



Corporate governance risks

Executive summary

The 21st century has seen an unprecedented surge in corporate scandals. As a result investor confidence has slumped and governments around the world are introducing reforms to corporate governance. The question now being asked is what effect this combination of scandal and reform is having on the liability of UK companies and directors. Will we see a dramatic rise in shareholder litigation?

Current position

Until now the scope for litigation brought by shareholders against companies and directors has been limited. Directors' duties have been developed over centuries, principally by common law, and are sometimes obscure, so that it has often been difficult to prove a breach in the absence of fraud.

Even if a breach can be ascertained, this does not usually lead to litigation. The primary means of control of the company's agents (such as directors) is through the company's own governance structures. The company, not the shareholders, is the proper claimant for wrong done to the company. Shareholders take action in the form of shareholder resolutions at general meetings. Minority shareholders cannot go to court, either against directors or the company itself, simply because they are dissatisfied with the conduct of the company's affairs. An action is only available where:

- there has been fraud on the minority shareholders ('derivative action');
- the company's affairs are conducted in a manner 'unfairly prejudicial' to the shareholders under section 459 of the Companies Act 1985;
- their personal rights under the company's constitution have been infringed (eg right to receive a dividend); or
- in very limited circumstances where a director has made a specific negligent misstatement which causes loss to a shareholder relying on it.

These issues are very difficult to establish in the case of quoted companies. A company can protect its directors

against personal liability by indemnifying them (within section 310 of the Companies Act) and by directors' and officers' insurance (D&O insurance). However, this environment is evolving.

US corporate scandals and Sarbanes-Oxley

The US, at the epicentre of the recent corporate scandals, has responded by introducing the Sarbanes-Oxley Act. This Act constitutes the toughest overhaul of US securities legislation since the 1930s and has a significant international dimension. It requires UK companies listed on a US stock exchange or Nasdaq to comply with new corporate governance controls and director independence standards. CEOs and CFOs will have to certify the adequacy of their companies' SEC disclosures and internal controls and procedures personally. There is an increasing trend for US shareholders to pursue claims against overseas companies, with 22 such suits in 2002 compared to 15 in 2001.

Changing standards of corporate governance in the UK

In the UK, the Higgs Report constitutes the latest review of governance standards, concentrating, in particular, on the role and effectiveness of non-executive directors (NEDs). Even in its reduced, adopted form, it implies an overhaul of British boardroom culture, increasing the accountability of the boards of UK-listed companies and resulting in NEDs having a more demanding and influential role. The report's recommendations came into effect in November 2003 as changes to the Combined Code.

Listed companies must state in their annual report and accounts whether they comply with the Combined Code and give reasons for any areas of non-compliance. This, in combination with the report's call for greater dialogue with shareholders, will lead to increased transparency of the internal operations of the company.

At the same time, the government has been overhauling UK company law, following various reports and consultation. The first of the white papers proposes, *inter alia*, to codify existing directors' duties, therefore giving clear reference points for what amounts to a breach (which will also be informed by codes of practice, such as the Combined Code). Changes on minority rights (to make it easier for shareholders to sue) are not yet being pursued, but were strongly recommended by the Company Law Review Steering Group and are likely to be covered in subsequent white papers. Such changes would codify derivative actions, extending their scope significantly from fraudulent acts to any breach of duty by a director, although ratification by a majority of independent shareholders will still effectively bar any legal actions.

The final Bill is not expected before the next general election but the push for reform is clearly there. The environment in which directors operate is changing and the boardroom is becoming a less comfortable place. This became only too apparent recently in connection with *Equitable Life* (and *Carlton*, *BSkyB* etc).

Equitable Life

On Friday 17 October 2003, the High Court held that *Equitable Life's* claims (brought by new management for negligence and breach of fiduciary duty, for up to £3.3bn) against nine former NEDs and six former executive directors were arguable. The trial, scheduled for April 2005, will mark the first full examination of non-executive directors' duties by a court post-*Higgs* (although the events occurred earlier). The decision will be a critical one for the scope of directors' duties. Although reflecting previous law, it favoured later cases imposing higher standards and eroded the distinction between NEDs and executives a little, and whether NEDs can delegate to executives. It was held that a NED might incur liability for decisions taken at a board meeting even if he was not there, provided he had received the board papers and was aware of the decision so that he could have intervened.

Class actions

Changes to the civil litigation system over the past five years make US-style class actions more viable, although there are still major differences. The courts now have express powers to facilitate and manage multiparty actions where claims give rise to 'common or related issues of fact and law'. This may include US-style class action case management making it easier for shareholders to unite against their company.

Although contingency fee agreements, the commonplace *mantra* for the plaintiff Bar in the US, are still not allowed in the UK, there is an increasing tolerance and frequency for conditional fee arrangements, eg a no win/no fee basis. 'After the event insurance' is also on the increase (insurance against the costs of unsuccessful litigation). The combination of the two is likely to encourage litigious shareholders, who would previously have been deterred by the significant cost of litigation.

Looking ahead

Whether the recent proposed changes to UK corporate governance will actually lead to an increase in shareholder litigation against companies and directors remains to be seen. Strong protection remains: unlike the US there is no general liability for breach of statutory obligations (eg disclosures); erosion of the principle that the company is the proper plaintiff is limited and prospective; and governance standards are increasing but the enforcement is still primarily through regulators or corporate control mechanisms.

However, company boards would be well advised to put in place well-structured compliance departments and to increase dialogue with shareholders. This will enable directors to address shareholder grievances in a timely manner, thereby preventing escalation and embarrassing publicity. Companies will also need to ensure that their directors are protected through comprehensive D&O policies and section 310 indemnities. Life in the boardroom is becoming considerably more demanding and this will continue.

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