309A(5) allowed a company to purchase director insurance. The indemnity provisions in s.309A(3) contained complex exemptions as set out in ss.309A(4) and 309B – C which permitted qualifying third-party indemnity provisions.

Section 233 permits, per the Explanatory Notes, '... a company to purchase and maintain insurance for its directors, or the directors of an associated company, against any liability attaching to them in connection with any negligence, default, breach of duty or breach of trust by them in relation to the company of which they are a director.'

Section 1157 of the CA 2006, previously s.727 CA 1985, provides relief for directors and NEDs from 'negligence, default, breach of duty or breach of trust against — (a) an officer of a company, or (b) a person employed by a company as auditor (whether he is or is not an officer of the company), [where] it appears to the court hearing the case that the officer or person is or may be liable but that he acted honestly and reasonably, and that having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused, the court may relieve him, either wholly or in part, from his liability on such terms as it thinks fit.'

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<sup>80</sup> Companies Act 1985, s.310(1). See also: Talbot, L. E. (2008). *Critical Company Law*. UK: Routledge. See, pp.65 – 66. Note: In relation to other officers i.e. auditors, see s.532 CA 2006 – where the prohibition reappears but can be limited through limitation of liability agreements or LLAs, see ss.535 – 7 of the CA 2006. Also note the courts power to relive wholly or in part auditor liability for negligence under s.1157(1) of the CA 2006.

<sup>81</sup> Sections 19 – 20 of the Companies (Audit, Investigations and Community Enterprise) Act 2004. Replaced by ss.234 – 8 of the CA 2006. See also: s.137 of the Companies Act 1989, s.310 of the CA 1985 and now s.233 of the CA 2006. See: Milman, D. (). *National Corporate Law in a Globalised Market. The UK Experience in Perspective*. UK: Edward Elgar. pp.70 – 72. See: Pettet, B. (2001). *Company Law*. UK: Pearson Education Limited.

## Appointment of Directors, NED Contracts and AGMs<sup>82</sup>

The Higgs Review suggested that board appointments should be made by a transparent nomination committee consisting mainly of NEDs, the proceedings of which would form part of the annual report. NEDs would also receive a letter of engagement that sets out their duties and responsibilities but was concerned at the limited number of candidates from which NEDs came and recommended that this be widened to include other non-commercial sectors. It was recommended that NEDs should only serve two terms of not more than three years in duration respectively. It was expected that each NED would only take up the post if they could devote the necessary time to meet its obligations and would be fairly compensated,<sup>83</sup> this would be reviewed on an annual basis. EDs holding NED positions of other companies then it must be determined whether he or she can be paid the remuneration and, if yes, how much it is. Where a NED has concerns, these should be raised with the chairperson and if he or she resigns, then the reasons must be set out and these should be circulated to the board. It was also recommended that NEDs attend the AGM to discuss any matters raised in terms of his or her role.

Even though it was argued that the code was unduly prescriptive,<sup>84</sup> all of these measures have had the effect of firmly embedding the NED into the framework of the corporate democracy.<sup>85</sup>

### Smith Report (2003)

In 2002 the Department of Trade and Industry and the Treasury created the Joint Co-ordinating Group on Audit and Accounting Issues in response to the failures of Enron and WorldCom in the United States of America.

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<sup>82</sup> Note: at the time of writing the Covid-19 pandemic requires AGMs to be conducted in compliance with the United Kingdoms 'Stay at Home Measures' under The Health Protection (Coronavirus) Regulations 2020, see also; Coronavirus Act 2020. Although the CA 2006 facilitates a 'hybrid' AGM this still requires some attendees, and thus a completely virtual meeting is not, at the time of writing, in compliance with the law. Although, the Business Secretary has stated that retrospective measures, dated back to 20.03.2020, will be introduced to ease the requirement for AGMs to be held in per the CA 2006 so that they can for instance be held virtually. The BEIS and the FRC issued joint guidance on the matter, see: BEIS and FRC. Measures in Respect of Company Filings, AGMs and Other General Meetings during Covid-19. 14<sup>th</sup> May, 2020. Available at: <https://www.frc.org.uk/publications>.

<sup>83</sup> Remuneration could be partly in shares but not options.

<sup>84</sup> Cassell, T. Call for Revisions to Boardroom Plan. Financial Times, April 2<sup>nd</sup>, 2003 at p.6.

<sup>85</sup> On the fact that the role of the NED is not given due regard in academic literature see; Taylor, B., Dulewicz, V. and Gay, K. (2008) How Part-time Directors create Exceptional Value: New Evidence from the Non-executive Director Awards. Journal of General Management. Vol. 33 Issue 4, p53-70. On the impact of NEDs on the board see; Lawler, E.E. and Finegold, D. Who's in the Boardroom and Does it Matter: The Impact of having Non-executive attend Board Meetings. Organizational Dynamics. February 2006, Vol. 35 Issue 1, p106-115.

This led to the creation of the Smith Group, led by Sir Robert Smith,<sup>86</sup> to reinforce the independence of auditors and further enhance the guidance on the same. The most salient recommendations were; the establishment of an audit committee consisting of three NEDs, one with substantial experience in finance. This was to facilitate, amongst other things, the monitoring of financial reporting and statements, the risk management and control systems in place, the internal audit system and to oversee the appointment and independence of an external auditor.

Both Higgs and Smith<sup>87</sup> did not differentiate on the basis of company size, to the extent that the Smith Report adopts an 'explain and justify non-compliance' approach – something that we still see throughout corporate governance in the United Kingdom today.<sup>88</sup>

### Walker Review (2009)

It is salient to mention the Walker Review, at this stage corporate governance in the United Kingdom was still struggling with remuneration practises within financial institutions. It shied away from defining the level of reward that should be given to directors but did propose the improvement of its structure relative to performance and risk-taking.

### Conclusion

The ICEAW highlighted that Cadbury, Greenbury, Hampel, Higgs and Turnbull, Tyson and Walker<sup>89</sup> produced over fifteen principles and eighty-two code points or revisions. This helps demonstrate the fact that NEDship has gained continuing support since Cadbury in 1992 through to the present day (2020). It is salient to accept that some of this has been promoted by large organisational failures highlighting the importance of independence at board level. Literature shows that a significant step forward, in terms of the role of the NED whilst managing risks in terms of liability in law and clarity, is required. The effect of the changes on the quality or pool of NEDs willing to participate in the corporate democracy hasn't seen the negative impact predicted. However, the issues are far from resolved, the role is still one that is subject to pressures and practical difficulties. The groundwork towards access to greater information, individual competence, increasing diversity at board level and clarity in relation to the role has been laid, the extent the Corporate

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<sup>86</sup> Smith was a Chairman of the Weir Group PLC and also a serving member of the FRC.

<sup>87</sup> The Financial Reporting Council supported both reports, it also took on board the Directors' Remuneration Report Regulations 2002 (SI 2002/1986) at the same time to revise the Combined Code (2003).

<sup>88</sup> Ibid note 11, Palmer's Company Law at Part 8, chapter 8.1113.

<sup>89</sup> Turnbull Report 1999 aimed to set out best practice on the internal controls for listed companies in the UK and the Tyson Report 2003 focussed on The Tyson Report on the Recruitment and Development of Non-Executive Directors. Discussion of these is beyond the scope of this article.

Governance Code 2018 builds on that is explored in part two of this duo of articles. The NED-ship is significant in the modern commercial world and is crucial to long-term sustainability but there is still room for improvement if they are to become an integral and fully functioning part of the corporate democracy.

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