

# Sounding Board

Good practice in company control and accountability for plc directors

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COMPANIES ACT  
SPECIAL EDITION

## Companies Act finally gets Royal Assent – but what does it mean for business?

**Nearly eight years after the Company Law Review began the process to modernise the UK's antiquated and piecemeal legislation for business, the newly titled Companies Act has finally achieved Royal Assent. This special edition of Sounding Board reviews the new law and assesses the key impacts on board directors.**

The historical patchwork of law covering directors' duties was ripe for rationalisation. In 1999, as the DTI's review got underway, early issues of Sounding Board asked whether the review would result in a formal codification of directors' duties and whether it would be helpful to introduce a statutory duty of care. The verdict has to be mixed, although it was always going to be a tough challenge. On page 2 we look at the newly codified directors' duties and analyse the practical implications for board members.

Since the review was started, Enron has come and gone and the litigious environment has only got worse. On page 4 we look at the highly contentious topic of derivative claims: does this herald the arrival of US-style class action suits?

The value of the formulaic directors' report was questioned in the original review and narrative reporting was identified for review. Confusion has been introduced with the change from the Operating and Financial Review (OFR) to the Business Review, and we analyse this on page 5. Are they really so different, and what protection is there for

directors for the forward looking parts of these reports?

It was widely recognised in 1999 that many Victorian procedures were overdue for simplification. Although some progress has been made in modernisation, it is questionable whether the outcome is much simpler. On page 6 we review the duties of directors to keep adequate accounting records, as well as the key audit provisions including auditor liability limitation. Finally, on page 7, we identify the key parts of the Act aimed at making it easier to communicate with shareholders, particularly online, together with the impact of the Act on shareholders and the information companies hold about them.

One of the aims of the original review was to promote an internationally competitive environment for UK business that balanced the need for confidence in the legal framework with flexibility for market-stimulated governance to allow best practice to evolve. This lofty ambition seems to have somewhat fallen by the wayside as Government has dealt with the detailed issues. The challenge remains. ■

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# Codified but not certain

**Government had an almost impossible task when it set out to codify fully for the first time directors' duties. At the outset it made clear its intention of doing so in a way that did not extend the duties to the point where it became unattractive to serve on boards. At the same time, Government looked to assuage the corporate and social justice movements seeking to impose further obligations and stiffer penalties for directors who fall short of the standards expected of them.**

The first major debating point centred on whether directors have one duty, to promote the success of the company, or whether the myriad of other obligations being placed on them added to a suite of duties.

Government clarified its thinking during the passage of the Act by bringing the other factors directors have to have regard to into a sub-clause of the main duty to promote the success of the company for the benefit of shareholders. But concerns persist about the relationship between what may well prove to be conflicting responsibilities.

In some ways, the topic of directors' duties promised more than it delivered during the passage of the Act. MPs and Peers were on the receiving end of a major and concerted lobbying campaign orchestrated by the trade unions and social justice lobbies.

Yet few Parliamentarians pushed for further extensions to the duties proposed by Government, and indeed many more argued powerfully for the simplification of the relevant clauses. The question is whether the set of duties framed in the Act really do more

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than capture what any competent and effective board member already does, or whether they go beyond this and create new duties and perhaps, jeopardies?

The clause that stipulates the new duties seems quite innocuous. It first sets out the new overarching duty for directors to promote 'the success of the company'. Importantly it recognises that the director must act in a way that 'in good faith' is 'most likely to promote the success of the company for the benefit of its members as a whole'. This would seem to confirm both the preservation of business judgement and the

primacy of shareholder interests over those of any other class of stakeholder. Indeed this might well be the Government's intention, and it alluded to this during the numerous debates on this topic in Parliament. However, ministers then went on to state that this duty to shareholders had to be set in the context of the other responsibilities being imposed on directors though requiring regard to the following potential constraints:

- the likely consequences of any decision in the long term
- the interests of the company's employees
- the need to foster the company's business relationships with suppliers, customers and others
- the impact of the company's operations on the community and the environment
- the desirability of the company maintaining a reputation for high standards of business conduct, and
- the need to act fairly between members of the company.

Two problems are apparent. First there is no clear hierarchy established between the duty to promote the interests of shareholders and the potentially competing responsibilities owed to just about everybody else. Ministers were never able to clearly articulate an idea of the tipping point where a decision that would benefit shareholders, but have some sort of detrimental impact on other classes of stakeholder, should not be taken. Furthermore some of the six supplementary duties are ambiguous. How does one define the boundaries of the community? Is it neighbours in the immediate vicinity of the business or should the duty be extended for larger or strategically significant businesses to a broader scale?

What seems clear is that boards will need to consider with their advisers how they can demonstrate and possibly document that they have taken their new obligations into account when reaching a board decision. Government has stated unequivocally on the record that this should not lead to board papers of encyclopaedic proportions. Amendments agreed to the derivative claims provisions during the passage of the Act (and covered later in this issue) lend some credence to the view that the bar for claims has been set high enough to prevent successful claims where directors have behaved responsibly.

The Act also lists a host of other less contentious duties to which directors are expected to have regard in the conduct of their business responsibilities including:

- to exercise independent judgement
- to exercise reasonable care, skill and diligence
- to avoid conflicts of interest
- not to accept benefits from third parties, and
- to declare an interest in proposed transactions.

To an extent, this panoply of new directors' duties can only properly be understood in due course when their relationship to the new law dealing with derivative claims has been established. The new duties and the process for claims will need to be tested by case law before directors can have any degree of certainty about the way the courts will view them. Until then many boards and their members may well feel the need to err on the side of caution. ■

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# US class action or UK pragmatism?

**There have been few more contentious topics during the passage of the new Companies Act than derivative claims, often cited as Government's attempt to import US-style class action suits to the UK. The reality is somewhat more complex.**

Government has, at times, exacerbated concerns about this part of the Act. Keen to demonstrate that the new directors' duties have bite, and seemingly apprehensive that much of the Bill fell short of investor and other stakeholder expectations, there was some spinning in Government circles to suggest that derivative claims could become a common feature of the UK litigation environment.

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However there has been something of a U-turn. First, the hurdle which litigants need to get over to launch a claim has been raised. Actions are barred where a board decision has been subject to a shareholder vote at an AGM. Second, the legislation does not create the opportunity for

large settlements for individual litigants. A successful derivative claim will lead to an award being made to the business. However the litigant could initiate a separate action themselves against the company.

One major change from the current position is that a derivative action can be brought against a director even if he or she has not personally benefited from the alleged negligence or breach of duty.

The fact that the financial risk of mounting the claim resides with the litigant should be expected to act as a deterrent to vexatious claims but the fear remains that some shareholder activist groups, or campaigning organisations with small shareholdings, could still seek to use the threat of litigation to influence the behaviour of boards.

The safeguard is that the courts have to be satisfied that a person acting in accordance with the new duty to promote the success of the company would seek to continue with the claim. The courts would have to judge what is most likely to promote the success of the company.

Some lawyers are still advising that, notwithstanding this policy refinement, the fact that the Act simplifies and clarifies the law might well lead to an increased appetite amongst shareholders to use the rights and powers afforded to them. Board members may well want to consider carefully the interaction between the newly codified directors' duties and the derivative claims provisions set out in the Act.

Board members may also wish to consider the fact that under the new rules a derivative action could be brought against directors even if they have not personally benefited from the alleged negligence or breach of duty, whereas under the previous legislation, directors would have to be shown to have personally gained from the wrongdoing. ■

# OFR or Business Review: the choice is yours

**Government's decision to drop the statutory Operating and Financial Review (OFR) and instead rely on what has been portrayed as a lighter touch Business Review, which will form part of the directors' report, has been the subject of considerable comment over the last six months.**

A number of questions have dominated the debate about the move from the OFR to Business Review reporting.

- When companies produce a voluntary OFR and are therefore exceeding the reporting requirements for a Business Review, does the production of an OFR meet the obligation to produce a Business Review?
- Government's decision to allow directors some statutory protection ('safe-harbour') for narrative reporting raised the question whether that protection extended from the statutory Business Review to the voluntary OFR
- The lack of a reporting standard for the Business Review raises concerns about levels of consistency and comparability.

Government has sought to offer reassurance on all of these points. A voluntary OFR prepared in accordance with the relevant Accounting Standards Board reporting statement will, according to the DTI, meet the obligation to produce a Business Review.

Where an OFR is cross-referenced to the Business Review we understand

that directors are likely to be afforded the same level of protection for statements they make 'in good faith'.

Government believes that the absence of a reporting statement or standard should not lead to a free-for-all approach. Further DTI guidance is expected in January 2007. Board members should be aware that the FRRP (Financial Reporting Review Panel) has the authority to review Business Reviews for the period beginning on or after 1 April 2006.

The aim of the Business Review is to inform members of the company and help them assess how the directors have performed the duty imposed on them elsewhere in the Act to promote the success of the company. The new requirements (for quoted companies only) are to disclose:

- a. the main trends and factors likely to affect the future performance of the company
- b. information about the environment, employees and social and community affairs and
- c. reporting on contractual relationships that are essential to the business of the company.

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The last requirement was a very late amendment which was the source of considerable debate in the final stages of the Bill. The actual wording of the new clause was lifted verbatim from the original OFR legislation.

Where directors judge there is nothing they wish to report on items b or c above, they will be free to say as much in the Business Review. Directors will also be allowed to exercise judgement to avoid disclosing impending developments of matters which might be the subject of ongoing negotiations. ■

# True and fair enters statute and AGMs to vote on liability agreements for auditors

The new 'true and fair' clause clarifies the existing position by imposing an explicit 'true and fair requirement' in respect of all accounts, regardless of the accounting framework adopted.

There are some fairly substantive reforms for directors in the new Act including:

- a duty to keep 'adequate accounting records' containing 'entries from day to day of all sums of money expended and received'
- reduced time limits to file annual accounts at Companies House, down to nine months for private companies and six months for public companies
- a permissive regime for companies and their auditors to agree liability limitations, subject to shareholder approval

- a new 'true and fair' provision in statute placing a duty on directors to confirm that the accounts represent an honest assessment and for auditors to attest to this fact
- a new offence for directors who 'knowingly or recklessly' withhold information from their auditors with a maximum prison sentence of two years or a fine (or both).

The duty to keep adequate accounting records also carries with it the threat of a two year sentence or a fine (or both) on conviction. While the threat of a custodial sentence is not new, there has certainly been a renewed focus on this potential punishment during passage of the legislation. There is recognition that a reasonable defence could be advanced where the person charged can show he or she acted honestly and that 'in the circumstances in which the company's business was carried on the default was excusable.'

The Act removes the UK's 80 year prohibition on auditors and their clients reaching contractual limitations for the auditor's liability. However, when companies and their auditors reach such an agreement the board still need to secure shareholder approval at the next AGM for the agreement to take effect and both the

courts and Secretary of State for Trade and Industry have powers to override what they feel to be unfair agreements. It is expected that 2008 might be the earliest date such an agreement could come before an AGM for a shareholder vote. In the meantime the Financial Reporting Council will consider whether to draft some model guidance for the market.

The new 'true and fair' clause clarifies the existing position by imposing an explicit 'true and fair requirement' in respect of all accounts, regardless of the accounting framework adopted. An explicit 'true and fair requirement' has always existed in the law for UK GAAP reporters but not for IFRS reporters, although IFRS requires accounts to give a 'fair presentation' which has, in practice, been regarded as equivalent to a true and fair view. The new clause has been introduced in response to deep-seated concern amongst some investors that the introduction of International Financial Reporting Standards weakened the traditional UK position. ■

# Companies Act round-up

**With more than 1,300 clauses filling nearly 700 pages, there are numerous other provisions in the Act which are worthy of directors' attention. A copy of the Act and departmental briefing papers can be found online at [www.dti.gov.uk](http://www.dti.gov.uk)**

## E-communications

More effective and efficient communication with shareholders, and especially making better use of online technology to speed the flow and improve the quality of information, has been one of the Government's overarching objectives.

The Act permits all companies to use e-communications to send:

- notices of meetings
- written resolutions
- and other documents or information (including annual reports).

Shareholders will still be able to elect to have paper-based communications, but this will now become the exception not the norm and shareholders will in future have to make a conscious effort to opt out of online delivery. The implementation date for this part of the legislation has been brought forward to January 2007.

## Requests for shareholders register

In future companies will be given only five working days to consider whether or not to accede to a request for a copy of the company's own Register of Members. The criterion by which companies are to judge the request is that it is being asked for 'a proper purpose'. It is still unclear whether broker requests, including suspected

'boilershops', would be deemed proper recipients of shareholder address details under the terms of the Act and one would expect boards to seek professional advice as they look to make their decisions.

## Indirect investors

The original Bill was silent on the topic of indirect investors. However, with more than half of all shareholdings now held by nominee accounts, those lobbying for easier access to company information for this constituency found willing support on both sets of Opposition benches in Parliament. Consequently, the Act now allows for those holding shares on behalf of members of a company to nominate that person to enjoy all the communications that the company sends to members generally.

## Institutional investor voting

The Act introduces a new power for the Secretary of State to bring forward regulations that would require institutional investors to disclose how they have exercised their votes. The investor community has been lobbying hard to persuade the DTI not to utilise this power given the moves towards voluntary disclosure and the alleged costs of a mandatory system which would presumably require investors to develop systems to record their voting and then a system for the regulators to monitor their performance.

## Home alone?

The question of public access to directors' home addresses has rumbled throughout the passage of the Act. The CBI and other business groups have lobbied hard to persuade Government to make it easier for directors to remove their home address from the public record to protect them from unsolicited mail and, potentially, threats and intimidation. Companies House makes these details available on payment without any real scrutiny of their likely end use.

Some progress has been made. In future, directors will be able to provide the Register of Companies with a service address, but there will still not be an obligation on Companies House to cleanse historical database entries to afford real protection.

## Indemnifying pension trustees

The legislation has been amended to permit companies to indemnify the trustees of their pension schemes against liability in connection with their role as trustees.

## When does the Act come in to force?

The Act has already passed in to law but a number of provisions require detailed regulations to be developed before the law can be fully implemented. These regulations need to be drafted, consulted on and then adopted to add flesh to the bones of the Act and the DTI now estimates that the full Act will not therefore come into force before October 2008, although measures required to implement various European Directives with a deadline for adoption before this date will come into effect sooner. ■

# NEDAgenda: hear from the experts

**NEDAgenda.co.uk, the leading online resource for non-executive directors, is running a series of multimedia discussions covering the key aspects of the Companies Act.**

Log on to the site this month to download the latest commentary and analysis from a PricewaterhouseCoopers team of experts, looking at the legislation from the board's point of view.

Hosted by Philip Wright, Chairman of the firm's Non-Executive Director Programme, the first in this series of Companies Act podcasts features:

- Sarah Holmes, a partner with PricewaterhouseCoopers Legal, discussing the impact on directors' duties and the issue of derivative claims;
- Janice Lingwood, a director in our Corporate Reporting Group, commenting on the requirements of the Act in relation to the Business Review;

- Peter Wyman, head of Professional Affairs, discussing accounting and audit reform from the point of view of the NED community.

Also log on to NEDAgenda to read the latest breaking news and features articles relevant to the NED role. The site also features boardroom development tools and exclusive video interviews with industry leaders and commentators including David Norgrove, Chairman of the Pensions Regulator, and Sir Christopher Hogg, Chairman of the Financial Reporting Council. ■

To find out more about NEDAgenda, or to request a password to access the site, please visit [www.pwc.com/ned](http://www.pwc.com/ned), or contact Abigail Pelster on 020 721 23985.

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