The City of London Law Society

4 College Hill
London EC4R 2RB

Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 – Cheapside 2
mail@citysolicitors.org.uk
www.citysolicitors.org.uk

Corporate Governance

Response of the Company Law Committee of the City of London Law Society (CLLS)

1. The CLLS represents approximately 17,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multijurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

2. This response has been prepared on behalf of the CLLS by a working party comprised of members of its Company Law Committee and certain other senior and specialist corporate lawyers (including Elizabeth Wall (Allen & Overy) and Ben Griffiths (Erskine Chambers)).

3. We welcome the opportunity to provide submissions to the Corporate Governance Inquiry being conducted by the Business, Innovation and Skills Committee (**the Inquiry**).

Executive Summary

- ***Questions 1-8***: We consider that the law on directors' duties as it presently stands provides the appropriate test and an effective framework for the management and supervision of the businesses of UK companies. We also consider that the law on directors' duties is sufficiently clear and necessarily flexible in its application. In many cases, the collapse of a company is not the consequence of any breach of duty by the directors. In our view, specific public interest concerns (eg employee, consumer or environmental protections) are best addressed by specific legislation or regulation. We consider that there is scope for improvement in the availability and guidance on directors' duties by Government.

- ***Question 13***: We are of the view that the current Companies Act requirements for shareholder participation in relation to directors' remuneration policies and remuneration reports has a strong impact on the behaviour of remuneration

committees, and that shareholders do not require a greater role in controlling executive pay.

- ***Question 16***: In our view, there are a number of challenges facing any proposal for worker representation on boards. These would require careful consideration.

Introduction

4. Certain duties of directors (referred to as the general duties) were put on a statutory footing by Part 10 of the Companies Act 2006. This followed an in-depth review of the law relating to directors' duties and corporate governance by: the Law Commission and the Scottish Law Commission; the Company Law Review; and the Government. As noted in paragraph 301 of the Explanatory Notes to the Companies Act 2006, the Company Law Review wanted (among other things):

   (a) to provide greater clarity on what is expected of directors and make the law more accessible. In particular, they sought to address the key question "in whose interests should companies be run?" in a way which reflects modern business needs and wider expectations of responsible business behaviour; and

   (b) to make development of the law in this area more predictable (but without hindering development of the law by the courts).

5. We consider that the law on directors' duties as it presently stands provides the appropriate test and an effective framework for the management and supervision of the businesses of UK companies.

6. We would emphasise the following overarching points about directors' duties under UK law:

   (a) The core duty of a director is the duty to act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole (section 172(1) Companies Act 2006). In doing so, a director is required by section 172 to have regard to (amongst other things) six specified factors, including the long-term consequences of any decision and the interests of the company's employees. The listed factors are not exhaustive and directors may need to have regard to others, such as the interests of former employees.

   (b) The effect of section 172 is that, whilst the overriding duty of a director remains to promote the success of the company for the benefit of its members, every director is now obliged when fulfilling that duty to have regard to the statutory (and other) factors. This approach was described by the Government as giving effect to "*enlightened shareholder value*". In a commercial company, the effect of the section 172 duty will ordinarily be to require the directors to operate and maintain an economically successful company on a sustainable basis.

   (c) As a company approaches insolvency, the duty of a director to have regard to the interests of the members under section 172 transforms into a duty to have regard to

the interests of the company's creditors (this duty having been preserved post-Companies Act 2006 by section 172(3)).

(d) The directors of a company (other than a company that is entitled to the "small companies" exemption) must prepare a strategic report for each financial year of the company. The purpose of that report is to inform members of the company and help them assess how the directors have performed their duty under section 172.

(e) All directors are subject to the same general statutory duties. The same duties apply, for instance, to directors of public companies as to directors of private companies, and to executive directors as to non-executive directors.

(f) However, the duties are deliberately flexible in their application. This is reflected in the fact that directors' duties are expressed in the legislation at a high level and in broad terms. The effect of this is that what is required of a director to discharge his or her duty in any particular case will be fact-sensitive.

(g) We consider the flexibility in the application of directors' duties to be appropriate. It has the advantage that a person who accepts office as a director can readily understand their duties, whilst allowing sufficient flexibility that directors can be held to account in a wide range of situations. It is axiomatic that directors' duties must be capable of applying to directors of a broad range of companies in a broad range of circumstances. It would in our view be very difficult to be significantly more prescriptive about directors' duties than the law presently is.

(h) In determining whether a director has acted in compliance with their duties, the courts do not second guess business judgments of directors. In many cases, the collapse of a company is not the consequence of any breach of duty by the directors, but of legitimate business decisions by the board.

(i) It is a core principle that directors owe their duties to the company as a corporate entity (and not to any specific shareholder or creditor of the company). The corollary of this principle is that it is the company which is entitled to bring legal proceedings against directors to enforce their duties. This means that the decision to pursue legal proceedings against a director or former director will ordinarily be a matter for a company's board of directors (and when deciding whether to do so they will themselves have to comply with their statutory duties).

(j) By way of exception, an individual shareholder may in certain cases bring legal action concerning a director's breach of duty (including via a derivative claim under Part 11 of the Companies Act 2006).

(k) Whilst there is no equivalent mechanism for an individual creditor to bring an action directly against a director, where the company is in an insolvency procedure (eg liquidation or administration), then the insolvency officeholder will be able to bring the action on behalf of the company. There are other legal protections for creditors beyond directors' duties, notably under UK insolvency law for wrongful trading and transactions at an undervalue. Moreover, a director who acts in breach of his duties also risks being disqualified where the company becomes insolvent.

(l) There is a fundamental distinction between, on the one hand, directors' duties and, on the other, laws that require directors and their companies to act in a specified way or to adhere to certain standards. Directors' duties are concerned with the relationship between a director and his or her company, including its members and creditors. In contrast, restrictions on the way in which a business (whether carried on by a sole trader, a UK company or any other form of legal entity) may be operated that are intended to address specific public interest concerns should not form part of UK law on directors' duties but instead be the subject of specific law and regulation on those matters (eg employee or consumer protections, environmental regulation, etc).

(m) We consider that it is important that this distinction is maintained. Specific public interest concerns are, in our view, more appropriately addressed by specific legislation or regulation. To seek to address them by amendments to the duties of directors would represent a fundamental change to the law on directors' duties. Furthermore, the protections in UK law which are based on public interest concerns are usually designed to apply to behaviour in the UK irrespective of the form or place of registration of the relevant business enterprise. Trying to deal with these by changes to UK corporate law would not achieve the desired effect because in particular it would not capture behaviour by non-UK incorporated entities.

Responses to Questions in Inquiry's Terms of Reference

Directors' Duties

Question 1: Is company law sufficient clear on the roles of directors and non-executive directors, and are those duties the right ones? If not, how should it be amended?

7. In our view, company law is sufficiently clear on the duties of executive and non-executive directors to their companies. (We have assumed that the reference to "the roles" in this question is intended to be to "the duties".) Whilst the statutory duties of all directors are identical, the application of those duties is fact-sensitive and will therefore differ from case to case to meet the particular circumstances of the case and to reflect the skills expected of a person in the director's position. This is expressly envisaged, for instance, in section 174(2) of the Companies Act 2006, which refers to "*the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company*". For the reasons expressed in paragraphs 6(f) and 6(g) above, we consider this flexibility to be desirable and do not consider there to be any advantage in attempting expressly to specify different duties for executive and non-executive directors. We regard it as key to the proper functioning of the unitary board that the directors are all subject to the same statutory duties.

Question 2: Is the duty to promote the long-term success of the company clear and enforceable?

8. The duty of a director under section 172 of the Companies Act 2006 is to act in the way he considers, in good faith, would be most likely to promote the success of the company

having regard to (amongst other things) six statutory factors, one of which is the likely long-term consequences of any decision. See paragraph 6(a) above.

9. In our experience, the duty of directors under section 172 of the Companies Act 2006 is clear. We do not consider there to be any benefit in seeking to amend or refine the section 172 duty. Directors of large companies, in particular, are usually well-briefed and well aware of their duties, including their duty under section 172.

10. In terms of directors' understanding and knowledge of their duties, there is some government guidance available on the duties but improvements could be made in the availability and nature of the guidance. In addition to legal resources and guidance issued by professional bodies, guidance is available on the nature and content of directors' duties from the Statement by Margaret Hodge MP, at the time Minister of State for Industry and the Regions, published by the DTI (as it then was) on 26 June 2007, although this is not in a particularly user friendly or practical format for directors. Some concern was expressed during the 2013/14 consultation by BIS on "Transparency and Trust" that there was a lack of understanding by directors of their duties. In its response statement in April 2014, BIS said that the majority of respondents had said that the Government could do more to communicate directors' duties to them. In its response, BIS said that it would therefore provide information on duties to new directors on appointment. This has been done via a short BIS leaflet which is sent by Companies House to all new directors on appointment (which does not appear to be available online). There is also very short form guidance on directors' responsibilities available from the Government website.[1] BIS also said in its response paper that it would make more widespread improvements in the availability and content of information about directors' duties in the UK, but we are not aware of any other steps that have been taken by the Government in this respect.

11. In light of our experience concerning the introduction of the statutory statement of directors' duties in the Companies Act 2006, there would undoubtedly be a cost involved in educating directors about any change in their statutory general duties.

12. The section 172 duty is enforceable primarily by the company, including the officeholder of a company which is in an insolvency procedure, or exceptionally by an individual member (see paragraphs 6(i)-(k) above). In our view, those means of enforcement provide effective mechanisms for those to whom directors' duties are owed to hold directors to account. Moreover, a director who breaches his section 172 duty is also at risk of disqualification where the company becomes insolvent.

Question 3: How are the interests of shareholders, current and former employees best balanced?

13. The overriding duty of directors under section 172 is to promote the success of the company for the benefit of members or, when the company is insolvent or approaching insolvency, for the benefit of creditors. To satisfy this duty, directors must have regard to the interests of the company's employees. In addition, insofar as current and former employees are creditors of the company, then their interests will be protected by the law

[1] See http://www.gov.uk/running-a-limited-company/directors-responsibilities under the heading "*Running a limited company*".

on directors' duties like other creditors. Where the interests of current and former employees require further protection, this would in our view be more appropriately addressed by specific legislation, outside the realm of directors' duties, for the reasons noted in paragraphs 6(l) and 6(m) above.

Question 4: How best should the decisions of Boards be scrutinised and open to challenge?

14. Please see response to Question 2 above.

Question 5: Should there be greater alignment between the rules governing public and private companies? What would be the consequences of this?

15. As part of the "think small first" policy objective of the Companies Act 2006, the Act differentiates to a greater extent between public and private companies. This was intended to make private companies easier to run and to reduce the regulatory burden on them. The duties of directors were an exception, as it was regarded as important to have the same statutory duties irrespective of the nature of the company (and historically, prior to the Companies Act 2006, all directors had been subject to the same duties).

16. To the extent that any greater alignment between the rules governing public and private companies would involve extending the rules applicable to public companies to private companies generally, we consider that this would be a regression in the law, increase the regulatory burden on private companies, and potentially make UK private companies less attractive as a business medium.

17. We do not consider, in particular, that there would be benefit in UK company law requiring private companies to comply with the UK Corporate Governance Code (**the Code**). At present, the Code applies only to companies with a Premium Listing of equity shares in the UK, requiring such companies to report on how they have applied the main principles of the Code (which comprise the core of the Code), and either to confirm that they have complied with the Code's provisions or, if not, to provide an explanation (known as the 'comply or explain' approach). That approach is appropriate in the case of listed companies, as they will typically have a large number of shareholders unconnected with management who wish to see the company comply with the Code to the extent practicable. On the other hand, we consider that shareholders of most private companies, who will typically be small in number and connected with the board and management, are unlikely to find compliance with the Code to be helpful. Indeed, many provisions of the Code – such as those concerning remuneration committees and independent directors – would be inapposite to most private companies. Nevertheless, some of the principles of the Code have been adopted by non-premium listed and private companies (as well as other organisations) that wish to follow best practice.

18. The European Confederation of Directors' Association (ecoDa) publishes a guide called "Corporate Governance Guidance and Principles for Unlisted Companies in Europe". The UK Institute of Directors also published a similar code directed specifically at directors in the UK, but we understand that it is currently revising the guidance with a view to then republishing it. The ecoDa guidance distinguishes between basic governance principles which could apply to most companies if they have the support of

the company's owners, and more sophisticated governance measures, in particular as regards the appointment of non-executive directors to the board, which are likely to be relevant only to larger and more complex unlisted companies.

19. In our view, specific regulators are the more appropriate source of corporate governance regulation or guidance for specific sectors, rather than company law. For instance, the Prudential Regulation Authority has issued guidance on corporate governance which refers to the Code as one example of more detailed guidelines on good or effective governance.

Question 6: Should additional duties be placed on companies to promote greater transparency, e.g. around the roles of advisors? If so, what should be published and why? What would the impact of this be on business behaviour and costs to business?

20. If there is to be any greater transparency around the role of advisors, it is important that this be carefully targeted. We note that some transparency on advisors is already required in relation to transactions under the Takeover Code and related party transactions under the Listing Rules, for example. We do not consider that it would be appropriate for companies more generally to have routinely to disclose publicly details of their advisors. It can sometimes be important to keep confidential the fact that advice has been sought (e.g. where advice is sought from a legal or insolvency advisor).

21. Even in the case of a targeted proposal, consideration of the cost/benefit analysis will be required, as there will undoubtedly be a cost to companies in complying with any additional regulatory burden. It is also important that any disclosure requirements do not have the effect of discouraging directors from seeking advice when it is appropriate to do so and that additional transparency obligations on UK companies do not amount to a reason not to incorporate a business in the UK.

22. It is also important that any proposal for greater transparency does not abrogate or interfere with the rule of legal professional privilege. This is a fundamental rule of law which protects communications between professional legal advisors and their clients from being disclosed without the permission of the client. In our view, it remains very important that directors and companies are not inhibited from seeking legal advice by any weakening of the rule of legal professional privilege.

Question 7: How effectively have the provisions of the 1992 Cadbury report been embedded? How best can shareholders have confidence that Executives are subject to independent challenge?

23. The recommendations of the 1992 Cadbury Report have been fully embedded into UK corporate governance rules (together with the recommendations of subsequent reports on UK corporate governance, such as the 1998 Hampel Report and 2003 Higgs Review). The corporate governance rules have since then been regularly consulted on and updated.

24. The current rules on UK corporate governance are to be found in the Code. As noted in paragraph 17, companies to which the Code applies must report on how they have applied the main principles of the Code, and either confirm that they have complied with the Code's provisions or, where they have not, provide an explanation. The impact and

implementation of the Code is kept under review by the Financial Reporting Council (**FRC**), which reports annually on how companies are complying with the Code, and the Code has been updated from time to time. The FRC also publishes guidance to boards to assist them in considering how to apply the Code to their particular circumstances. Surveys have shown that over 90% of FTSE 350 companies comply with all but one or two of the Code requirements.

25. We consider that the Code adequately addresses the issue of independent challenge of the decisions of executive directors. For instance, it is one of the Main Principles of the Code that "*[a]s part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy*".

Question 8: Should Government regulate or rely on guidance and professional bodies to ensure that Directors fulfil their duties effectively?

26. As we set out above, our view is that the law on directors' duties and the enforcement of those duties is adequate and does not require revision. We consider that the appropriate approach would be to rely on guidance and professional bodies to educate directors about their legal duties and to ensure that directors fulfil those duties effectively. It may be noted that there are a number of professional bodies which already provide guidance to directors and their advisors on directors' duties.

Executive pay

Questions 9-12

27. No comment.

Question 13: Do recent high-profile shareholder actions demonstrate that the current framework for controlling executive pay is bedding in effectively? Should shareholders have a greater role?

28. We are of the view that the Companies Act requirement for quoted companies for a three-yearly binding vote of shareholders on directors' remuneration policy, and an annual non-binding vote of shareholders on the backward-looking remuneration report, has a strong impact on the behaviour of remuneration committees, and that shareholders do not require a greater role in controlling executive pay. The period of three years for the remuneration policy approval was chosen because investors wanted remuneration committees to take a long term view when drafting the policy. In addition, the UK Listing Rules also require long term incentive plans to be specifically approved by shareholders.

29. We consider that requiring a binding vote from shareholders on the remuneration report for the prior year would be inappropriate and would give rise to a number of practical difficulties. One issue would be timing. As the report relates to prior year payments, how would these be clawed back if shareholder approval is not obtained? There would also be an issue as to what the effect of the vote would be: for instance, would the remuneration for the prior year have to be revised and then put to a further vote, and would this process have to continue until the remuneration report is finally approved?

30. We also consider that to require a binding vote from shareholders for the remuneration packages of individual directors would be inappropriate and unduly onerous. Making individual packages subject to a binding vote could have a significant impact on recruitment. The company would not be able to give a binding commitment on the terms of a proposed service agreement. There would also be an issue as to the effect of a vote striking down the remuneration aspects of a service agreement on the rest of the agreement and as to any resulting employment law rights for the director (eg potential breach of contract and/or constructive dismissal claims).

31. Often a significant part of a director's remuneration in any given year is awarded via maturing share scheme and long-term incentive plan awards. Assuming those awards have been properly approved at the outset (ie via shareholder approval of the remuneration policy and in accordance with Listing Rule and other requirements), then the participants have a legal right to receive the relevant returns. By the time those returns appear in a remuneration report it is too late to take them away.

Composition of Boards

Questions 14-15

32. No comment.

Question 16: Should there be worker representation on boards and/or remuneration committees? If so, what form should this take?

33. In our view, there could be some potential benefits to having worker representatives on boards, such as the diversity of perspective that they might bring to the boardroom and the opportunity for enhanced communication between management and the wider workforce. However, introducing the worker representative model in the UK would fundamentally alter our corporate governance and industrial relations framework and would entail a significant cultural shift for boards. Whilst the model is used in some Continental European countries, it is consistent with the very different approach to industrial relations and corporate governance practices that exist in those countries, as well as the different company law structures that exist in some (eg the two-tier board in Germany).

34. We note that worker representation on boards was recommended in the Report of the Committee of Inquiry on Industrial Democracy (Chairman: Lord Bullock) in January 1977 but that the Report's recommendations were never implemented.

35. If a worker representative regime were to be introduced in the UK, a number of risks, issues and practicalities would need to be addressed, including those set out below.

    (a) The impact of worker representatives on the status and role of the unitary board, which is a fundamental part of UK company law and should, in our view, be retained.

    (b) Any potential for the presence of worker representatives to impede open discussion and decision-making.

(c) The corporate law status of worker representatives. As part of a unitary board, they should, in our view, have the same duties and be bound by the same rules on confidentiality as any other director. If worker representatives are required to represent workers' views, they are likely to be in a difficult position where views are mixed or where views conflict with duties to other stakeholders. If, for example:

- a company is considering closing down a location and making redundancies, those working at that location are likely to oppose that, whereas employees at other locations may be in favour if the closure reduces the risk of wider redundancies; or

- a company is facing potential insolvency, the employees and other creditors (including the pension fund) may well have directly conflicting interests.

(d) The extent to which workers could or should consider the views of workers worldwide in large companies where the workforce is spread over a number of different countries.

(e) The consequences of director status for worker representatives. This may raise difficult questions as to their remuneration, accountability, personal liability and coverage under D&O insurance. It may also raise corporate law and governance issues. For example:

- workers are not independent in the way that non-executive directors are, and there could be a risk of conflicts of interests arising;

- as worker directors would not be independent under the UK Corporate Governance Code, it is likely that an additional non-executive director would need to be appointed to redress the balance on the board, creating additional compliance costs for listed companies; and

- in regulated industries, notably financial services, it would be very difficult to appoint anyone other than a worker who is already performing a senior management role to a director position given the overlay of regulatory (eg experience and competency) requirements and related potential liabilities.

(f) The need to ensure that worker representatives have the necessary knowledge and skills to fulfil their duties effectively and on an on-going basis. Any requirement to up-skill would have to be manageable and realistic for companies. The burden would be higher in regulated industries, for example financial services, given the overlay of competency requirements.

(g) The rights and influence of worker representatives. In our view, voting rights at board level should be adapted and limits on the numbers of worker representatives imposed to ensure that worker representatives have neither voting control nor a right of veto.

(h) Access to information. Clarity about the duty of confidentiality would be important, particularly if worker representatives are required to report back to the workforce. Unless worker representatives are permitted to report on confidential matters, they

may find it difficult to explain their decision. There could also be potential issues in terms of conflicts with other legislation, eg the Market Abuse Regulation and associated rules.

(i) Companies will have to address the appointment (and removal) of worker representatives if workers are required or allowed to sit on boards.

(j) Managing the burden of any new regime. In our view, any new regime should apply only to large, UK incorporated, listed companies which meet a workforce size threshold in the UK. Also, consistent with our current corporate governance framework, the regime should be applied on a "comply or explain" basis and not enforced through legislation.

36. There are alternatives to a worker director regime, such as a consultative regime, where employee representatives are provided with appropriate information about, and consulted on, relevant matters at an appropriate point in time, which avoid many of the issues highlighted above.

37. The issue of worker representatives on company remuneration committees was considered by the Department for BIS in its Discussion Paper of September 2011 relating to directors' remuneration and in its Summary of Responses of January 2012. We note that around two-thirds of those who responded to the Discussion Paper did not consider there would be benefits in having employee representatives on remuneration committees.

38. The UK Corporate Governance Code already requires remuneration committees to be sensitive to pay and employment conditions throughout the whole company.

Question 17

39. No comment.

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Company Law Committee Members

William Underhill (Slaughter and May) (Chairman)
E-mail: William.Underhill@slaughterandmay.com

Mark Austin (Freshfields Bruckhaus Deringer LLP)
Mark Bardell (Herbert Smith Freehills LLP)
Robert Boyle (Macfarlanes LLP)
Lucy Fergusson (Linklaters LLP)
Michael Hatchard (Skadden Arps Slate Meagher & Flom (UK) LLP)
Nicholas Holmes (Ashurst LLP)
Chris Horton (Simmons & Simmons LLP)
Simon Jay (Cleary Gottlieb Steen & Hamilton LLP)
Vanessa Knapp (Independent)
Stephen Mathews (Allen & Overy LLP)
Andrew Pearson (Hogan Lovells International LLP)
Chris Pearson (Norton Rose Fulbright LLP)
David Pudge (Clifford Chance LLP)
Richard Spedding (Travers Smith LLP)
Patrick Speller (Nabarro LLP)
Keith Stella (Berwin Leighton Paisner LLP)
Martin Webster (Pinsent Masons LLP)
Victoria Younghusband (Charles Russell Speechlys LLP)
Emma-Louise Wilson (Slaughter and May) (Secretary)