

**The Law Commission  
and  
The Scottish Law Commission**

**(LAW COM No 261)**

**(SCOT LAW COM No 173)**

**COMPANY DIRECTORS:  
REGULATING CONFLICTS OF  
INTERESTS AND FORMULATING  
A STATEMENT OF DUTIES**

**September 1999**

The Law Commission and the Scottish Law Commission were set up by the Law Commissions Act 1965 for the purpose of promoting the reform of the law.

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This report was approved by the Law Commission and the Scottish Law Commission on 14 July 1999.

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# EXECUTIVE SUMMARY

In this report we consider the responses which we received to our Joint Consultation Paper “Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties”. We make the following principal recommendations.

## **A STATEMENT OF DUTIES**

We recommend

- The introduction of a statutory statement of the principal duties which a director owes to a company
- The statutory definition of a director’s duty of skill and care using a dual objective/subjective standard similar to the terms of section 214(4) of the Insolvency Act 1986
- The use of company forms and official pamphlets to publicise the duties of directors.

## **PART X OF THE COMPANIES ACT 1985**

We recommend

- The retention of most of the provisions of Part X in order to supplement the protection provided by the general law
- Further disclosure in a company’s annual accounts of compensation paid to individual directors for loss of office
- Limitation on the interests which a director requires to disclose to the board and the introduction of civil remedies for non-disclosure
- A reduction from five to three years of the period of duration of a director’s service contract which requires shareholder approval and extension of statutory control to rolling contracts
- The amendment of section 320 to allow a company to agree a substantial property transaction with a director by a contract which is conditional on the company first obtaining shareholder approval
- The extension of the prohibitions on loans and similar transactions in sections 330-337 to all companies and the retention of existing exemptions from prohibitions
- The repeal of sections 311, 318(5) and (11), 323 and 327
- The introduction of a coherent code of civil remedies.

# ACKNOWLEDGEMENTS

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THE LAW COMMISSION

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COMPANY DIRECTORS: REGULATING  
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# GLOSSARY OF ABBREVIATIONS

**Act** - the Companies Act 1985

**AIM** - Alternative Investment Market

**CBI** - Confederation of British Industry

**Combined Code** - the Stock Exchange's Principles of Good Governance and Code of Best Practice

**Cohen Committee** - the Committee on Company Law Amendment, chaired by Mr Justice Cohen.

**CPS** - Crown Prosecution Service

**D&O insurance** - directors' and officers' liability insurance

**DTI** - Department of Trade and Industry

**DTI's Consultative Paper** - Department of Trade and Industry, "Modern Company Law for a Competitive Economy" (1998)

**Company Law Review** - the DTI's review of company law launched in March 1998

**ESRC Centre for Business Research** - Economic and Social Research Council, Centre for Business Research at the University of Cambridge

**FRS** - Financial Reporting Standard

**general law** - in England the common law and equity and in Scotland the common law

**ICAEW** - The Institute of Chartered Accountants in England and Wales

**IoD** - Institute of Directors

**Jenkins Committee** - the Company Law Committee, chaired by Lord Jenkins

**Listing Rules** - the Listing Rules for the official list of the Stock Exchange

**Model Code** - a code of dealing for transactions in securities by directors, certain employees and connected persons, which appears in an appendix to chapter 16 of the Listing Rules

**OECD** - the Organisation of Economic Co-operation and Development

**the Paper** - joint consultation paper by the Law Commission and the Scottish Law Commission on Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties (1998) (Consultation Paper No 153; Discussion Paper No 105)

**PIRC** - Pensions Investment Research Consultants Ltd

**plc** - public limited company

**Stock Exchange** - London Stock Exchange Limited

**Strategic Framework Document** - Company Law Review Steering Group,  
“Modern Company Law for a Competitive Economy: The Strategic Framework”  
(1999)

**Table A** - Companies Act 1985, Table A (SI 1985/805, Schedule)



# **THE LAW COMMISSION AND THE SCOTTISH LAW COMMISSION**

## **COMPANY DIRECTORS: REGULATING CONFLICTS OF INTERESTS AND FORMULATING A STATEMENT OF DUTIES**

*To the Right Honourable the Lord Irvine of Lairg, Lord High Chancellor of Great Britain,  
and the Scottish Ministers*

### **PART 1 INTRODUCTION**

#### **BACKGROUND**

- 1.1 In September 1998 the Law Commission and the Scottish Law Commission issued a joint consultation paper entitled “Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties”.<sup>1</sup> The Paper stimulated considerable interest and debate. We received over 130 responses to the Paper, and we were particularly pleased that the responses should come from a wide range of respondents including judges, solicitors, barristers and Scottish advocates, academics, accountants, companies, directors, company secretaries, representative organisations, Government departments, public bodies and individuals. In addition, there have been several journal articles and conferences discussing or referring to it.<sup>2</sup> We are most grateful to all those who responded and contributed their views.
- 1.2 The responses confirmed our provisional view that there was a need for an overhaul of the complex provisions of Part X of the Act.<sup>3</sup>
- 1.3 This has been an unusual project for the Law Commissions. Normally the Commissions examine a specific area of law with a view to making recommendations for reform and preparing a draft bill to give effect to those

<sup>1</sup> (1998) Consultation Paper No 153; Discussion Paper No 105.

<sup>2</sup> See for example John Garcia in (1998) 19 *Company Lawyer*, pp 279-281 and PLC 1998 9(10), pp 10-11. In addition the Paper was the subject of discussion at a conference organised by the Centre for Commercial and Corporate Law in Cambridge on 5 December 1998, and a conference organised by the Institute of Advanced Legal Studies in London on 20 November 1998. The Law Commission was represented at these conferences and the discussion at them has been taken into account in the preparation of this report.

<sup>3</sup> On the need for reform in this area, see further paras 1.13 and 1.14 below.

recommendations.<sup>4</sup> In this project, however, we are contributing to the wider Company Law Review and a number of our recommendations may require to be reconsidered as that Review develops.<sup>5</sup> Further, it would be inappropriate for us to produce a draft bill in view of the possible changes to some of our recommendations and the fact that the Company Law Review will itself require a bill to implement those of its recommendations that the Government decide to adopt. This project, therefore, is not a self-contained exercise. We are also, unusually, examining the presentation of the general law on directors' duties rather than its reform.

#### **TERMS OF REFERENCE**

1.4 The terms of reference for this project were as follows:

- to review Part X of the Act with a view to considering how the provisions can be simplified and modernised
- to consider the case for a statutory statement of the duties owed by directors to their company under the general law, including their fiduciary duties and their duty of care
- to review additional provisions of the Companies Acts which the Commissions consider should be reviewed at the same time as part of the above work

and to make recommendations.<sup>6</sup>

#### **RELATIONSHIP BETWEEN THIS PROJECT AND THE COMPANY LAW REVIEW LAUNCHED BY THE DTI**

1.5 In March 1998, after the Law Commissions had commenced work on this project, the DTI launched a wide-ranging review of company law and issued a consultation paper entitled "Modern Company Law for a Competitive Economy". The DTI's Consultative Paper referred to the Law Commissions' work on directors' duties. As part of the process for the review, an independent Steering Group was appointed, with members drawn from outside Government,<sup>7</sup> to oversee the management of the review and to ensure that its outcome was consistent and workable. The review would cover the whole of core company law and in the course of it the Steering Group would issue consultative documents.

1.6 As we explained in the Paper<sup>8</sup> it is our objective, by this project, to contribute to the Company Law Review. The issues covered by the terms of reference for this

<sup>4</sup> The process of drafting instructions to and working with Parliamentary Counsel is often valuable in exposing, and subsequently remedying, any contradictions, anomalies and gaps in policy.

<sup>5</sup> See paras 1.5 to 1.9 below.

<sup>6</sup> Paper, para 1.3.

<sup>7</sup> Mrs Justice Arden, Chairman of the Law Commission from January 1996 to February 1999, is a member of the Steering Group.

<sup>8</sup> Executive Summary, para 5.

project lie at the heart of company law, and the outcome of many of these issues have implications for other aspects of company law being considered by the Company Law Review. In addition, the approach and methodology of this project are likely to have value beyond this particular project and to contribute to questions of present and future company law reform generally.

- 1.7 The DTI's Consultative Paper stated that the Company Law Review would lead to a final report in March 2001 and legislation in the next Parliament.<sup>9</sup> Given the breadth of core company law, the Company Law Review is being conducted against a tight timetable. In order to assist the review the Commissions agreed with the DTI that the project would be completed in July 1999 and that the results would be made available to the DTI at that time. Certain matters would be omitted from the report and be dealt with as part of the Company Law Review.<sup>10</sup>
- 1.8 The DTI received this report in July 1999, and placed it before the Steering Group of the Company Law Review. The Steering Group has made the report available to a number of its working groups whose work is likely to be affected by the Commissions' recommendations. The Steering Group will also be able to decide whether or not to adopt the Law Commissions' recommendations or whether to seek further views. We emphasise that, while this report will contribute to the work of the review, the conclusions in this report are those of the Commissions.
- 1.9 Since the Paper was published, the Steering Group of the Company Law Review has issued a consultation document entitled "Modern Company Law for a Competitive Economy: The Strategic Framework". We describe the relevant parts of that document below.<sup>11</sup>

#### **BACKGROUND TO THIS AREA OF LAW**

- 1.10 This project involves consideration of the general law relating to directors' fiduciary duties and their duty of skill and care and Part X of the Act. We explained in the Paper how many of the provisions of Part X had been enacted for the first time in the Companies Act 1980 in an endeavour to regulate conduct of directors which involved self-dealing.<sup>12</sup>
- 1.11 As we also explained in the Paper, self regulation - for example, by the corporate governance codes, the Listing Rules and accounting standards - plays a major part in modern company law. There are many areas where such self-regulation operates, and statute and the general law do not. Likewise there are many occasions when self-regulation and the Act interact or overlap. In making recommendations about the Act, we have taken self-regulation into account.

<sup>9</sup> DTI's Consultative para 8.2; see also "Our Competitive Future-Building the Knowledge Driven Economy", DTI (1998) (Cm4176), para 4.34.

<sup>10</sup> Paras 1.32 to 1.39 below.

<sup>11</sup> Paras 1.19 to 1.21 below.

<sup>12</sup> Paper, paras 1.9-1.10.

- 1.12 In addition, the issues raised by this project are an important element in the current, worldwide debate on corporate governance. There are many facets to this debate, but the basic tenet is that corporate performance and prosperity can be enhanced by raising the standards of management and ensuring that they are efficiently and effectively monitored by shareholders or in some other way. The importance attached to this debate is indicated by the Guidelines on Corporate Governance which were approved at a ministerial meeting of the OECD on 27 May 1999.<sup>13</sup>

#### **THE NEED FOR REFORM**

- 1.13 This project falls into two halves: first the consideration of the case for a statutory statement of directors' duties and second the review of Part X. The case for a statutory statement of duties of directors has been considered on several occasions and it seemed that the matter ought to be canvassed fully and publicly. We explained in the Paper that Part X was widely perceived as an extremely detailed, fragmented, excessive and in some respects defective, regulation of directors, and many criticisms have been made of its provisions to the DTI by directors and other users of company law.
- 1.14 The two parts of the project were linked since it was thought that increased awareness and accessibility of the law regarding directors' duties under the general law might enable Parliament to dispense with some of the detailed provisions of Part X. For this reason, in this report the discussion of the law regarding directors' duties precedes the detailed discussion of Part X.

#### **CENTRAL ISSUES**

- 1.15 At the outset of the Paper<sup>14</sup> we identified a number of central general questions which in our view underlie the whole of the project. These were:
- (1) Should detailed substantive amendments be made to Part X?
  - (2) Should large parts of Part X be repealed (for example because they duplicate areas covered by the general law)?
  - (3) Should Part X be disapplied where appropriate self-regulatory rules exist?
  - (4) Should Part X be rewritten in simple language?
  - (5) Should Part X be decriminalised?
  - (6) Should directors' duties under the general law be codified? (This involves deciding on the standard of the duty of care).
  - (7) Should there be a non-binding but authoritative statement of directors' duties under the general law?

<sup>13</sup> See para 1.24 below.

<sup>14</sup> Paper, para 1.13.

We continue to be of the view that these are the central issues in the project. However, as we explain below,<sup>15</sup> issues (3), (4) and (5) will not be dealt with in this report but will now be dealt with as part of the DTI's Company Law Review.

## **SIGNIFICANT DEVELOPMENTS SINCE THE PUBLICATION OF THE PAPER**

### **Shareholder Remedies**

- 1.16 One of the ways in which the actions of directors are regulated is through the exercise by shareholders of their legal remedies to bring proceedings. In October 1997 the Law Commission, in consultation with the Scottish Law Commission, published its final report on Shareholder Remedies.<sup>16</sup> It recommended among other things that there should be a new provision,<sup>17</sup> which sets out in modern and accessible form the circumstances in which the courts will permit a derivative, or in Scotland a shareholder's, action<sup>18</sup> to be brought. This would facilitate such an action where the cause of action arises out of a breach, or threatened breach, of duty by a director to his company. It would include negligence, which is not actionable in a derivative action at the present time unless it also involves a fraud on the minority.
- 1.17 The report also recommended that in a private company in which substantially all the members are directors, there should be a statutory presumption in unfair prejudice proceedings<sup>19</sup> that the removal of a member as director is unfairly prejudicial conduct.<sup>20</sup> This would help to make the outcome of litigation more certain and encourage parties to settle claims at an early stage.<sup>21</sup>
- 1.18 In November 1998, the Government<sup>22</sup> published a consultative document on Shareholder Remedies. This supports the majority of the Law Commission's recommendations. It sought the views of consultees on a number of specific points, including a winding-up remedy in section 461, a limitation period for unfair prejudice proceedings, and several points of Scottish law. The consultation period ended on 26 February 1999, and the DTI is now considering the responses.

<sup>15</sup> See paras 1.35 to 1.38 below.

<sup>16</sup> Shareholder Remedies (1997) Law Com No 246. The DTI's Consultative Paper states: "So far as civil sanctions are concerned, the Law Commissions have made a valuable contribution in their recent report on shareholder remedies" (para 6.3).

<sup>17</sup> For England and Wales a new rule of court and for Scotland a new statutory provision.

<sup>18</sup> That is, by one or more shareholders on behalf of the company. The Lord Chancellor's Department has since issued a consultation paper entitled "Access to Justice - Specialist Jurisdictions: Proposed New Procedures", including a recommendation for the derivative action and certain other recommendations, which can be implemented in conjunction with the new Civil Procedure Rules. The new Civil Procedure Rules came into force in England and Wales on 26 April 1999.

<sup>19</sup> Under the Act, s 459.

<sup>20</sup> Shareholder Remedies (1997) Law Com No 246 at paras 3.40-3.43.

<sup>21</sup> In *Re a company (No 00709 of 1992) O'Neill and another v Phillips and others*, (1999) 2 All ER 961 (HL) at p 975, their Lordships referred to this recommendation, which they endorsed as being in line with existing practice.

<sup>22</sup> The DTI, with the Lord Chancellor's Department and the Scottish Courts Administration.

## **Modern Company Law for a Competitive Economy: the Strategic Framework**

- 1.19 In February 1999, a consultation paper under this title was issued by the Steering Group of the Company Law Review. This paper set out the overall strategic framework for the review, and sought the views of consultees on a number of issues. The consultation period ended on 1 June 1999.
- 1.20 The Strategic Framework Document identified two particular issues of general importance: first, the identification of the interests which company law should serve;<sup>23</sup> and secondly the special needs of small and closely-held companies, which were thought to be ill-served by the Act.<sup>24</sup>
- 1.21 We agreed with the DTI at the outset of the project that the first of these issues should be outside the scope of our Paper, even though it is relevant to the duties of directors, and the regulation of their conduct, and hence to the ultimate conclusions on many of the issues which we are considering. We did not specifically consider the second issue. To that extent our conclusions are inevitably provisional, and subject to further consideration by the Company Law Review.

### **Directors' Remuneration**

- 1.22 In July 1999 the DTI published a consultative document on Directors' Remuneration. In this document the Government has invited comments on, among other things, proposals to simplify and improve the disclosure requirements on individual directors' remuneration, to require information on directors' service contracts and on compensation arrangements for loss of office to be disclosed and explained to shareholders and to give shareholders more power over directors' remuneration. The consultative document focused on the remuneration of directors of quoted companies.

### **Developments in the Corporate Law Economic Reform Programme in Australia**

- 1.23 In the Paper<sup>25</sup> we referred to section 232 of the Australian Corporations Code, setting out the basic duties of a director, and to the Corporate Law Economic Reform Bill 1998, which had then been recently published by the Australian Government and under which it was proposed to set out a fuller statement of directors' duties,<sup>26</sup> together with a statutory business judgment rule.<sup>27</sup> In May 1999, the Parliamentary Joint Committee on Corporations and Securities presented its report to the Australian Parliament, welcoming the reforms on

<sup>23</sup> Strategic Framework Document, chapter 5.1. A distinction was drawn between "the enlightened shareholder value" approach, based on existing principles, and a "pluralist" approach under which directors would be required to balance shareholders' interest with those of others committed to it, such as employees and suppliers. This issue is sometimes known as the "stakeholder" debate.

<sup>24</sup> *Ibid*, chapter 5.2.

<sup>25</sup> Paper, para 14.23.

<sup>26</sup> Paper, paras 13.7-13.10.

<sup>27</sup> This was set out in the Paper, para 15.39.

directors' duties and corporate governance, as well as the proposed business judgment rule.

### **OECD Guidelines on Corporate Governance**

- 1.24 The OECD exercises an important role in setting global standards for corporate governance. In May 1999 the OECD Council approved Principles of Corporate Governance.<sup>28</sup> These cover the rights of shareholders, the equitable treatment of shareholders, the role of shareholders in corporate governance, disclosure and transparency and the responsibilities of the board. Among other guidelines for directors, it emphasised the role of the board in monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

### **Neill Committee recommendations on donations to political parties**

- 1.25 In October 1998, the Committee on Standards in Public Life under the chairmanship of Lord Neill of Bladen presented its report to the Government on the funding of political parties.<sup>29</sup> The report recommended that a company wishing to make a political donation should have the prior authority of its shareholders. The Government have accepted this recommendation. In March 1999 the DTI issued a consultative document<sup>30</sup> seeking views on how the recommendation might be implemented. The document expressed the view that, where the director was a member of the political party to which the donation was given, there were analogies which might be drawn between the approval proposed by the Neill Committee recommendation and provisions of Part X, such as section 319.<sup>31</sup>

### **Qualification of Chartered Director**

- 1.26 In June 1999, the IoD, whose members include some 47,000 company directors throughout the United Kingdom and abroad, introduced a new examined qualification for company directors, that of Chartered Director. To obtain this status a director will have to pass an examination which tests (among other things) a director's knowledge of his or her duties under the general law. In addition the Institute introduced a Code of Professional Conduct. This applies to directors generally but a Chartered Director must give a commitment to observe it. Under Article 7 of this Code a Chartered Director must avoid a conflict between his personal interests, or the interests of any associated company or person, and his duties to the company. These developments may be very significant in future, particularly as the introduction of the status of Chartered Director is the first qualification of its kind for a director and it should lead to higher standards of conduct by directors.

<sup>28</sup> Endorsed at the OECD Council Meeting at ministerial level, Paris, 27 May 1999.

<sup>29</sup> The Funding of Political Parties in the United Kingdom, (1998) Cm 4057-1.

<sup>30</sup> Political Donations by Companies, March 1999, URN 99/757.

<sup>31</sup> *Ibid.*

## **Law Commission report on Trustees' Powers and Duties**

- 1.27 On 21 July 1999 the Law Commissions published their report on Trustees' Powers and Duties,<sup>32</sup> in which they recommended the codification of a trustee's duty of care. Clause 1 of the bill appended to the report sets out the proposed statutory duty. Our consideration of whether to codify a director's duty of care has also led us to recommend codification.<sup>33</sup>

### **STRUCTURE OF THE REPORT**

- 1.28 We begin this report by reviewing the economic analysis and empirical research and our guiding principles for reform. The remainder of the report is divided into two sections, dealing with (a) the case for a statutory statement of directors' duties; and (b) our review of Part X of the Act.
- 1.29 In Section A we consider the case for a statutory statement of a director's fiduciary duties and duty of skill and care. We also consider the use of prescribed forms and official pamphlets to publicise a director's duties. We consider what the standard of a statutory duty of care should be. We end by looking at the need for a statutory business judgment rule and provisions regulating reliance on and delegation to third parties.
- 1.30 In Section B we consider the reform of Part X. We start with a discussion of whether large parts of Part X should be repealed and reliance placed instead on the general law. We also note the option of disapplying Part X where appropriate self-regulation applies. The bulk of Section B is a review of our proposals for substantive amendments to Part X.<sup>34</sup> We also consider the benefits of introducing a single code of remedies and effects into Part X.<sup>35</sup>
- 1.31 In the Appendices we set out the draft statement of duties that is described in Part 4,<sup>36</sup> the report by the ESRC Centre for Business Research on its empirical research;<sup>37</sup> extracts from the Act;<sup>38</sup> and a list of respondents to the Paper.<sup>39</sup>

### **MATTERS OUTSIDE THIS REPORT**

#### **Matters excluded from consultation**

- 1.32 In the Paper, we stated that certain matters were outside the project.<sup>40</sup> These included the identification of the interests which company law should serve.

<sup>32</sup> Law Commission and Scottish Law Commission, Trustees' Powers and Duties (1999) Law Com No 260; Scot Law Com No 172.

<sup>33</sup> See para 4.48 below.

<sup>34</sup> Parts 7-14.

<sup>35</sup> Part 15.

<sup>36</sup> Appendix A.

<sup>37</sup> Appendix B.

<sup>38</sup> Appendix C.

<sup>39</sup> Appendix D.

<sup>40</sup> Paper, para 1.55.



Likewise the Paper did not discuss insider dealing, or review the general law on remedies for breach of duty or examine the amount of directors' remuneration or any special rule relating to charitable companies. We discuss the duties of directors of charities further below.<sup>41</sup> We also assumed that boards would continue to be structured on the present UK model.<sup>42</sup>

- 1.33 In relation to small companies, we drew attention in the Paper to the many different types of companies, and to the fact that many companies are owner-managed.<sup>43</sup> We did not however propose the adaptation of Part X to small companies. As noted above,<sup>44</sup> the Strategic Framework Document identifies the problems of small companies as one of the key problems of company law. The Steering Group has set up a working party to consider, among other matters, the need for any special rules for owner directors.<sup>45</sup> This report accordingly does not consider the special needs of small and closely-held companies.

#### ***Duties of directors of charitable companies***

- 1.34 The Charities Commission has pointed out to us that in a charitable company the shareholders do not have the same incentive to monitor the activities of the board because they do not have an economic interest in its assets. They considered that the directors of a charitable company should so far as possible operate in the same legal environment as charitable trustees. Another respondent, SCOPE, made the point that accessibility to the law on directors' duties may be particularly important in the case of the directors of a charitable company since they tend to be drawn from a wide cross-section and they do not necessarily have a background as company directors.<sup>46</sup> They also stated that there should be discussion as to whether if (as we recommend) there is a statutory statement of directors' duties, there should be some special provision for the directors of charitable companies. We consider that there is force in this point, and recommend that this point is drawn to the attention of the Steering Group to be dealt with as part of the Company Law Review.

#### **Matters consulted on but excluded from the report**

- 1.35 We have also agreed with the DTI that certain issues on which we did seek the views of consultees should not be dealt with in this report. These matters are:

- (1) decriminalisation of Part X;

<sup>41</sup> The Company Law Review does not include the law relating to charitable companies (DTI's Consultative Paper, para 6.5).

<sup>42</sup> See para 5.1.33 of the Strategic Framework Document.

<sup>43</sup> Paper, paras 1.46-1.48.

<sup>44</sup> Para 1.20.

<sup>45</sup> Strategic Framework Document, Annex I. Miss Diana Faber, the Company and Commercial Law Commissioner of the Law Commission is a member of this working party.

<sup>46</sup> SCOPE's views were in fact made in response to the DTI's Consultative Document. They have kindly given us permission to refer to their response in this report. SCOPE is a charity for people with cerebral palsy.

- (2) the role of self-regulation in general;
- (3) the draft rewrite of the loans provisions (sections 330 - 344 and part of section 347 of the Act) prepared by Parliamentary Counsel and set out in Appendix B to the Paper; and
- (4) application of the law to different categories of director.

1.36 We explain the reasons for the exclusions in paragraphs 1.37 to 1.39 below. We also briefly summarise respondents' views on decriminalisation, the role of self-regulation, the rewrite of the loans provisions and the application of the law to different categories of director. We have submitted full summaries of respondents' views on these matters to the DTI so that they may be considered as part of the Company Law Review.<sup>47</sup>

### ***Decriminalisation and self-regulation***

1.37 Once the Steering Group decided to examine decriminalisation and self-regulation in the context of company law generally, it was thought inappropriate for the Law Commissions to do so solely in the context of Part X. In relation to decriminalisation, there was considerable support among respondents for the tests of proportionality and efficiency, which we provisionally identified in the Paper in considering the imposition of criminal penalties. In addition there was considerable opposition to the idea of removing the criminal sanctions even if there were few prosecutions. There was no clear support for a system of civil penalties such as is found in Australia or in section 242A of the Act 1985.<sup>48</sup> There was also considerable opposition to disapplying statutory regulation in favour of self-regulation.

### ***Rewrite of loans provisions***

1.38 In the Paper<sup>49</sup> we asked consultees for views on a re-draft of the loans provisions (sections 330-344 and part of section 347) which Parliamentary Counsel had prepared using simplified language and structures. As we explained in paragraph 1.3 above, we have not prepared a bill to give effect to our recommendations in this report. Accordingly, we have not addressed the question of whether to rewrite the loans provisions. It is interesting to note that there was considerable support by respondents for the redraft of the loans provisions in Part X.

### ***Application of the law to different categories of director***

1.39 In the Paper<sup>50</sup> we analysed the different categories of director (de jure, de facto, shadow and alternate) and asked consultees for views on the application of Part X and directors' duties to each of these categories. We also discussed the role of executive, non-executive and nominee directors. The DTI's Company Law Review

<sup>47</sup> In the Paper we said that, unless consultees informed us to the contrary, we proposed making their responses available to the DTI. Paper, para 1.15.

<sup>48</sup> See also section 9 in the empirical research report in Appendix B.

<sup>49</sup> Paper, paras 9.34 - 9.43.

<sup>50</sup> Part 17.

will be considering the role of directors, including shadow directors, board structures and powers, non-executive directors and delegation of powers.<sup>51</sup> Having regard to this wider review, we consider that it may be inappropriate for us to take this issue forward solely in the context of directors' duties and Part X. A majority of respondents felt the provisions of Part X and any statutory statement of directors' duties should apply both to shadow directors and to directors who have not been legally appointed, but there was a difference of view as to whether any special provision was needed for alternate directors.

#### **NORTHERN IRELAND**

- 1.40 The Law Reform Advisory Committee for Northern Ireland has worked closely with us in the preparation of this report and is in full accord with its contents and the recommendations for law reform which we make. The Committee proposes to recommend to the Secretary of State for Northern Ireland that parallel legislation should be introduced in Northern Ireland to give effect to our recommendations in this report.

#### **GENERAL COMMENTS ON THIS REPORT**

- 1.41 Where appropriate in this report we summarise the views of respondents on questions raised by the Paper. Where we describe the number of respondents in favour or against a proposal we are referring to those respondents who answered that particular question, and not the number of respondents to the Paper in general. This is because respondents did not generally answer every question.
- 1.42 Throughout this report, the use of the pronouns 'he' and 'his' is meant to include both men and women, except where the context indicates otherwise.

#### **ACKNOWLEDGEMENTS**

- 1.43 This project was commenced under the Chairmanship (at the Law Commission) of Mrs Justice Arden. Although she ceased to be Chairman at the end of January this year, she has continued to play a leading role, and fully supports the conclusions. The present Commissioners are very grateful for her finding time for this work in her busy schedule, and for her special expertise and commitment, without which it could not have been completed.
- 1.44 We are grateful to all those who commented on the Paper and those who have subsequently provided comments or assistance on our proposals. They are listed in Appendix D. We are also grateful to Dr Simon Deakin and Professor Alan Hughes of the ESRC Centre for Business Research for their report on empirical research, to The Centre for Business Performance at The Institute of Chartered Accountants in England and Wales who supported the research by a grant and to the Institute of Directors who facilitated the research by providing access to its database of members. We would like to express our particular thanks to the following who have acted as our consultants throughout this project: Professor D D Prentice of the University of Oxford, Mr Richard Nolan of the University of Cambridge, the Scottish Law Commission's Advisory Group, namely, Mr Robert

<sup>51</sup> Strategic Framework Document, para 9.4 and page 209.

Bertram of Heriot-Watt and Edinburgh Universities, Mr Michael Livingston of Maclay, Murray & Spens, Ms Morag McNeill of McGrigor Donald, Mr David Sellar, Advocate, Edinburgh, Mr William Simmons of Tods Murray WS, Mr Campbell Smith of Biggart Baillie and Mr James Birrell of Shepherd & Wedderburn WS. We would also like to thank Clifford Chance and McGrigor Donald for their support.

# **PART 2**

## **ECONOMIC CONSIDERATIONS AND EMPIRICAL RESEARCH**

### **INTRODUCTION**

- 2.1 Parts 2 and 3 of the Paper were entitled, respectively, General Principles for Reform, and Economic Considerations. The former proposed twelve general principles which it was suggested should guide reform of the law in Part X, and asked for consultees' comments on them. The latter, as well as providing an economic analysis of the present law,<sup>1</sup> also sought to identify issues which would be appropriate for empirical research.<sup>2</sup> That empirical research has now been completed.<sup>3</sup>
- 2.2 We received a number of helpful comments on the general principles, to which we refer below.<sup>4</sup> We did not raise any specific questions on Part 3, but several respondents commented on it, and it has also stimulated academic debate.<sup>5</sup> A particular concern of some respondents was that the relationship between the general principles and the economic considerations needed to be clarified. Before addressing those comments, it will be convenient to summarise the conclusions from the economic analysis, and the results of the empirical research, which we do in this Part. In the next Part we shall refer to the guiding principles, and the comments upon them; we shall explain their relationship with the economic considerations, and seek to extract certain *headline* principles to guide the subsequent consideration of individual issues.
- 2.3 Accordingly in this Part -
- We explain the role of economic considerations in our work;
  - We set out a summary of the economic considerations discussed in the Paper;
  - We summarise the results of empirical research done during the consultation period.

<sup>1</sup> Part 3 was in the form of a report, prepared for us by the ESRC Centre for Business Research at the University of Cambridge.

<sup>2</sup> Paper, para 3.9, and Part 16.

<sup>3</sup> Report to Law Commissions, ESRC Centre for Business Research, "Directors' Duties: Empirical Findings", August 1999. The full report is at Appendix B to this report.

<sup>4</sup> Para 3.5ff, below.

<sup>5</sup> See, e.g., the special issue of *Company Lawyer*, June 1999, Vol. 20, and the special issue of the *Company, Financial and Insolvency Law Review*, autumn 1999 (forthcoming). In November 1998, Lord Hoffmann gave a lecture entitled "Duties of Company Directors" to the University of Manchester in which he referred to the findings in the ESRC report (13 November 1998, unpublished).

## **THE ROLE OF ECONOMIC CONSIDERATIONS**

- 2.4 Reform of the existing law starts with an evaluation of that law in the light of changes that have occurred since it was introduced, and also in light of evidence as to how it is working. Generally speaking, the evidence is available from cases decided by the courts, or representations made by users of the law in question or in other ways. Evidence of how the law is working can also be obtained by empirical research. Having made an evaluation of the existing law, the Commissions must then formulate their recommendations for reform.
- 2.5 There are many different levels at which questions of law reform can call for examination. There is the level of policy issues: what objectives should the law as reformed seek to achieve? There is also the more technical level of ensuring that the law as reformed will be sufficiently comprehensive and consistent and thus will work well. Both these areas are important and form integral parts of the Commissions' approach and process.
- 2.6 In some cases, the Commissions may feel it appropriate to look at the law in a wider context. The present project provided that opportunity for two reasons in particular. First, this project forms a part of a much wider review of company law, and thus there is an opportunity for more fundamental change. Our recommendations will be considered, not simply against the backdrop of our terms of reference, but also against the objectives of the wider review of company law.
- 2.7 Added to that, there is the consideration that directors' duties and Part X are essentially regulatory and prescriptive areas of the law. Their fundamental purpose is to regulate directors' conduct or, put another way, to promote high standards of behaviour. The extent of regulation in Part X of the Act far exceeds that, for instance, in Canada or other member states of the EC. There are environmental reasons for this, particularly the division of ownership and control in larger enterprises and the nature of our capital markets.<sup>6</sup> But these considerations do not tell us how the regulation is working or whether it is really necessary.
- 2.8 In those circumstances, it seemed to us appropriate to look not only at the immediate impact of the law under review but also, beyond that, at its function in the wider economic context. The wider context of company law is regulating commercial activity so that it operates efficiently and promotes prosperity. With those considerations in mind, we sought assistance on the economic considerations.
- 2.9 Before we move to them, two points must be made. First, respondents and scholars have said there is also a wider social context to the questions we are considering, epitomised by what we called "the stakeholder issue". But this area is expressly outside our project and within the remit of the Company Law Review.<sup>7</sup> Secondly, the objective of the economic considerations is not to substitute, for a wider judgment on policy issues, a narrower judgment based on economic

<sup>6</sup> On this issue, we were provided with an in-depth paper by Luca Enriques LM (Harv) of Università Bocconi, Milan for which we are most grateful, "The Law on Corporate Directors' Self-Dealing: A Comparative Analysis" (October 1998, unpublished).

<sup>7</sup> Paras 1.20 and 1.32 above.

considerations alone. Its purpose is to inform and enhance our understanding. We believe that the economic analysis, especially now that it has been reinforced by empirical research as explained below, achieves that purpose.

## **SUMMARY OF THE ECONOMIC CONSIDERATIONS**

### **Aims of the study**

- 2.10 Part 3 of the Paper contained a report on Economic Considerations prepared for the Law Commissions by Dr Simon Deakin and Professor Alan Hughes.<sup>8</sup> Several aims for economic analysis were identified in the report in Part 3:
- to see how far features of the existing law could be explained using economic concepts;
  - to predict the range of potential effects of legal change;
  - to provide a framework for evaluating legal reform by reference to criteria of economic efficiency.
- 2.11 It was not suggested that economic efficiency should provide the sole point of reference for the reform process. Economic efficiency embodies a number of criteria for judging outcomes according to how far they involve the minimisation of waste ('technical' efficiency), the allocation of resources to those who are able to make best use of them in the sense of valuing them most highly ('allocative' efficiency), and the promotion of systems (in this context, companies and industries) which can compete and survive in a rapidly changing environment ('dynamic' efficiency).<sup>9</sup> The report did not purport to offer a basis for weighing considerations of efficiency against other, non-economic considerations which could be relevant for the law reform process. A weighing process of this kind lies outside the scope of what is possible in an economic analysis.<sup>10</sup>
- 2.12 An additional purpose of Part 3 was to identify more precisely those questions which could be addressed by empirical research into corporate governance practices, which, as we explain below, has now been completed.

### **Findings**

- 2.13 The analysis in Part 3 of the Paper identified three ways in which company law could contribute to economic efficiency:
- by promoting efficient bargaining between corporate actors;

<sup>8</sup> Assistant Director and Director, respectively, of the ESRC Centre for Business Research at the University of Cambridge. The following summary of Part 3 of the Paper has been provided by them.

<sup>9</sup> Paper, paras 3.3-3.5.

<sup>10</sup> See S. Deakin and A. Hughes, "Economics and company law reform: a fruitful analysis?" (1999) 20 *Company Lawyer* 212-218.

- by protecting the interests of third parties, such as creditors, who might be adversely affected by corporate transactions;
- and by providing incentives for co-operation in corporate relations, thereby promoting competitiveness.

2.14 Part 3 referred to an extensive body of economic work analysing the fiduciary relationship. It was suggested that the fiduciary principle, as applied to company directors, could be understood as a rule which had the effect of promoting efficient sharing of risk and information in corporate transactions.<sup>11</sup> The principle of fiduciary obligation played an important role in reducing transaction or agency costs arising from the separation of ownership and control. Many of the more detailed rules of Part X of the Act could be seen in a similar light.

2.15 However, Part 3 also demonstrated that Part X lacked a unifying principle. Such a principle was needed to explain why, in some instances, transactions were completely prohibited while, in others, they could be validated by one or more of a number of means (in some cases, shareholder approval, in others disclosure to the shareholders, the board, or the Stock Exchange).<sup>12</sup> Certain existing provisions were particularly difficult to justify using economic reasoning; section 319, setting limits to the duration of directors' service contracts which could be avoided through shareholder approval, was the principal example of this.

2.16 Concepts of economic efficiency (allocative, technical and dynamic efficiency)<sup>13</sup> were then used to develop a 'normative' analysis of how the law could be changed so as to promote efficiency. On this basis, it was argued in Part 3 that *prohibitions* should be used only where third parties (such as creditors) could be seen to be clearly at risk from transactions. In other cases, Part 3 recommended that the law should move towards a general principle of meaningful *disclosure*, and that *approval* rules should be seen as the exception.<sup>14</sup>

2.17 It was suggested that the purpose of disclosure should be to ensure that each organ of the company (such as the board or the shareholders) had available to it the information which it needed to ensure that it was effectively carrying out its particular monitoring role. This was to be subject to two qualifications: first, the need for confidentiality (which, in economic terms, is the problem that excessive disclosure of information may destroy its value); and, secondly, the need to avoid excessive costs in the process of dissemination.<sup>15</sup>

2.18 Part 3 considered possible outcomes of legal change with regard to the standard set for the duty of care. The danger that increased risks of personal liability would

<sup>11</sup> In technical terms, it operated as a 'default rule'. The meaning and significance of the analysis of company law rules as 'default rules' of different kinds was explained in Part 3 of the Paper at paras 3.19-3.50.

<sup>12</sup> See Table of rules governing disclosure and consent, at p 23 below (which appeared at Paper, p 47).

<sup>13</sup> Para 2.11 above.

<sup>14</sup> Paper, para 3.72.

<sup>15</sup> Paper, para 3.57.



deter potential directors from standing for office was noted.<sup>16</sup> The issue of whether criminal sanctions should be retained under Part X was also considered.<sup>17</sup> It was suggested that, in principle, a role for public enforcement of certain aspects of directors' duties could be made out, given the costs of private litigation in this area. The value of criminal sanctions would depend, in part, on how effective civil litigation might become in the future.

- 2.19 The analysis in Part 3 accepted that more information was needed on existing corporate governance practices, many of which were likely to operate beyond the law in the sense of making little or no reference to it. As noted above, a number of areas were singled out for empirical research and listed in Part 16 of the Paper. In particular, it was suggested that an important aspect of the empirical research would be to show how corporate governance differed in companies of different size (by employees and by turnover) and type (listed versus non-listed; companies where the board held a controlling stake against those with dispersed control; companies with non-executive directors against those without).

## **THE EMPIRICAL STAGE OF THE RESEARCH**

### **Introduction**

- 2.20 In the project the Commissions were concerned to know about the regulation of conflicts of interest involving directors as it operated in practice, among as many directors as possible; and also to ascertain the views of directors on a possible statutory statement of directors' duties. This has been made possible by the empirical research done by the ESRC Centre for Business Research in the University of Cambridge for us during the consultation period. The full report of ESRC Centre for Business Research with supporting tables will be found in Appendix B to this report. In paragraphs 2.21 to 2.40 we set out a summary, also provided by the ESRC Centre for Business Research.

### **Aims**

- 2.21 A central aim of empirical research was to clarify the nature of the relationship between shareholders and directors, focusing in particular on the role played in this process by representatives of institutional shareholders and non-executive directors. It was also intended that the work should uncover evidence on the various types of procedures and practices which exist in companies of different types (in particular, listed and unlisted companies) and size.
- 2.22 The empirical stage of the research was also designed to ascertain the extent to which bargaining over the form and content of directors' duties in fact takes place. A central contention of the economic theory of the corporation is that legal rules can be used to induce the parties to arrive at efficient allocations of resources through contractual arrangements. However if, in practice, bargaining is seen as excessively costly or impractical, it may not be feasible to expect the law to play this role. Again, whether this is the case is not a question which could be answered solely from first principles; it also requires empirical investigation.

<sup>16</sup> Paper, paras 3.85-3.91.

<sup>17</sup> Paper, paras 3.79-3.84.

2.23 Part 3 of the Paper also considered the issue of whether raising the standard of care for directors' duties of care and skill would deter directors from taking office or from taking normal business risks. A possible tightening in the standard of care could have effects upon internal systems of communication within companies. In order to address these questions, the empirical stage of the work aimed to find out more about the way directors perceive their current legal responsibilities under the duty of care, and how they would regard a possible restatement of the law. It was also intended to seek the views of commercial creditors, banks, and the insurance industry.

### **Methods**

2.24 In order to examine these issues, a dual approach was undertaken.<sup>18</sup> First, a number of face to face interviews were conducted with directors, institutional shareholders, commercial lenders, and legal advisers. The aim of these interviews was to obtain qualitative evidence of the nature of current practices with regard to director-shareholder relations, and the effects of possible changes to the law.

2.25 Secondly, information concerning corporate practices was obtained through the administration of a questionnaire, which was circulated to a large sample of directors in companies of different types and sizes. The design of the questionnaire and the interpretation of responses to it were informed by the qualitative insights gained from the interviews.

2.26 A sample of approximately 5,500 directors was drawn from the membership of the IoD. The target for the achieved sample was 1,000 director responses. In the event a response rate of over 20% was achieved, with 1,259 directors responding in respect of the full size range of companies. This response rate was consistent with that achieved in good practice surveys of this kind.

### **Findings**

#### ***(1) Diversity of corporate governance practice***

2.27 The key finding of the empirical research relates to the diversity of corporate governance mechanisms which operate in practice. The research confirms the suggestion of economic theory to the effect that complex procedures – involving an expanded role for non-executive directors, intra-board monitoring, and the use of internal codes of practice – are most likely in larger companies with a dispersed share structure. Whether a company is listed or not is also a good indicator of the type of procedures it adopts. This illustrates the influence of the listing rules, although agency cost considerations are also highly relevant in the case of listed companies.

2.28 Given this degree of diversity, the general approach of the law should be one of encouraging corporate actors to adopt the types of measures which best suit them in practice. As suggested in the Paper, the law could do this by encouraging disclosure in various ways. A general principle of disclosure to shareholders of

<sup>18</sup> The research was supported by The Centre for Business Performance at The Institute of Chartered Accountants in England and Wales, and, as explained in the text, was facilitated by the IoD which provided access to its database of members.

matters relating to conflicts of interests and the use of corporate opportunities should inform reform of Part X. This general principle should be qualified by the need to retain confidentiality of information in certain instances. Where, however, confidentiality is an issue, there is a good case for retaining and if necessary strengthening rules relating to disclosure to the board (as in the case of section 317).

***(2) The balance between disclosure and approval in Part X***

- 2.29 The findings of the empirical research on the diversity of existing practices also have important repercussions for the extent of disclosure to shareholders which the law should require. It was found that in larger, open<sup>19</sup> and listed companies, disclosure to shareholders is often seen as highly costly. In open companies, monitoring increasingly takes place within the board, where the role of non-executive directors is growing in importance. The growing role of non-executive directors in such companies need not imply, though, that shareholder disclosure is of no value. The accountability and independence of non-executive directors is a matter requiring further research. Their independence with regard to the executive directors could be strengthened by rules which require information to be made available beyond the board, that is to say, to the shareholders.
- 2.30 In smaller,<sup>20</sup> closed companies, direct shareholder monitoring and control through directors' service contracts, shareholders' agreements and the articles of association were found to be more common than in open companies. In smaller and closed companies, non-executive directors play a less significant role. The empirical research also showed that bargaining over the use of corporate opportunities does take place in closed companies where shareholder approval can be sought if necessary; again this is much less likely in listed and 'open' companies. In the case of smaller and closed companies, there is a strong case for rules maintaining a high level of disclosure of conflicts of interest to the shareholders so that such bargaining can take place.
- 2.31 For the above reasons, statutory rules requiring shareholder *approval* should be seen as the exception in this area, as was suggested in the Paper. The empirical evidence shows that the scope for bargaining around such rules is particularly limited for larger, 'open' companies, which tend to see the cost of obtaining shareholder approval as excessive. Hence such rules end up operating as de facto mandatory rules. While such rules will not *necessarily* be inefficient, they *may* have adverse effects in terms of efficiency if they lock the parties into transactions which they would not otherwise have chosen or if they give rise to costly attempts to avoid the effect of the prohibition in question.

<sup>19</sup> The ESRC Centre for Business Research uses the term "open" to mean companies where the board holds less than 50% of the equity and "closed" to mean those where the board holds 50% or more. See n 5 to section 4.1 of the empirical research report in Appendix B.

<sup>20</sup> In presenting its empirical research, the ESRC Centre for Business Research provides particular definitions in terms of size where it distinguishes 4 groups based on turnover. The terms "small" and "large" refer to those groups and are used in a relative analytical sense. See n 5 to section 4.1 of the empirical research report in Appendix B.

- 2.32 In general, then, both the economic analysis contained in Part 3 of the Paper and the empirical research suggest that rules which require shareholder approval should be confined to cases of exceptional risk to shareholders, such as those relating to certain substantial property transactions. Likewise, complete prohibitions (which cannot even be overcome by shareholder approval) should be confined to situations where third parties (that is, creditors) are clearly at risk.
- 2.33 In open companies, disclosure to shareholders performs important functions notwithstanding the existence of processes of intra-board monitoring. The growing role played by non-executive directors does not obviate the need for shareholders to be informed about issues relating to the loyalty and performance of directors. The nature of the relationship between non-executive directors and shareholders is currently undergoing considerable change as a consequence of corporate governance reforms and all aspects of this process of change are not, as yet, clearly understood. Nevertheless, it is plausible to suggest that for non-executive directors to operate effectively it is important that the shareholders should have the necessary information to perform their role as the body to which the board as a whole (including the non-executive directors) is ultimately responsible.
- 2.34 In the case of closed companies, shareholder monitoring and control through the articles of association and shareholders' agreements were found to be widespread. For these processes of direct monitoring to function effectively, the provision of reliable information from the directors to the shareholders would seem to be essential. Here, the law would appear to have a significant part to play in ensuring that meaningful disclosure takes place.

### ***(3) Criminal sanctions***

- 2.35 The use of criminal sanctions as part of the enforcement of the obligations imposed on directors by Part X may in principle play an important role for reasons discussed initially in the Paper.<sup>21</sup> Given the difficulties of observing a breach of the duty of loyalty by directors and the costs to shareholders of mounting litigation, it was concluded there that an element of public enforcement would continue to be appropriate. This view was reinforced by the empirical research which found evidence to the effect that legal advisers regard the existence of criminal sanctions as an important means of ensuring that clients comply with their obligations in this area of the law.
- 2.36 Restitutory remedies can be seen as heightening the incentives for shareholders to bring civil claims and hence may reduce the need for criminal penalties. However, interviews carried out at the empirical stage confirm the impression that the procedural difficulties facing shareholders contemplating civil litigation (in particular minority shareholders) are still considerable and are likely to remain so for the foreseeable future. This reinforces further the case for retaining criminal sanctions.

<sup>21</sup> The issue of decriminalisation is not part of our study, but will be considered as part of the Company Law Review: see para 1.37 above.

#### ***(4) Directors' service contracts***

- 2.37 The empirical evidence on directors' service contracts suggests that the current law is not consistently capable of meeting the objectives apparently set for it. At present, larger companies find it more costly to obtain shareholder approval for contracts of long duration than do smaller firms. They are therefore more likely to bargain round the law in other ways, by, for example, increasing direct remuneration. Arguably shareholders are no better off as a consequence, and the law is failing in its ostensible purpose. One option therefore is to remove the current controls on the length of directors' service contracts, and allow a completely free balancing of duration of contracts against level of remuneration.
- 2.38 An alternative route is to amend section 319 and put strict limits on rolling contracts, possibly in conjunction with a shortening of the permitted duration from five years to three. This could address the issue of ensuring that directors remain properly accountable to shareholders – the power of removal at the general meeting would not be watered down by fear of a high compensation payment for loss of office of the kind associated, at present, with long-term rolling contracts. Even this reform would not, of course, remove completely the possibility of contracting around the law (for example, by increasing remuneration levels). If, moreover, this step is taken, care must be taken with smaller companies, since in their case it was found, on the basis of the survey, that contracts for more than three years are still common. For listed companies, the matter of contract duration is already dealt with by the high level of de facto compliance with the Combined Code.

#### ***(5) The duty of care***

- 2.39 With regard to the duty of care, it was found that raising the standard of care for directors would be in line with developments taking place already in listed companies, which are moving towards more systematic internal audit procedures. It would, however, have a bigger impact on smaller companies, among which it was found that there is still some support for the more traditional *Re City Equitable* principle.<sup>22</sup>

#### ***(6) The statement of directors' duties***

- 2.40 The empirical research revealed widespread support for the use of a statement of directors' duties. This was particularly the case among directors of smaller companies (who make up the vast majority of the total population of company directors). For such directors, who often have no regular access to legal advice, there is evidence to suggest that a statement of directors' duties would be an important source of information and clarification of the law.

### **CONCLUSION**

- 2.41 We consider that the economic considerations have provided a useful tool for analysing the existing law and for evaluating proposals for legal reform. In the next Part we explain the different functions of the guiding principles and economic considerations. However, the results of both the economic analysis and the

<sup>22</sup> *Re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407; see para 5.3 below.

empirical research tend to confirm the significance of the *headline* principles identified in that Part of the report.

**TABLE**

**Rules governing disclosure and consent through approval, release and ratification under Part X of the Act<sup>23</sup>**

	<b>Disclosure (General meeting*) (Notice to shareholders**) (Notification to company***) (Company accounts†) (Inspection††)</b>		<b>Consent</b>	
	<b>Before</b>	<b>After</b>	<b>Before (Approval)</b>	<b>After (Release, Affirmation Ratification)</b>
<b>Board</b>	<i>s 317(1), (2) (a), (3), (4), (8)</i>	<i>s 317(2) (b)  s 322B</i>		
<b>Share- holders</b>	<i>s 312*  s 313(1)*  s 314(2)**  s 319(5) ††  s 337(3) (a)*</i>	<i>s 318††  s 324 and Sched 13, Pt II***  s 325 and Sched 13, Pt IV††  s 328(3) ***  Sched 6, Pt II †  ss 343-344††</i>	<i>s 312  s 313(1)  s 315(1) (b)  s 319(3)-(4)  s 320(1)  s 337(3)</i>	<i>s 322(2) (c)  s 322A(5) (d)</i>
<b>Stock Exchange</b>		<i>s 329</i>		

<sup>23</sup> As mentioned in para 2.15, n 12 above, para 3.20, n 21 below and para 6.1, n 6 below.

# PART 3

## GUIDING PRINCIPLES

### INTRODUCTION

3.1 A key objective of our work is to produce recommendations for systematic and principled law reform. In Part 2 of the Paper we set out the aims of company law reform, by reference to the objectives and terms of reference stated for the DTI's Company Law Review;<sup>1</sup> and we sought to identify certain guiding principles for reform, drawing on the principles identified in our report entitled "Shareholder Remedies".<sup>2</sup> We took note of the Government's objective, stated in the DTI's Consultative Paper, of providing an effective framework of law and non-statutory regulation, which, in particular -

promotes consistency, predictability and transparency and underpins high standards of company behaviour and corporate governance.<sup>3</sup>

3.2 The function of our list of guiding principles was to specify the relevant principles that apply in our work. They will not all be relevant in any particular situation. Which ones are to be applied and what weight is to be given them in any instant case are questions on which we have sought to exercise our judgment informed by the views of respondents, the economic and empirical research, and the aims and objectives of the Company Law Review. Such a list permits conceptual questions to be identified, and can provide a benchmark for testing different views expressed to us by respondents.

3.3 In this Part -

- We summarise the guiding principles as set out in the Paper
- We comment on views expressed by respondents
- We discuss the different functions of the guiding principles and the economic considerations
- We set out the guiding principles identified by the Steering Group for the purposes of the Company Law Review
- We set out our conclusions and identify *headline* principles

<sup>1</sup> Paper, para 2.3-4. The terms of reference and objectives were subsequently confirmed by the Steering Group in the Strategic Framework Document para 1.12.

<sup>2</sup> (1997) Law Com No 246.

<sup>3</sup> DTI's Consultative Paper, para 5.1.



## SUMMARY OF GUIDING PRINCIPLES IN THE PAPER

3.4 Drawing on the guiding principles in “Shareholder Remedies”,<sup>4</sup> we set out twelve guiding principles in the Paper:

**(1) A principle of separate but interdependent roles for shareholders and directors**

We noted in the Paper that, depending on the type of company, in general the role of the directors is to manage the business while that of the shareholders is to monitor their stewardship. The question of what that monitoring role should involve, and how it should be carried out, is at the heart of the current debate on corporate governance. In this project the monitoring role is in issue in our review of Part X.

**(2) Law as facilitator principle<sup>5</sup>**

The law should facilitate not impede the conduct of proper business transactions.

**(3) Appropriate sanctions principle<sup>6</sup>**

There should be a range of sanctions, and sanctions should be effective and realistic. The specific issue of criminal sanctions is not part of this project, but is to be considered in the review.<sup>7</sup> Appropriate sanctions need also to encompass appropriate oversight and enforcement machinery.<sup>8</sup>

**(4) A company-specific principle**

Consideration should be given to different types of company. Numerically the largest group of companies has the smallest number of shareholders. This principle continues to be relevant, but we have agreed with the DTI that the application of Part X to smaller companies should be considered not in this project but in the Company Law Review.<sup>9</sup>

<sup>4</sup> (1997) Law Com No 246.

<sup>5</sup> This principle, taken with principles (8) and (9) below is similar to principle of facilitation of transactions identified by the Steering Group: see para 3.14 below.

<sup>6</sup> This is consistent with but wider than the principle of regulatory boundaries identified by the Steering Group: see para 3.14 below.

<sup>7</sup> Para 1.37, above.

<sup>8</sup> A point made on consultation by the Financial Services Authority.

<sup>9</sup> Para 1.33, above.

**(5) An inclusive principle**

We expressed concern that the law should permit directors to take into account the interests of persons other than shareholders, to the extent the law allows this.

**(6) A usability principle<sup>10</sup>**

The law should be accessible, comprehensible, clear and consistent with common sense.

**(7) A certainty principle<sup>11</sup>**

In general, company law should be precise and certain but there will be situations where this not achievable.

**(8) An "enough but not excessive" principle**

This counselled against excessive regulation of management action. Part X must strike the right balance between necessary regulation and the freedom of directors to make business decisions.

**(9) A principle of ample but efficient disclosure**

Disclosure has a prophylactic effect but care must be taken to ensure that the costs of disclosure do not outweigh the utility.

**(10) The principle of efficiency and cost-effectiveness<sup>12</sup>**

The law must achieve its purpose without unnecessary waste of costs and management resources.

**(11) The commercial judgment principle**

In general, the courts should not substitute their judgment for the proper commercial judgment of directors.

**(12) The principle of sanctity of contract**

The starting point is that the law will generally uphold contractual relationships, but there may be exceptions. For example, the issue arises as to whether protection of the company's interests may require it to be

<sup>10</sup> Our usability and certainty principles are within the Steering Group's principle of accessibility: see para 3.14 below.

<sup>11</sup> See previous footnote.

<sup>12</sup> There is some overlap here with the economic considerations, but efficiency in this context is primarily directed to the working of the legal rule rather than the wider meaning of efficiency as used in Part 2 of the Paper.

relieved from a contract that it has entered into in consequence of a breach of a provision of Part X.<sup>13</sup>

#### **VIEWS EXPRESSED BY RESPONDENTS**

- 3.5 There was a substantial degree of support for the guiding principles as stated in the Paper, and several respondents thought the principles were comprehensive and made good sense. Others offered alternative formulations; for example, the IoD emphasised the need to encourage enterprise and competitiveness, preserve the benefits of the company form, focus on core company law, encourage good practice in company direction, and to modernise, rationalise and simplify company law.
- 3.6 There were some criticisms of the content or scope of particular principles. These differences were largely matters of emphasis. We do not think it helpful to analyse them in detail, since the precise formulation of the principles is not fundamental to the issues we have to consider. Our approach to individual provisions, and the comments on them, will be apparent in the remainder of this report. We therefore confine the following comments to the more general points raised.
- 3.7 The principal criticism was that the relationship between the general principles in Part 2 of the Paper and the economic considerations in Part 3 needed to be clarified. It was also suggested that the number of principles needed to be rationalised into a core group. Others argued that the focus of the principles was too narrow, and that other constituencies, such as creditors, deserved greater recognition. Another respondent considered that the principles should be augmented to reflect the tests already applied by the courts in relation to the assessment of directors' fiduciary duties, and have regard to the commercial reality that over 99% of companies on the UK registers are privately owned.
- 3.8 We comment below on the relationship between the guiding principles and the economic considerations, and also the possibility of extracting certain core or *headline* principles. Issues relating to the inclusion of other constituencies are within part of the stakeholder debate, which as we have explained is not within the scope of this project. Similarly, the special concerns of smaller companies are matters for consideration in the Company Law Review.<sup>14</sup>
- 3.9 Other respondents drew attention to possible conflicts. The Institute of Chartered Accountants of Scotland said that the principles contradicted the DTI's objective of producing clear, concise, and unambiguous legislation. It was argued that it was not easy to see how all the principles could be accommodated and which, if any, take priority.<sup>15</sup> The possibility of conflict between principles was also a point made by Professor Wooldridge. However, we agree with the Faculty of Advocates in Edinburgh who observe that the weight to be attached to each will depend upon the nature and context of the legal rule concerned.

<sup>13</sup> See e.g. the discussion of remedies under s 317: Part 8 below.

<sup>14</sup> Para 1.20 above.

<sup>15</sup> This point was also made by David Milman, Centre for Law and Business, University of Manchester who suggested the weighting would vary from company to company.

### **THE DIFFERENT FUNCTIONS OF THE GUIDING PRINCIPLES AND THE ECONOMIC CONSIDERATIONS**

3.10 As to the relationship between the guiding principles and the economic considerations, we saw them as having different functions. The latter enabled us to form a view as to how the present law is operating and how any amended law might operate and it also suggested areas in which empirical research would be of *potential value*. In company law, efficiency is important. Company law must operate smoothly and unnecessary costs must be minimised to enable business and society to prosper. But company law must also achieve other ends. One of those is the promotion of high standards of behaviour by directors and their accountability. Many companies probably already observe high standards but the role of the law is to set the standards in this regard below which directors are not allowed to fall. Setting those standards is not a function of efficiency alone.

3.11 Similarly, the authors of the economic report have commented to us:<sup>16</sup>

The main purpose of Part 3, as explained in the Paper, was to bring an *external* point of view, namely the perspective of economics, to bear on the law reform process. This is in contrast to the role of Guiding Principles which were laid out in Part 2 of the Paper, the aim of which was to identify core principles for law reform by reference to an essentially *internal* analysis, focusing on key elements within company law and practice. The analyses in Parts 2 and 3 therefore provide separate but complementary perspectives on the process of law reform.

3.12 While the guiding principles and economic considerations often overlap, we did not intend to use them to establish a single set of considerations for reform. In both cases, the purpose was to put forward as wide a range of considerations as possible to ensure that the issues were looked at from all angles. Accordingly we do not in this report seek to provide a synthesis of the guiding principles and economic considerations.

3.13 It is also important to emphasise that the Paper did not put forward economic efficiency as the sole point of reference for the reform process. In seeking to show how rules of company law might enhance or detract from efficiency, the report on economic considerations aimed to inform the law reform process. It did not purport to offer a basis for weighing considerations of efficiency against other non-economic considerations which could be relevant for the law reform process. A weighing process of this kind lies outside the scope of what is possible in an economic analysis.

### **GUIDING PRINCIPLES IDENTIFIED BY THE STEERING GROUP FOR THE PURPOSES OF THE COMPANY LAW REVIEW**

3.14 After the Paper was published, the Steering Group published its Strategic Framework Document.<sup>17</sup> In it, the Steering Group set out three guiding principles

<sup>16</sup> Dr Deakin and Professor Hughes in a note to the Commissions commenting on the consultation responses.

<sup>17</sup> Para 1.19, above.

for the purposes of their wider review of company law. These principles (with summaries of the explanations given by the Steering Group)<sup>18</sup> were:

**(a) Facilitation of transactions - a presumption against prescription**

In order to allow companies to be responsive to change, and to leave space for developing best practice, company law should facilitate the operation of market forces. For this purpose there must be adequate disclosure of information. This presumption in favour of facilitation must, however, yield where markets and informal pressure combined with transparency cannot be expected to work, for example because participants lack the market power, skill or resources to contract effectively.

**(b) Accessibility - ease of use and identification of the law**

Competitiveness requires the minimum complexity and maximum accessibility, both in terms of the substance of the law and the way in which it is communicated. Sometimes the law must provide for complex situations (many company transactions are inevitably subtle and complicated) But this legitimate need of the few should not result in cost and confusion to the majority.

**(c) Regulatory boundaries - proper jurisdictions**

Rule making and enforcement should be assigned to the most suitable body among the various regulatory jurisdictions which operate in the field. Overlaps, duplications and conflicts should be avoided.

**CONCLUSIONS AND HEADLINE PRINCIPLES**

- 3.15 As we explain above, the function of Part 2 of the Paper was to identify the underlying principles guiding our consideration of the issues. Because this was done in the abstract, opinions can differ as to the level of generality in which they should be expressed. Not surprisingly, the principles identified by the Steering Group, while differently expressed, cover much of the same ground. They could all be summarised, in relation to Part X as *fair regulation* but that would not communicate the complexity of the competing policy considerations which are involved. Likewise many people may find the principles self-evident. However, the debate on the regulation of directors is not confined to those who are already skilled in this field and so we think it helpful for the principles to be stated.
- 3.16 We believe, however, that it is helpful to seek to extract, from the discussion in this and the previous Part, certain *headline* principles (or combinations of principles) that may properly guide the consideration of the individual issues. We would identify four such headline principles:
- (1) ***accessibility***
  - (2) ***certainty***
  - (3) ***graduated regulation of conflicts of interests***

<sup>18</sup> Strategic Framework Document, paras 2.21-2.26.

(4) ***efficient disclosure***

- 3.17 (1) and (2) require little elaboration. *Accessibility* is one of the strands of our principle of “usability” (principle (6)). We have used the word “accessibility” because it is the word used by the Steering Group (principle (b)) to cover substantially the same ground.<sup>19</sup> *Certainty* is our principle (7).
- 3.18 Headline principle (3) - *graduated regulation* - requires more explanation. Here we seek to draw on a number of the principles that we identified in the Paper - notably (1), (3), (4), (8) and (9) - and to *refine* them in the light of responses, the recommendations in this report, and the report on economic considerations.
- 3.19 In cases of conflict of interest, the issue to a large extent becomes - when should the law prohibit the transactions and when should shareholders or the board be given the means to intervene and monitor what the directors are doing? Directors are accountable; in the last resort shareholders have to have the means to ensure that accountability. This will help enhance corporate governance and high standards of company behaviour.<sup>20</sup>
- 3.20 The report on economic considerations contained an analysis of the existing rules in Part X into various types,<sup>21</sup> and observed that, at present, there appeared to be no unifying principle. The conclusions drawn in the report<sup>22</sup> suggest that a graduated response is appropriate for regulating conflicts of interest, as follows:
- ***prohibitions*** should be confined to exceptional situations, e.g. where there is a significant risk of prejudice to interests of persons other than the directors or the shareholders.
  - ***shareholder approval*** should be required in other situations where there is a real risk of prejudice to the shareholders. This could be a risk of financial prejudice through damage to the company, or a risk of prejudice because what the directors are proposing to do affects the balance of power between the directors and shareholders.
  - ***disclosure after the event to shareholders*** - this should be sufficient in other cases.
  - ***disclosure to the board before the event*** - disclosure by the interested director to his or her colleagues should normally be required, provided that disclosure is efficient.
- 3.21 The last point leads on to headline principle (4) - *efficient disclosure*. Disclosure plays a major role in regulating conflicts of interest. The principle of *efficient disclosure* implies a *qualitative assessment* of the disclosure, which may also affect the circumstances in which it should occur. It corresponds to our guiding principle

<sup>19</sup> Para 3.14, above.

<sup>20</sup> In accordance with the Government’s objectives quoted in para 3.1 above.

<sup>21</sup> See the table at p 23 above.

<sup>22</sup> Paper, para 3.92.

(9). Disclosure requirements should as far as possible exclude disclosure of the immaterial or that which is already known. To this can be added the economic view point of disclosure, expressed in Part 3 of the Paper, that disclosure should ensure that the board and shareholders each receive the information which they need to exercise their respective functions.

3.22 We do not think it possible or necessary to provide a detailed analysis of the part played by each of these principles in our thinking on individual recommendations. In reaching the conclusions and making the recommendations contained in this report we have been informed generally by the economic considerations and empirical research, as we have also by our own researches, by the views of respondents and our guiding principles. The function of this discussion of principles is to set the context for what follows. We refer to salient points at the appropriate points of this report.

# **SECTION A: A DIRECTOR'S DUTIES UNDER THE GENERAL LAW**

## **PART 4 A STATUTORY STATEMENT OF DIRECTORS' DUTIES?**

### **INTRODUCTION**

- 4.1 Parts 4 and 5 are concerned with the duties a director owes under the general law.<sup>1</sup> We will not, however, be reviewing the content of these duties in any way as this is a matter for the Company Law Review. We consider in this Part the various ways in which a director's duties under the general law could be made more accessible, certain and comprehensible.<sup>2</sup> We examine the case for some kind of codification and explain the ways that this could be done, namely a full or partial codification or an additional statutory statement.<sup>3</sup> We also discuss how non-binding material could help to modernise and simplify the law, and how this could be either instead of or in addition to a form of codification.
- 4.2 Part 5 focuses on the standard of care, skill and diligence which a director must exercise under the general law and sets out our conclusions on this.

### **FULL OR PARTIAL CODIFICATION**

#### **Consultation issues**

- 4.3 The Law Commissions were asked to consider the case for a statutory statement of the duties owed by directors to their companies under the general law.<sup>4</sup> The Commissions are under a statutory duty to have regard to the question of codification when reviewing a specific area of law,<sup>5</sup> and have considered this in a number of areas.<sup>6</sup>

<sup>1</sup> We described these duties in Parts 11 and 12 of the Paper.

<sup>2</sup> These formed Options 1-5 (see Paper, para 14.2). The Options were also set out in Questions 96-100 and 102.

<sup>3</sup> We explain below what we mean by each of these concepts: see paras 4.3ff.

<sup>4</sup> Paper, para 1.3. The scope of the project does not extend to suggesting any change to directors' fiduciary duties. In particular we were not asked to consider whether any change should be made to the constituencies to whom directors owe their duties: see Paper, para 1.55. This issue is being considered by the DTI in its review of company law: see the Strategic Framework Document, chapter 5.1.

<sup>5</sup> Law Commissions Act 1965, s 3(1).

<sup>6</sup> See, for example, the discussions in M Arden, "Time for a Commercial Code?", [1997] CLJ 516 and JC Smith, "Codification of the Criminal Law" (1986) Child & Co. Lecture.



- 4.4 In the Paper, we proposed two main options for codifying directors' duties: *full codification* or *partial codification*.<sup>7</sup>
- 4.5 *Full codification* would be a statutory statement of all a director's fiduciary duties as well as his duty of care and skill. It would be an exhaustive statement and would entirely replace the general law.
- 4.6 *Partial codification* would be a statement of the main, settled duties, including the director's duty of care. It would not be exhaustive. The general law would continue to apply in those areas not covered by statute. It would, however, be superseded in relation to the duties set out in the statement.
- 4.7 We discussed in the Paper how *full codification* might make the law more consistent, certain, accessible and comprehensible. However, we noted that some duties are not well-settled. It might therefore be difficult to state them in statutory form. For example, a director is in breach of duty if he misappropriates information which he has received and should have reported to his board. But the courts have not defined the circumstances in which he ought to report. The Paper observed that views are likely to differ on what those circumstances should be.<sup>8</sup> To put duties that were not yet well-settled into statutory form might well restrict the ability of the law to develop. Importantly, with any codification, the approach of those who use it and advise on its meaning is likely to change from one of looking at the policy or principle behind the decided cases to one of statutory interpretation of the wording used.<sup>9</sup> Likewise "the court's task is diverted into one of statutory construction".<sup>10</sup>
- 4.8 This was an argument that was also advanced against codification of a director's duty of care.<sup>11</sup> We explained how the standard of care which the director must show in carrying out his functions has evolved over the century to adapt to changing commercial circumstances.<sup>12</sup> To set the standard out in statute would freeze it at the time of enactment. We also observed, though, that stating it in statutory form would clarify the law and make it more certain.
- 4.9 If the statutory statement of duties covers only those duties that are settled<sup>13</sup> and if the general law continues to apply in those areas not expressly governed by statute

<sup>7</sup> There have been several earlier attempts to codify directors' duties: see Part 13 of the Paper and e.g. M Arden, "Codifying Directors' Duties" in *Law, Society and Economy: Centenary Essays for the London School of Economics and Political Science 1895-1995* (1997) ed. Rawlings, Clarendon Press, Oxford.

<sup>8</sup> Paper, para 14.13.

<sup>9</sup> Paper, para 14.17.

<sup>10</sup> Lord Millett.

<sup>11</sup> Paper, para 15.8.

<sup>12</sup> Paper, paras 12.3 - 12.7. As Hoffmann LJ said in *Bishopsgate Investment Management Ltd v Maxwell (No 2)* [1993] BCLC 1282, 1285, "In the older cases the duty of a director to participate in the management of a company is stated in very undemanding terms. The law may be evolving in response to changes in public attitudes to corporate governance, as shown by the enactment of the provisions consolidated in the Company Directors Disqualification Act 1986".

<sup>13</sup> Such as the duty to act in what the director considers to be the company's best interests.

(*partial codification*), a director might be confused to discover that he was subject to other duties not set out in the statement.<sup>14</sup> However, it was noted that the statement could be drafted to make it clear that a director was subject to other duties. This is the position in some of the common law jurisdictions.<sup>15</sup>

#### **An additional statutory statement**

- 4.10 We also considered a statutory statement of a director's principal duties which would be in addition to the general law. However, we have not pursued this option. It would be open to the strong objection that the director would find himself subject to two overlapping regimes covering the same subject-matter, one under the general law and one under statute.

#### ***Drafting of statement: general or detailed?***

- 4.11 In the Paper we explained that the statement of a director's duties could be drafted in detail setting out all the circumstances in which duties might conceivably arise. Alternatively it could be framed as a general statement of broader principles.
- 4.12 The main argument in favour of a detailed statement is that it might make the law more accessible to directors and might help to make it more consistent and certain, reducing the scope for judicial development. The argument against it is the converse: the flexibility of the law would be lost.<sup>16</sup>
- 4.13 By contrast the advantage of a statement expressed in broad and general language is that it would leave some scope for flexibility and development. The corollary is that the statement would be less certain and less accessible. It would in many cases need to be scrutinised and explained by legal advisers to see how it applied to a particular case. An example of this style is the draft statement set out in Appendix A to the Paper,<sup>17</sup> which also forms Appendix A to this report.

#### ***Questions for consultees***

- 4.14 We asked consultees whether there should be *full* or *partial codification* or an additional statutory statement.<sup>18</sup> We also asked which of the fiduciary duties described in the Paper could be considered as settled,<sup>19</sup> and whether there was any

<sup>14</sup> In para 14.23 of the Paper we had discussed under the option of *partial codification* how in Australia the statutory duties were stated to be in addition to and not in derogation of any rule of law relating to the duties or liabilities of directors. We did not, however, intend to suggest here that the general law should be maintained in those areas covered by statute and that additional new statutory duties would be created. This is a quite separate issue which we discussed in paras 14.25 - 14.27 of the Paper, and which we discuss in this report in paras 4.10, 4.24 and 4.29.

<sup>15</sup> See, e.g., s 232(11) of the Australian Corporations Law.

<sup>16</sup> An example of this style of drafting is clause 44(3) and (4) of the Companies Bill 1978, which we discussed in para 13.15 of the Paper.

<sup>17</sup> It is to be noted that Appendix A of the Paper was drafted to be non-binding. This is discussed further below in para 4.34.

<sup>18</sup> Paper, paras 14.8-14.27.

<sup>19</sup> Paper, para 14.24.

objection to a statutory statement of the duty of care without a statutory statement of the fiduciary duties of directors.<sup>20</sup>

### **Summary of respondents' views**

- 4.15 Most respondents were not in favour of *full codification*. One of the most common arguments against it was that in an effort to retain some flexibility and allow for judicial development, the duties would have to be stated widely and in general terms. The general language would require interpretation by the courts: directors without ready access to legal advice (the main beneficiaries of the exercise) would, therefore, have no better idea of their duties. One respondent said that a lack of precision could give considerable scope to those looking for grounds upon which to defend disqualification proceedings or offer mitigation.
- 4.16 The duties might, of course, be drafted in a more detailed and specific way. Most respondents thought that this would reduce the likelihood of directors reading the statement, particularly if legalistic language was used. Again, it was considered that this would not improve the accessibility of the law to lay directors. Many respondents emphasised that if directors' duties were set out in detail, the law might be too rigid and would lack the present flexibility to cope with and reflect continuing developments. It was also felt that once the duties were embodied in legislation, there was a danger that directors and their legal advisers would merely comply with the letter of the law as opposed to its spirit.
- 4.17 It was generally thought that codification was only possible for duties that were well-settled and were not contentious. Many respondents argued that there are only a number of fiduciary duties within this category.<sup>21</sup> Other duties were dynamic and subject to constant commercial development.<sup>22</sup> One respondent thought that, due to their dynamic nature, directors' fiduciary duties could never be effectively put into statutory form, and consequently any statement would be vague and incomplete.
- 4.18 There was also concern that a codifying statute (whether framed as a general or detailed statement) might produce an unexpected result, which could then only be remedied by further legislation.
- 4.19 Not all respondents were against *full codification*. A number of respondents, including the Law Society of Scotland, the Stock Exchange and KPMG, indicated varying levels of support for this option. Several respondents, such as the Stock Exchange, thought that a full binding statement of duties was the best option in terms of the accessibility and certainty of the law (particularly for lay directors). Most in favour of codification thought that the statement should be in general terms. The courts would then be able to expand and 'flesh out' the duties.

<sup>20</sup> As is the case in Germany: see Paper, paras 15.51 and 12.27 - 12.32.

<sup>21</sup> Such as the duty to act in good faith in what the director considers to be the company's interests.

<sup>22</sup> Such as the duty not to misuse corporate opportunities.

- 4.20 The argument put forward in the Paper that codification may be impossible if there are differences of opinion was criticised by KPMG.<sup>23</sup> They asked how directors and others are expected to understand and comply with the law if experts could not reach agreement about it. The difficulty of achieving *full codification* was no reason not to attempt it. Moreover, it could be argued that the common law has not been satisfactory in identifying the duties of directors. The courts can only develop the law as and when appropriate cases come before them. A more systematic and comprehensive approach to this area might, therefore, be beneficial.
- 4.21 A smaller majority of respondents also opposed *partial codification*. Many of the disadvantages and concerns identified in respect of *full codification* were said to apply equally to a partial binding statement. A common criticism was that although *partial codification* might maintain the flexibility of the law, it would also render it more uncertain by having some duties in a statutory statement and some under the general law. A partial binding statement was a potentially misleading substitute for a complete statement. It would not inform the director of the full range, extent and scope of his duties. A member of the judiciary commented that the director would not know what was omitted. This would defeat the object of certainty and accessibility which it was intended to provide. Two respondents were concerned that a director might use a statement of duties to support his case that he had done everything he reasonably needed to if the statement made no reference to duties in the area in which the director stood accused of misconduct.
- 4.22 However, there were a number of respondents who favoured *partial codification*, including the Institute of Chartered Accountants of Scotland, PIRC, PricewaterhouseCoopers and academics, such as Professor Wooldridge, Professor Parkinson and Professor Cheffins. The main reason for support was that it would best achieve a balance between certainty and flexibility. Setting out the main duties in statute would emphasise their seriousness. If done by general principles, codified duties could still be developed by the courts. This was the experience of Canada where there is *partial codification* of the main duties. Many respondents in favour of this option felt that *partial codification* might also be complemented by referring to the statement on prescribed forms<sup>24</sup> or by non-binding explanatory material (such as pamphlets).<sup>25</sup>
- 4.23 By contrast to the general views against codification (whether full or partial), a large majority of respondents were in favour of having a director's duty of skill and care set out in statute. It was felt that this would be generally useful and would clarify the standard of the duty. Of those who did not support this, most felt that there was no clear advantage when the common law had developed effectively and was also more flexible, particularly as the standard would have to apply to directors in different types of companies. A large majority of respondents also did not object to having a statutory statement of the duty of care without a statutory statement of fiduciary duties.

<sup>23</sup> Paper, para 14.13.

<sup>24</sup> Para 4.52ff below.

<sup>25</sup> Para 4.62ff below.

- 4.24 Generally respondents thought that an additional statutory statement would not be helpful. It was felt that a statutory statement that did not replace the general law but was in addition to it would be highly unsatisfactory and very misleading. Having a second layer of duties would be an additional burden without offering any obvious benefit. It was also considered that (as with *full* and *partial codification*) there were dangers that the statement might become inflexible and quickly outdated.

#### **Summary of responses of directors: the empirical research**

- 4.25 61% of all directors surveyed in the empirical research thought that it would be helpful for the Appendix A statement to be set out in the Act, even though it would only be a partial statement of directors' duties. Respondents in non-listed companies, closed companies and companies with few non-executive directors were significantly more likely to approve of this suggestion.<sup>26</sup>
- 4.26 Around a quarter of directors considered that the statement was likely to be of either great assistance or very great assistance. Approval was higher among directors of smaller, non-listed and closed companies as well as companies without non-executive directors.<sup>27</sup> This is consonant with the suggestion that in larger and listed companies, where use is made of non-executive directors, internal corporate governance procedures already deal effectively with many of the issues raised in the statement. In addition these companies will usually have company secretaries and in-house legal staff who can give advice. However, in companies without such procedures, it would appear that the statement would play a valuable informative and guiding role.<sup>28</sup>

#### **Commentary on arguments against codification**

- 4.27 We agree with the majority of our respondents that *full codification* is undesirable. The law governing directors' duties is dynamic. It continues to develop. For example, the courts have recently had to determine the duties of a director who has resigned, but who then uses commercial opportunities connected with the company's business for his own benefit.<sup>29</sup> They have also considered the duties which directors owe when there are groups or classes of shareholders whose interests conflict.<sup>30</sup> We expect that the law will need to continue to evolve incrementally as circumstances require. The commercial context is constantly changing. It is important that the law retains the capacity to develop.
- 4.28 For this reason we think that a *full codification* of directors' duties would not be desirable. To set out in statute duties that were still developing might restrict their ability to adapt to changing circumstances. However, not all duties are evolving.

<sup>26</sup> See Table 20 of the empirical research report in Appendix B.

<sup>27</sup> See Table 16 of the empirical research report in Appendix B.

<sup>28</sup> See section 8 of the empirical research report in Appendix B.

<sup>29</sup> *Industrial Development Consultants v Cooley* [1972] 1 WLR 443; *Balston Ltd v Headline Filters Ltd* [1990] FSR 385; *Island Export Finance Ltd v Umanna* [1986] BCLC 460.

<sup>30</sup> *Mutual Life Insurance Co of New York v Rank Organisation Ltd* [1985] BCLC 11.

Many are settled. To state the settled duties in statutory form might increase the accessibility of the law.

- 4.29 We also agree with respondents' general view that an additional statutory statement would not be helpful. To have a statutory statement in addition to existing law could be misleading and therefore the law would not become more certain or accessible. This option would appear to add further complexity while offering little benefit. We therefore reject this option.
- 4.30 Partial codification of directors' fiduciary duties was not favoured by the majority of our respondents, but a slightly smaller majority did support the codification of a director's duty of care. An explanation may, however, lie in the way in which the issues were presented. In relation to the duty of care, the codification issue was raised with respect to a particular duty. Respondents may have shared our view of the development of the modern law,<sup>31</sup> and concluded with us that once the appropriate standard of care has been settled codification presents little difficulty.<sup>32</sup> In relation to other duties, the partial codification issue was presented more generally, and could have included duties the boundaries of which are less well developed in the common law. The issue, therefore, may be less about the principle of partial codification, where the content of the duties is reasonably settled, than the identification of the duties which fall into that category.
- 4.31 We think that *partial codification* could be a valuable piece of law reform. We discuss below why we consider that the main arguments against a *partial codification* - loss of flexibility, uncertainty of its extent and no gain in accessibility - can be rebutted. We then explain why there are other reasons that make the case for *partial codification* a powerful one, namely the coherence of company law and the international dimension.

#### ***Loss of flexibility?***

- 4.32 We do not accept the argument that there will necessarily be a loss of flexibility if any part of the law is codified. As was recently noted by the Joint Committee on Parliamentary Privilege on the question of whether to codify case-law on parliamentary privilege, this is not the case if the law sets out general principles.<sup>33</sup>
- 4.33 Concepts such as "good faith in the interests of the company" and "conflict of interest" which might be included in a *partial codification* are relatively easily understood. The difficulty which often arises is the application of such concepts to particular facts. If in a *partial codification* the duties are formulated using general language which addresses the principles on which detailed duties are based and avoids the level of detail which specifies the circumstances in which the duties arise, any loss of flexibility may not be significant. A distinction may be drawn

<sup>31</sup> Paper, paras 12.8-12.11, referring to the Courts' move towards a stricter, dual standard, in line with Insolvency Act 1986 s 214(4).

<sup>32</sup> Paper, para 14.14.

<sup>33</sup> Volume 1 - Report and Proceedings of the Committee, (1998-99) HL Paper 43-I, HC (1998-99) 214-I, paragraph 379. If the statement is drafted in this way, it should also mean that directors could not rely on the absence of anything specific in the statement of duties in mitigation of their conduct in disqualification proceedings.

between the meaning of a term such as “conflict of interest” or “reasonable care” and its content. While the meaning of the concept is understood, the content of a duty may vary in different circumstances and be developed by the judiciary over time. The more abstract the rule, the less useful it is to the director or legal adviser who seeks to apply it to the facts of a particular case. Nevertheless, the benefit of *partial codification* is that the general statement of duties is available in the Act.

- 4.34 Although Appendix A was drafted as a non-binding explanatory statement, it contains the level of detail which we envisage in a *partial codification*.<sup>34</sup> Indeed a comparison between the duty of care in the non-binding explanatory statement and draft section 309A (also in Appendix A of the Paper), shows a very similar level of detail. Many of the words in this statement, such as “the interests of the company”<sup>35</sup> and “the company’s property, information or opportunities”,<sup>36</sup> are capable of significant judicial interpretation.
- 4.35 We had asked consultees whether they considered that the draft statement in Appendix A set out the principal duties of directors under the general law.<sup>37</sup> The consensus on consultation was that it did set out the principal duties.<sup>38</sup> Furthermore, over 80% of directors in the empirical survey also thought that the statement was about right in terms of content.<sup>39</sup> This does not mean that Appendix A could not be improved and we would expect that the outcome of the debates in the Company Law Review may affect the content of the statement. For example, it could contain a duty to act honestly, on the basis that this would impose an objective standard of behaviour<sup>40</sup> (which the requirement to act in good faith does not) and is a concept which can be given a dynamic interpretation.
- 4.36 Some respondents were concerned that the statement could be interpreted in a novel, unanticipated way. It will, however, be clear from the Act that the intention of our *partial codification* is to state the principal duties and not to alter them in any respect. As with any Act of Parliament, the courts should give effect to the meaning of the words used by Parliament. In the event of any ambiguity in the statutory statement, the courts could have regard to the general law that the statute was intended to codify.<sup>41</sup>

<sup>34</sup> The exact form of wording would be a matter for Parliamentary Counsel in due course.

<sup>35</sup> Paragraph (3) of the statement of duties in Appendix A.

<sup>36</sup> Paragraph (5) of the statement of duties in Appendix A.

<sup>37</sup> Paper, para 14.40.

<sup>38</sup> However, there was concern that principle 9 only referred to employees and not to other stakeholders, such as creditors, and that it differed in tone from s 309(1). Most respondents also thought that the statement should not refer to the possibility of the company in general meeting ratifying the breach of duty or releasing a claim that it may have: see para 14.40 of the Paper.

<sup>39</sup> See Table 15 of the empirical research report in Appendix B.

<sup>40</sup> As in relation to dishonest assistance in a breach of trust see *Royal Brunei Airlines v Tan* [1995] 2 AC 378, 390F (PC).

<sup>41</sup> See *Bank of England v Vagliano Brothers* [1891] AC 107, 144-145 per Lord Herschell; and *Cross on Statutory Interpretation* (1995, 3rd ed, pp 6-7).

4.37 More problematic is the possibility that the statutory statement might become out of step with changing commercial circumstances. Primary legislation would then be necessary to amend it. The Strategic Framework Document has noted that the difficulties in bringing forward primary legislation quickly might mean that company law becomes out-dated. It discussed, therefore, whether the DTI could take powers in primary legislation to amend the Act by Statutory Instrument. It was noted that this would aid flexibility, although difficult constitutional issues were involved, notably the lack of detailed Parliamentary scrutiny inherent in secondary legislation.<sup>42</sup> It is for that reason that we do not recommend amending primary legislation on directors' duties by statutory instrument. The duties are fundamental to the relationship between a director and his company and merit the higher level of scrutiny. We note that the Strategic Framework Document invited views on new institutional arrangements to ensure effective continuing reforms.<sup>43</sup> If there were such arrangements, it would assist in the updating of a statutory statement of duties.

#### ***Uncertainty about extent of duties?***

4.38 To ensure that the duties which are not codified are preserved, the statutory statement would make it clear that to the extent that there were other duties, they would not be affected by the statement of duties.<sup>44</sup> It was argued with some force that such a statement would be unhelpful and misleading: a director would not know the extent of his duties.

4.39 We are not persuaded by this argument for four reasons. First, the director will know what his *main* duties are. Secondly, codification has been done in a similar way before and it has not given rise to great difficulties.<sup>45</sup> Thirdly, we think that there are other ways of bringing to a director's attention a fuller range of his duties, notably the use of pamphlets.<sup>46</sup> Fourthly, the statutory statement would be drafted to make it clear that a director was subject to other duties.<sup>47</sup>

#### ***Accessibility?***

4.40 Many respondents were concerned that the attempt to improve accessibility by codifying the law would prove to be illusory. The statement would still need to be interpreted by lawyers.

<sup>42</sup> An alternative approach is that adopted in South Africa for the close corporation. This was a new type of company established by the Close Corporation Act 1984 with very few regulatory controls. The South African Parliament set up a committee, the Standing Advisory Committee on Close Corporations, to monitor its operation. Something similar could apply to a revised UK Companies Act.

<sup>43</sup> Pages 137-139.

<sup>44</sup> The precise wording would be a matter for Parliamentary Counsel in due course.

<sup>45</sup> See the Bills of Exchange Act 1882 (s 97), the Partnership Act 1890 (s 46), the Sale of Goods Act 1893 (s 61) and the Marine Insurance Act 1906 (s 91).

<sup>46</sup> Paras 4.65-4.67.

<sup>47</sup> This may help address the concern expressed at the end of para 4.21.



- 4.41 This is undoubtedly true, but it seems to us an insufficient reason not to *improve* the accessibility. As Lord Herschell noted in *Bank of England v Vagliano Brothers*,<sup>48</sup> the singular benefit of a codifying statute is there is no longer a need to “[roam] over a vast number of authorities in order to discover what the law [is], extracting it by a minute critical examination of the prior decisions”. Moreover, the majority of the directors surveyed in our empirical research thought that a statement set out in Appendix A was helpful, even though it was only partial. Furthermore, in the important area of directors’ duties, the law should aim to educate and inform directors, and not merely impose liabilities on them.

### ***Coherence of company law***

- 4.42 The provisions of Part X of the Act are intended to fortify the inhibitions on directors when their duties conflict with their interest. There are, for example, obligations to obtain approval from shareholders, even where this is not required by the company’s articles. And yet the Act does not contain the seminal principle, that a director should act in good faith in what he considers to be the interests of the company, nor does it give any indication that the general law has rules which apply when a director has an interest in a transaction which may conflict with that of his company. The absence of a statutory statement of duties makes it difficult, therefore, to understand the law in relation to directors’ duties. For example, section 309 of the Act, which deals with the position of employees, is grafted onto the rule of law that the directors owe a duty to act in what they consider to be the best interests of the company.<sup>49</sup>

### ***International dimension***

- 4.43 Company law is used internationally: companies are often owned or run by persons who are not citizens of the country in which the company is registered. As awareness of corporate governance continues to increase, it is becoming the norm for the company law of the developed nations to have a statutory statement of the duties of directors.<sup>50</sup> We consider that a modern UK Companies Act would look odd without one. If the Act is, as envisaged by the DTI’s objectives in launching the Company Law Review,<sup>51</sup> to provide an internationally competitive framework for business, so that the UK continues to be an attractive place to do business, then in our view it needs a statement of a director’s main duties.

### ***Certainty and the Human Rights Act 1998***

- 4.44 We have considered whether the case for codification is likely to be strengthened by the coming into effect of the Human Rights Act 1998,<sup>52</sup> and with it the direct application of the European Convention of Human Rights. The Law Commission has discussed elsewhere the principle of “certainty” as developed by the

<sup>48</sup> [1891] AC 107,145.

<sup>49</sup> Note that the Company Law Review may recommend reform of s 309.

<sup>50</sup> See Australian, New Zealand and Canadian legislation in Appendices H, I and J of the Paper.

<sup>51</sup> See the DTI’s Consultative Paper, para 5.1.

<sup>52</sup> On 2 October 2000.

Strasbourg Court in the context of criminal proceedings,<sup>53</sup> and the relevance of this principle to the case for codification of the criminal law.<sup>54</sup> In the criminal law, Article 7 of the Convention<sup>55</sup> has been held to encompass the principle that “an offence must be clearly defined in the law”; a requirement which is satisfied -

... where the individual can know from the wording of the relevant provision and, if need be, with the assistance of the courts’ interpretation of it, what acts and omissions will make him criminally liable.<sup>56</sup>

- 4.45 Civil rights and obligations are not subject to Article 7, although they are subject to Article 6(1) which guarantees “a fair and public hearing” in their determination.<sup>57</sup>
- 4.46 Breach of directors’ duties may lead, not merely to remedies in favour of other parties, but also to action by public authorities and the possibility of disqualification.<sup>58</sup> It has been argued that, for the purpose of the Convention, the serious consequences of disqualification proceedings justify treating them as criminal.<sup>59</sup> Under the Convention, the term “criminal” is an “autonomous concept”, which does not necessarily bear the same meaning as in domestic law.<sup>60</sup> The Court of Appeal, however, has preferred the view that, even under this extended approach, such proceedings are not criminal in nature, being regulatory rather than penal.<sup>61</sup>
- 4.47 Accordingly, the case for codification, total or partial, must be made without specific reliance on principles of certainty under the Convention. However, the Commissions are under a statutory duty to promote codification of the law where appropriate.<sup>62</sup> With or without help from Strasbourg, the arguments for certainty and accessibility in this area of the law, derived from general principles,<sup>63</sup> can only be reinforced by consideration of the potentially serious consequences of breach.

<sup>53</sup> Legislating the Criminal Code: Fraud and Deception, (1999) Consultation Paper No 155, paras 5.33ff.

<sup>54</sup> Thirty-Second Annual Report 1997, Law Com No 250, para 1.25.

<sup>55</sup> On its face, Article 7 simply prohibits retrospectivity in the criminal law.

<sup>56</sup> *SW v United Kingdom* (1996) 21 EHRR 363, 399, para 35.

<sup>57</sup> Articles 6(2) (presumption of innocence) and (3) (minimum rights) are also confined to criminal proceedings.

<sup>58</sup> Under the Company Directors Disqualification Act 1986. One of the matters to which regard is to be had by the Court is any “breach of any fiduciary or other duty”: *ibid*, s 9, Sch 1 para 1.

<sup>59</sup> *R v Secretary of State for Trade ex p McCormick* [1998] BCC 379 (CA).

<sup>60</sup> *Ibid*, at p 386.

<sup>61</sup> Per Staughton LJ, *ibid*, at p 395. The Court followed the approach of the European Commission of Human Rights in *EDC v United Kingdom* [1998] BCC 370.

<sup>62</sup> Law Commissions Act 1965, s 3(1).

<sup>63</sup> See the discussion of General Principles in Part 3 above.

## **Recommendation**

4.48 For the reasons set out above, we think that *partial codification* would modernise the law. It would make company law more coherent and more accessible. **Accordingly, we recommend that:**

- (1) **there should be a statutory statement of a director’s main fiduciary duties and his duty of care and skill, being those duties which are set out in Appendix A;**<sup>64</sup>
- (2) **the statement should so far as possible be drafted in broad and general language as in Appendix A; and**
- (3) **it should not be exhaustive i.e. it should state that a director is subject to other duties which have not been codified.**

## **STATUTORY STATEMENT WITHOUT OPERATIVE EFFECT**

4.49 We have recommended that we should have a statutory statement that replaces the general law in the areas it covers. We can, therefore, deal briefly with the suggestion made in the Paper for a statutory statement of directors’ duties which would have no legal effect and which would merely be for guidance.<sup>65</sup> There are some fundamental arguments against it. First, the statement and the general law as developed by the courts may diverge over time. Secondly, the traditional view is that a statute should not contain explanatory material.

4.50 Most respondents rejected this option. Most saw little point in having a statutory statement for information only. Indeed one respondent argued that a statement for guidance only was bizarre and inconsistent with the concept of law. We agree that this would be inappropriate.

4.51 Most respondents preferred the idea of producing guidance in the form of pamphlets or a non-binding statement in prescribed forms. It is to this that we now turn.

## **A NON-BINDING STATEMENT OF THE MAIN DUTIES OF DIRECTORS IN CERTAIN PRESCRIBED FORMS**

### **Consultation issue**

4.52 We discussed in the Paper other, non-statutory ways of presenting a statement of directors’ duties. We considered the role of a statement without legal effect that could be contained in certain prescribed forms. This would be a way of informing a director of his main duties, but would preserve the flexibility of the general law.<sup>66</sup>

<sup>64</sup> We recommend, however, that the *content* of the duty of care and skill is that described in paragraph 5.20 below and not that set out in Appendix A.

<sup>65</sup> Paper, paras 14.28-14.31.

<sup>66</sup> One way of doing this was to give the Secretary of State power to insert a statement of the main duties of directors into a number of prescribed forms which must be filed with the Registrar and in documents which must be laid before the company in general meeting: see Paper, paras 14.32-14.39.

We set out in Appendix A of the Paper a statement of the duties to illustrate this option. We have already referred to this above.<sup>67</sup>

- 4.53 We asked consultees whether a director should sign that he has read the statement when he submits the return confirming that he has been appointed as a director; whether each director should be required to sign that he has read the statement when the company submits its annual return; and whether the statement should be annexed to the company's articles and be included in the directors' report attached to the company's annual accounts.<sup>68</sup>

#### **Summary of respondents' views**

- 4.54 A large majority of respondents favoured the inclusion of a non-binding statement in prescribed forms. Inclusion of the statement on Form 288a (intimation of change of director) was seen as the most practical way to bring the duties to directors' attention. Many respondents, such as the CBI, ICAEW, Serious Fraud Office, the Commercial Bar Association and the Law Society of England and Wales, were attracted to the idea of complementing this statement with explanatory pamphlets as part of an overall education package for directors.
- 4.55 Some considered that the statement should also appear on Forms 10(2) (intimation of the first director of a company) and 680(1) (for companies incorporated under an Act of Parliament). A few respondents supported its inclusion in the directors' report, although others thought that this would add unnecessary length to the annual accounts. Attaching the statement to the company's articles had limited support: most respondents took the view that articles are already sufficiently long and confusing and, in any event, most directors never read them. There was also little support for inclusion in the annual return. Most respondents felt that it would be impractical to require each director to sign the annual return.
- 4.56 Respondents recognised that it might be difficult to make the statement comprehensible and succinct, while also giving sufficient information. The Stock Exchange wondered whether a more basic statement such as "remember you have fiduciary duties" might be more effective. Others thought that it should concentrate on more practical duties such as the duty to keep proper accounting records.

#### **Summary of responses of directors: the empirical research**

- 4.57 88% of the directors surveyed supported the proposal that they should sign that they had read the statement of duties when confirming their appointment.<sup>69</sup> The directors surveyed were significantly less in favour of the other proposals for

<sup>67</sup> Para 4.13.

<sup>68</sup> We also asked whether it should appear in any other statutory return which the company makes: see Paper, para 14.36.

<sup>69</sup> See Table 17 of the empirical research report in Appendix B.

publicising the statement, although there was some support for annexing it to the company's articles of association.<sup>70</sup>

### **Recommendation**

- 4.58 We have explained above why we have recommended *partial codification* of a director's principal duties. This significantly changes the context of the debate over a statement in prescribed forms. As (on our recommendations) there will be a statutory statement of the main duties with legal effect, it would make little sense to produce a non-binding statement covering the same ground on prescribed forms. Instead the educational aspect of having a statement on prescribed forms can be combined with the *partial codification* by using the statutory statement of a director's main duties. The only question then is which forms should contain the statement.
- 4.59 In the light of the responses from our respondents and the empirical research, we consider that when a director signs a Form 10(2) or Form 288a he should sign that he has read the statutory statement of duties. We think that the statement should be set out in the form itself, as many directors are unlikely to follow up a reference to the legislation.
- 4.60 As respondents and directors surveyed were less in favour of the inclusion of the statement in the articles, directors' report, annual return or other statutory return, we recommend that only Forms 10(2) and 288a should contain the statement.
- 4.61 **We recommend that Forms 10(2) and 288a should contain the statutory statement of duties and that when a director signs the Forms he should acknowledge that he has read this statement.**

### **NON-BINDING AUTHORITATIVE PAMPHLETS (QUESTION 100)**

#### **Consultation issue**

- 4.62 We also explored another possible form of non-binding material, namely an authoritative pamphlet summarising the duties of directors. We noted that a pamphlet of this kind could be used in addition to a statutory statement of directors' duties.<sup>71</sup> Various private bodies issue pamphlets on directors' duties, and there are also a number of books written for directors. But, at present, apart from a pamphlet issued by Companies House describing a directors' duties in very general terms,<sup>72</sup> which is sent out on request, there is no pamphlet issued by an official source of which we are aware.
- 4.63 We envisaged that such a pamphlet would need the support of the DTI and, amongst others, the IoD, the Institute of Chartered Secretaries & Administrators, the Federation of Small Businesses, the Law Societies and accountancy bodies. We suggested that Companies House could send out a copy of the pamphlet at certain

<sup>70</sup> See section 8 of the empirical research report in Appendix B.

<sup>71</sup> Paper, para 14.41.

<sup>72</sup> "Companies and their Directors".

times,<sup>73</sup> for example, to a person appointed as director or secretary and to those who had applied for registration of the company.

### **Summary of respondents' views**

- 4.64 A large majority of respondents supported the preparation of pamphlets setting out the duties together with explanations and practical examples. However, it was stressed by some respondents that care would need to be taken to ensure that any such pamphlet was treated only as guidance and not as a comprehensive, binding statement of the law. There was also concern that the pamphlet should be regularly updated. Some respondents, such as the Stock Exchange, thought that many directors - particularly of small companies - would probably not read them. Another criticism was that if there were omissions in the pamphlet, this might offer a defence to a claim that a duty had not been complied with.

### **Recommendation**

- 4.65 We consider that since Companies Acts and related legislation are complex and impose heavy liabilities on those who breach the law,<sup>74</sup> the Government should take steps to provide information about directors' duties to directors in a comprehensible form.<sup>75</sup> It might be helpful if the pamphlets contain practical examples by way of illustration. Any pamphlet would have to be kept up to date, and there would have to be resources and a mechanism for this.
- 4.66 Any pamphlet would state that it was not a comprehensive or binding statement of the law and that it should be read in conjunction with other duties and responsibilities which directors owe under statute and the general law. Such a caveat would make it difficult for a director to rely on an omission in the pamphlet as a defence to a breach of his duties.
- 4.67 **Accordingly, we recommend that the DTI should consider the most effective way of producing and distributing a pamphlet explaining a director's duties.**

### **SUMMARY OF RECOMMENDATIONS UNDER THIS PART**

- 4.68 **To summarise, our recommendations under this Part are that there should be a statutory statement of a director's main fiduciary duties and a director's duty of care and skill; that this statement should be set out on Forms 10(2) and 288a; that when a director signs such a form he should acknowledge that he has read this statement; and that the DTI should consider how pamphlets explaining a director's duties might be made available to directors.**

<sup>73</sup> We asked consultees how they thought the pamphlet would be best brought to the attention of directors.

<sup>74</sup> Especially where ignorance can result in disqualification under the Company Directors Disqualification Act 1986.

<sup>75</sup> An analogy can be drawn with the Charity Commissioners, who issue pamphlets (and videos) to charity trustees.

# **PART 5**

## **A DIRECTOR'S DUTY OF CARE AND SKILL: SETTING THE STANDARD**

### **INTRODUCTION**

- 5.1 We have recommended above that a director's main duties should be set out in statute. We have explained how our basic intention is to state the existing law and not to alter it. However, in one respect we had considered the possibility of *changing* the content of one of the director's core duties, namely the standard of care and skill. In the Paper we invited consultees' comments on three possible options for the standard of a director's duty of care and skill, namely a subjective, a dual objective/subjective or an objective test.<sup>1</sup> We also asked consultees whether the duty should be codified or left as general law.<sup>2</sup> We provisionally considered that a dual objective/subjective test, which in our view currently represented the law, should be set out in statute.<sup>3</sup>
- 5.2 We consider these options and respondents' views. We then examine whether a statutory statement of a director's duty of care should be complemented by a statutory business judgment rule and by provisions dealing with delegation to and reliance on third parties.

### **Consultation issues: the standard of a director's duty of care**

#### ***A subjective test***

- 5.3 One option for a statutory statement of a director's duty of care was for a director to owe a duty to his company to exercise the care, diligence and skill that would be exercised by a reasonable person having his knowledge and experience.<sup>4</sup> This is effectively the traditional view of the standard of care.<sup>5</sup> Account would be taken of the responsibilities of the individual director and the circumstances of the particular company.<sup>6</sup> A subjective standard would be low if the director has little knowledge and experience, although for directors with special expertise it would be higher than a purely objective standard.<sup>7</sup>

<sup>1</sup> These formed Options 1-3 (see Paper, para 15.10). The Options were also set out in Questions 103-105.

<sup>2</sup> We consider arguments for and against codification of directors' duties in Part 4, and summarise respondents' discussion on this point at para 4.23.

<sup>3</sup> Para 5.8 below.

<sup>4</sup> Paper, paras 15.11ff.

<sup>5</sup> See *Re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407 and Paper, paras 12.3-12.7.

<sup>6</sup> See *Department of Health and Social Security v Evans* [1985] 2 All ER 471; *Bishopsgate Investment Management Ltd v Maxwell (No 2)* [1993] BCLC 1282, 1285b; and *Re Barings plc (No.5)* [1999] 1 BCLC 433.

<sup>7</sup> Paras 5.11 - 5.17 below.

- 5.4 We explained that a subjective standard might be appropriate because management is not a profession. Directors do not require particular skills to discharge their duties. A company might appoint a person as a director for some attribute he possesses, knowing that he lacks skill in business matters.
- 5.5 However, we noted that many areas of business do require specialised skills and knowledge beyond those possessed by the layman. Moreover a subjective standard would be out of line with the duties generally imposed on persons who agree to provide services (particularly where they are paid) and would also be out of step with many other jurisdictions that require directors to act as reasonable, competent businessmen.<sup>8</sup>

***A dual objective/subjective test***

- 5.6 The second option we discussed was for a director to owe a duty to his company to exercise the care, diligence and skill that would be exercised by a reasonable person in the same circumstances having both (a) the knowledge and experience that may reasonably be expected of a person in the same position as the director, and (b) the director's knowledge and experience. This requires the conduct of directors to be judged both objectively and subjectively by reference to their own personal characteristics.
- 5.7 For illustrative purposes we appended to the Paper a draft clause imposing a dual objective/subjective standard.<sup>9</sup> We explained that it was important that the standard of care set out in statute should take account of the responsibilities of directors of different types and in different situations,<sup>10</sup> for example the difference between what executive and non-executive directors are expected to do. The test therefore looks at the notional knowledge and experience that may reasonably be expected of a person *in the same position* as the director.<sup>11</sup> This involves taking account of the particular role which the director is expected to take on in the particular company. We also proposed that the same standard should apply to each of the duties of skill, care and diligence.<sup>12</sup>
- 5.8 This test is based on that in section 214(4) of the Insolvency Act 1986,<sup>13</sup> which imposes a liability on directors to contribute to the assets of the company if they

<sup>8</sup> Such as Australia, Canada, Germany and the USA. See Paper, para 15.17 and appendices H-K.

<sup>9</sup> See Paper, Appendix A. We explained that if we did recommend this option, the ultimate draft might not be in this form.

<sup>10</sup> See *Re Produce Marketing Consortium Ltd (No 2)* [1989] BCLC 520, 550 per Knox J, and cases cited in n 6 above.

<sup>11</sup> Paper, para 15.26.

<sup>12</sup> Paper, para 15.24.

<sup>13</sup> Section 214(4) and (5) provide that:

(4) For the purposes of subsections (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both-



have caused their company to trade at a time when it could not avoid entering into insolvent liquidation. The courts have recently used this section as a basis for the standard of care which a director must show under the common law.<sup>14</sup> Our view was that this statement now represents the law and would be followed by the higher courts.<sup>15</sup>

5.9 In the Paper we explained our provisional preference was for a dual objective/subjective test. We considered that all directors should be subject to a general standard of care. A director should not be able to rely on his own lack of knowledge or experience to avoid liability. We thought that it was only fair that a director with some special expertise should be bound to exercise it. Accordingly, it was our view that the subjective limb could operate only as a requirement in addition to the objective standard and could not be used by the director to avoid being subject to the minimum standard of care required by every director. We also noted that it would be sensible to base the standard on section 214(4). Not only would directors then have the same duties during the life of the company and as it approached insolvent liquidation, but the courts had also had over 12 years' experience in interpreting this section.<sup>16</sup>

5.10 However, we did note that there were fears that a dual standard might lead to an increase in the number of claims against directors and that this might deter people from acting as directors (particularly as non-executive directors) or lead to over-cautious behaviour.<sup>17</sup> We referred to the existence of a market in D&O insurance and concluded that there was an expectation that the market for this kind of insurance will increase with greater awareness of the responsibilities of directors.<sup>18</sup>

### ***An objective test***

5.11 The third option was for a director to owe a duty to his company to exercise the care, diligence and skill that would be exercised by a reasonable person having the knowledge and experience which may reasonably be expected of a person in the

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and

(b) the general knowledge, skill and experience that that director has.

(5) The reference in subsection (4) to the functions carried out in relation to a company by director of the company includes any functions which he does not carry out but which have been entrusted to him.

<sup>14</sup> See *Norman v Theodore Goddard* [1992] BCC 14 and *Re D'Jan of London Ltd* [1993] BCC 646 which were followed by Nelson J in *Bairstow v Queen's Moat Houses plc* 23 July 1999, unreported. *Re D'Jan of London Ltd* was also followed by Hart J in *Re Landhurst Leasing plc, Secretary of State for Trade and Industry v Ball and others* [1999] 1 BCLC 286, 344.

<sup>15</sup> Paper, para 15.5.

<sup>16</sup> Although the interpretation of s 214 has been questioned: see Paper, para 15.27, n 37.

<sup>17</sup> There had been concern along these lines in Australia. See Paper, para 15.22.

<sup>18</sup> Paper, para 11.57. For a description of the cover that can be provided by D&O insurance, see Insurance Institute of London, *Directors and Officers Liability Insurance* (1999) Report No 234, chapters 7 and 8.

same position as the director without taking account of any special expertise that the particular director possesses.<sup>19</sup>

- 5.12 We pointed out a number of problems with this purely objective standard. It would ignore the special qualifications that a director has, even if they were the reason why the company appointed him. An objective standard would also mean that the standard would change when the company approached insolvent liquidation.<sup>20</sup>

### **Summary of respondents' views**

- 5.13 There was little support amongst respondents for a subjective test. One respondent said that this would be appropriate for an owner-manager whose role as a director would be secondary to his role as an owner. It was pointed out, though, that this would not be acceptable for a director of a plc and that it would be undesirable to draw a distinction between the two types of companies.
- 5.14 Indeed most respondents thought that a subjective test would produce too low a standard for modern business. It was considered that in the absence of a formal assessment of a person's fitness to become a director, the public interest demanded that directors should be subject to at least an objective standard. This might afford some protection to shareholders and creditors. (It was noted, however, that many executive directors owe duties under their contracts of employment that impose objective standards.)
- 5.15 Instead the vast majority of respondents favoured the dual objective/subjective test. This included the IoD. Many agreed with our view that this was the current common law position. The dual test was widely regarded as the best way to account for the differing levels of knowledge and experience possessed by directors. Some respondents suggested that our illustrative clause needed to be more carefully drafted to ensure that it took into account both the functions to be performed by the individual director and the size and type of company. We agree that this is important.<sup>21</sup>
- 5.16 A number of respondents argued that the test should be the same as that in section 214(4) of the Insolvency Act 1986. This was thought to be a workable formula. If a different standard were introduced, there would be two overlapping yet distinct duties in the same area. However, some respondents considered that there was no incoherence in a different duty arising on impending insolvency: a director would then owe duties to creditors in addition to those owed to the company.
- 5.17 There was little support for a purely objective test. It was thought that a director with special skills should be expected to use them. An objective test would be too low for skilled directors. Those who supported this option did so largely because they were concerned about the position of non-executive directors. It was thought that a dual objective/subjective test would discourage non-executive directors from

<sup>19</sup> We appended to the Paper s 137 of the New Zealand Companies Act 1993 as an example of an objective duty of care: see Appendix I to the Paper.

<sup>20</sup> This would also be the case with the subjective test referred to in paras 5.3 to 5.5 above.

<sup>21</sup> Para 5.7 above.

taking up office or from taking risks. The fact that a director is a non-executive would be something that would be taken into account under this standard in any event.<sup>22</sup>

### **Summary of responses of directors: the empirical research**

- 5.18 The dual objective/subjective test was favoured by around half of the directors surveyed. Just under a third supported the subjective test.<sup>23</sup> Support for the subjective test was significantly more likely in 'closed' companies where the directors, together, held a majority of the shares. However, even among this group, a majority of the respondents favoured the objective/subjective test. The interview component of the empirical research also suggested that setting out the dual test in statute would probably not in itself lead to an increase in litigation by institutional shareholders against directors.<sup>24</sup>

### **Recommendation**

- 5.19 The Commissions provisionally supported codification of the dual objective/subjective standard. Respondents clearly supported setting this dual test out in statute. It is important that regard should be had to the functions of the particular directors and the circumstances of the particular company. The wording of the standard would be a matter for Parliamentary Counsel in due course. We consider that the statutory statement should supersede the general law.
- 5.20 **Accordingly, we recommend that (1) a director's duty of care, skill and diligence to his company should be set out in statute; (2) the standard should be judged by a twofold objective/subjective test; and (3) regard should be had to the functions of the particular director and the circumstances of the company.**<sup>25</sup>

### **SHOULD THERE BE A STATUTORY BUSINESS JUDGMENT RULE ?**

#### **Consultation issue**

- 5.21 In relation to commercial decisions in general, the courts take the view that it would be wrong "to substitute [their] opinion for that of the management, or indeed to question the correctness of the management's decision ... if bona fide arrived at".<sup>26</sup>

<sup>22</sup> Para 5.7 above.

<sup>23</sup> See Table 14 of the empirical research report in Appendix B.

<sup>24</sup> Section 7 of the empirical research report in Appendix B.

<sup>25</sup> The circumstances of the company would include the size and type of the company.

<sup>26</sup> *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, 832 (PC); see also e.g. *Re Smith & Fawcett Ltd* [1942] Ch.304; *Re Tottenham Hotspur plc* [1994], BCLC 655,660; *Runciman v Walter Runciman plc* [1992] BCLC 1084; and *Devlin v Slough Estates Ltd and others* [1983] BCLC 497, 504 per Dillon J: "The court does not interfere with the business judgment of directors in the absence of allegations of mala fides". See also Cheffins, *The Theory, Structure and Operation of Company Law*, pp 312-314; *Gower's Principles of Modern Company Law* (6 ed, 1997), p 644.

- 5.22 In many states of the USA the courts have adopted a business judgment rule.<sup>27</sup> The basic rule is that a director who makes a business judgment in good faith fulfils his duty of care if (1) he is not interested in the subject of the business judgment; (2) he is informed about the subject to the extent he reasonably believes to be appropriate; and (3) he rationally believes that the business judgment is in the best interests of the corporation.<sup>28</sup> The American Law Institute described the rule as a “judicial gloss on duty of care standards that sharply reduces exposure to liability” and explained that the standard in (3) “is intended to provide directors ... with a wide ambit of discretion”.<sup>29</sup>
- 5.23 We noted in the Paper how the Australian Government had recently proposed a statutory business judgment rule similar to this.<sup>30</sup> This may have been due, in part, to recent case law such as *Daniels v Anderson*,<sup>31</sup> which has increased concern in Australia about the liability of directors. The Government was concerned that uncertainty over the extent of this liability might be encouraging risk-averse business behaviour. Although the Government noted that the courts already declined to review the merits of business decisions, it thought that a statutory business judgment rule would create a presumption in favour of a director’s judgment that would lead to greater certainty.
- 5.24 We noted that the UK courts do not currently review the commercial decisions made by directors in good faith or judge them with the wisdom of hindsight.<sup>32</sup> In this context we thought that the best argument for introducing a statutory business judgment rule was if empirical research showed that directors were concerned about a statutory statement of the duty of care,<sup>33</sup> or if there was evidence that such a rule would help raise the standard of behaviour by directors.
- 5.25 On the assumption that the director’s duty of care was made statutory, we asked consultees whether there should be a statutory principle of non-interference by the courts in commercial decisions made in good faith, and, if so, whether it should be similar to that proposed in Australia or stated by the American Law Institute.<sup>34</sup>

<sup>27</sup> Paper, paras 15.32 - 15.34.

<sup>28</sup> The American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (1994).

<sup>29</sup> *Ibid*, at pp 141-2.

<sup>30</sup> Directors’ Duties and Corporate Governance: Corporate Law Economic Reform Programme, Proposals for Reform: Paper No 3. It has two main differences: (1) the judgment of a director must be in good faith for a proper purpose; and (2) the director must prove that he qualifies for the presumption, which is then rebuttable. See also para 1.22 above. In the USA the plaintiff must rebut the presumption.

<sup>31</sup> (1995) 16 ACSR 607 (at first instance, *AWA Ltd v Daniels* (1991-2) 7 ACSR 759).

<sup>32</sup> We noted that the Hong Kong Consultancy report considered that a case had not been made for a statutory formulation of their business judgment rule: see Paper, Appendix L.

<sup>33</sup> We noted that the initiatives in Australia seem to have been directed at easing uncertainty on this point.

<sup>34</sup> Paper, para 15.41 (Question 106).

### **Summary of respondents' views**

- 5.26 A small majority of respondents were against the introduction of a business judgment rule into statute. Most recognised that the courts already respect commercial decisions under the general law and did not see any reason to codify this. The principle would be best left to be developed by the courts. Some argued that it was implicit in the duty of care and that the courts would see it as such. A number of respondents also noted that the UK was less litigious than either the USA or Australia: a flood of litigation following the introduction of a statutory duty of care was considered unlikely.
- 5.27 Those in favour based their support largely on the need to clarify the law and to relieve concerns that a statutory duty would raise the standard of care and lead to defensive management.

### **Recommendation**

- 5.28 The courts currently do not judge directors with the wisdom of hindsight and do not 'second-guess' directors on commercial matters. There is nothing to suggest that this long-established judicial approach would not apply. It would in any event be difficult to formulate a business judgment principle without either narrowing it or making it too rigid. The examples reviewed in the Paper suggest that there is no simple way of embodying the principle in the statutory form.<sup>35</sup>
- 5.29 We had considered in the Paper that the main reason for introducing a statutory business judgment rule would be if there was evidence that directors were concerned about the dual objective/subjective standard. Those respondents who favoured its introduction thought that this might be the case. However, our empirical research did not reveal particular concern among directors about this.<sup>36</sup>  
**Accordingly, we do not recommend a statutory business judgment rule.**

### **SHOULD THERE BE STATUTORY PROVISIONS DEALING WITH DELEGATION TO AND RELIANCE ON THIRD PARTIES?**

#### **Consultation issue**

- 5.30 Currently the general law sets out when a director may properly delegate his responsibilities to third parties and rely on third parties.<sup>37</sup> These rules have been codified in some common law jurisdictions. For example the New Zealand Companies Act 1993<sup>38</sup> provides that the board of directors remains responsible for the exercise of powers it delegates *unless* the board (a) believed on reasonable

<sup>35</sup> Paper, paras 15.30-15.41.

<sup>36</sup> Para 5.18 above, and section 7 of the empirical research report in Appendix B.

<sup>37</sup> A director may delegate matters to one of the company's employees where the articles of association permit this and the needs of the business require it, in the absence of grounds for suspicion. Likewise, a director might need to rely on information provided to him by employees and others. See *Re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407, *Dovey v Corey* [1901] AC 477 and *Bishopsgate Investment Management Ltd v Maxwell (No 2)* [1993] BCLC 1282.

<sup>38</sup> We also referred in the Paper to s 123(4) of the Canadian Business Corporations Act 1985: see Paper, Appendix J.

grounds at all times before the exercise of the power that the delegate would exercise the power in conformity with the duties imposed on the directors of the company; and (b) has properly monitored the exercise of the power by the delegate.<sup>39</sup> It further provides that a director may rely on information given by an employee, expert, professional adviser or another director in relation to matters within their competence or responsibility, provided that the director acted in good faith, made proper enquiries and had no grounds for suspicion.<sup>40</sup>

- 5.31 We noted in the Paper that the Australian Government is consulting on the introduction of draft legislation similar to this.<sup>41</sup> The Government was concerned about the implications of *Daniels v Anderson*,<sup>42</sup> which concerned the monitoring of management by the board. With the complexity of modern business this is an important and difficult area. The court had stressed in that case that a director could not blindly rely on the judgments of others, but must take positive steps to satisfy himself that the company was being properly run. As with the business judgment rule discussed above,<sup>43</sup> there is fear that this decision may lead to an over-conservative business approach.
- 5.32 The courts in this country have also recently had to consider the responsibility of a director who delegates. In *Re Barings plc*<sup>44</sup> Sir Richard Scott VC confirmed that the overall responsibility of a director is not delegable. He said that the degree of personal blameworthiness that may attach to the individual with the overall responsibility, on account of a failure by those to whom he has delegated, must depend on the facts of each particular case. For example it might be that personal responsibility would attach because the system in which the failure occurred was inadequate. Similarly, in *Re Westmid Packing Services Ltd* Lord Woolf MR said that each individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them. A proper degree of delegation and division of responsibility was of course permissible, and often necessary, but not total abrogation of responsibility.<sup>45</sup>
- 5.33 Unless the empirical research showed that there were similar concerns in the UK, we considered that there was probably no reason for supposing that the present judge-made law was not working satisfactorily. We asked consultees whether there should be a statutory provision that set out the circumstances in which a director

<sup>39</sup> This is a summary of s 130: for the full wording, see Paper, Appendix I.

<sup>40</sup> This is a summary of s 138: for the full wording, see Paper, Appendix I.

<sup>41</sup> A bill has now been introduced. See also the recommendation 6.14 of the Hong Kong Consultancy Report (set out in Appendix L to the Paper).

<sup>42</sup> (1995) 16 ACSR 607 (at first instance, *AWA Ltd v Daniels* (1991-2) 7 ACSR 759). The relevant parts of this important decision are summarised in paras 15.44-15.46 of the Paper.

<sup>43</sup> Paras 5.21 - 5.29 above.

<sup>44</sup> Unreported, applied by Jonathan Parker J in *Re Barings plc (No 5)* [1999] 1 BCLC 433, 487.

<sup>45</sup> *Re Westmid Packing Services Ltd v Griffiths* [1998] 2 All ER 124, 130.

may delegate his powers to others and rely on information provided by others without incurring liability.<sup>46</sup>

### **Summary of respondents' views**

- 5.34 The majority of respondents were not in favour of such a statutory provision. Most preferred this issue to be left to the courts to develop on a case-by-case basis. Some thought that the present law was clear and satisfactory. It was pointed out that providing specifically for all the circumstances in which a director may delegate or rely on others might cause difficulties in interpretation and, therefore, might not help advisers and courts.
- 5.35 Few reasons were given by those who supported a statutory provision. One respondent thought that it might be useful as part of a general statement of the rights and liabilities of non-executive directors. Another supported it on the grounds of certainty and clarity, although the difficulty in drafting the provisions was recognised.

### **Recommendation**

- 5.36 We consider that the law in relation to this area is still developing. We see real problems in setting out in statute detailed circumstances in which a director can properly rely on a third party. We think that any such rules are likely to be too restrictive and to fail to deal with a situation in which a director should be able to rely on another.
- 5.37 As our empirical research did not reveal undue concern amongst directors on the question of delegation and reliance under the present law, we agree with the majority of our respondents and **recommend that there should not be a statutory provision setting out the circumstances in which a director may delegate his powers to others and rely on information provided by others without incurring liability.**

### **SUMMARY OF RECOMMENDATIONS UNDER THIS PART**

- 5.38 **To summarise, our recommendations under this Part are (1) that a director's duty of care, skill and diligence to his company should be set out in statute; (2) that the standard should be judged by a twofold objective/subjective test; (3) that regard should be had to the functions of the particular director and the circumstances of the company; and (4) that there should not be a statutory business judgment rule or statutory provisions dealing with delegation of a director's powers to others or reliance on information provided by others.**

<sup>46</sup> Paper, para 15.50 (Question 107).

# SECTION B: PART X OF THE COMPANIES ACT

## PART 6 INTRODUCTION TO SECTION B; MAJOR REPEAL OF PART X

### INTRODUCTION

- 6.1 In this Section we consider Part X of the Act. Part X underpins a director's fiduciary duties to his company in that it regulates possible conflicts of interests. For example, it regulates a director's service contract and payments for loss of office;<sup>1</sup> it requires a director to disclose any personal interest in company transactions;<sup>2</sup> it restricts certain transactions between a company and a director or a person connected with him;<sup>3</sup> it requires a director to disclose interests in shares in the company;<sup>4</sup> and it restricts loans made by a company to a director.<sup>5</sup> In the main Part X regulates conflicts of interest by requiring compliance with specified procedures. The Paper contained a useful table of those procedures which we have reproduced above.<sup>6</sup>
- 6.2 We have described in Part 1 above why Part X needs to be reformed. In the Paper we proposed three main options, which were:
- (1) whether large parts of Part X should be repealed;
  - (2) whether Part X should be disapplied where appropriate self-regulatory rules exist; or
  - (3) whether substantive amendments should be made to Part X.<sup>7</sup>

### Repeal

- 6.3 We discuss the question of repeal in this Part. We asked consultees for views on whether large parts of Part X could be repealed.<sup>8</sup> This would clearly place greater reliance on the general law and our proposals for increasing awareness of and accessibility to the general law are discussed in Parts 4 and 5 above. However, our provisional view was that large parts of Part X should *not* be repealed. We consider

<sup>1</sup> Sections 318-319 and ss 312-316.

<sup>2</sup> Section 317.

<sup>3</sup> Sections 320-322.

<sup>4</sup> Sections 324-329.

<sup>5</sup> Sections 330-342.

<sup>6</sup> See page 23 above.

<sup>7</sup> Paper, para 1.13.

<sup>8</sup> Paper, para 9.28. The sections in question are ss 312-316, s 319, ss 320-322 and ss 330-344. We also asked for views on repeal of some individual sections. See para 6.14 below.



that the provisions of Part X provide protection which is often superior to that of the general law. The majority of respondents supported this and we have not altered our provisional view through consultation. Accordingly, our recommendation below is that the relevant sections be retained.

### **Self-regulation**

- 6.4 We described the extent to which self-regulation covers the same ground as Part X and asked consultees for views on whether Part X should be disapplied where appropriate self-regulatory rules exist.<sup>9</sup> As noted in Part 1, we have agreed with the DTI that the role of self-regulation should not be dealt with in this report, and we have therefore not discussed it in general terms.<sup>10</sup>

### **Substantive amendment**

- 6.5 Our third option was for substantive amendments to be made to Part X. Respondents were in favour of this and, in light of our recommendation that these provisions should be retained, most of this Section consists of a discussion of our proposed substantive amendments. In Parts 7 to 14, we consider individual sections or groups of related sections in turn.
- 6.6 At the end of this Section we also consider our proposal for the introduction of a single code of civil remedies and effects into Part X.<sup>11</sup>

### **MAJOR REPEAL OF PART X**

- 6.7 In the Paper we set out the option of repealing a number of significant provisions in Part X.<sup>12</sup> If these provisions were repealed, reliance would be placed on more general principles of law to regulate the transactions which the provisions now cover. The sections in question were:

sections 312-316 (compensation for loss of office etc.);

section 319 (the period of directors' service contracts);

sections 320-322 (substantial property transactions); and

sections 330-344 (loans and similar transactions).

- 6.8 Several of these provisions<sup>13</sup> governed transactions which are now subject to considerable self-regulation where the company in question is a listed company.<sup>14</sup> On the other hand private companies and many public limited companies are not

<sup>9</sup> Paper, para 1.13.

<sup>10</sup> We have, however, discussed some specific cases in this report. See for example the discussion at paras 13.12-13.18 as to whether to disapply Schedule 6, Part II and rely instead on FRS 8.

<sup>11</sup> Part 15.

<sup>12</sup> Paper, para 9.3.

<sup>13</sup> Sections 312-316, 319, 320-322.

<sup>14</sup> Para 1.37 above.

subject to the Listing Rules or the AIM Rules and are regulated only by the Act and the general law.

- 6.9 The principal argument in favour of repeal of these provisions is that it would simplify Part X by removing complex legal provisions on which directors require legal advice. Removal of these provisions, which contain a number of loopholes, would allow the remaining provisions of Part X to be expressed more coherently and Part X as a whole to be simplified.<sup>15</sup> Reliance on the principles of the general law would be assisted if there were a statutory statement of the duties of directors under the general law.
- 6.10 The principal argument against repeal of these provisions is that they provide protection which is superior to that offered by the general law.<sup>16</sup> The provisions were enacted to prevent abuses which the general law had failed to prevent. We are not aware of any evidence that the development of the general law has removed the need for the protection which these provisions give. Self-regulation does not apply to private companies and many public limited companies. Repeal of the provisions and reliance on the general law would mean that the criminal sanctions<sup>17</sup> and civil remedies<sup>18</sup> which are now available under these provisions would no longer be available. The prohibitions in sections 330-342 against loans and similar transactions provide protection not only to shareholders in a company but also to the company's creditors. Reliance on the general law to regulate directors would not provide that protection to the company's creditors unless the general law were to develop so as to impose duties on directors in relation to a company's creditors.
- 6.11 In the Paper we expressed the view that the arguments against repeal appeared to outweigh those in favour but invited consultees' views.

#### **Summary of respondents' views**

- 6.12 A significant majority of respondents did not favour repeal of these provisions. It was suggested that there was no basis for confidence that the general law would prevent the abuses which caused these provisions to be enacted. Some company lawyers emphasised that they found it helpful to be able to refer to clearer statutory rules rather than general principles when advising directors in situations where there was a conflict of interest. A minority supported repeal of some or all of these provisions and reliance on disclosure to shareholders. One respondent pointed out that Canada had no equivalent to the provisions of Part X but placed reliance on a partial codification of directors' duties and on the general law. Other respondents expressed concern that repeal of these provisions would send the wrong message to directors.

<sup>15</sup> Paper, paras 9.22-9.23.

<sup>16</sup> Paper, para 9.25.

<sup>17</sup> Sections 314(3) and 342.

<sup>18</sup> Sections 315, 322 and 341.

### **Recommendation**

- 6.13 Having considered the responses we accept that it would not be appropriate to repeal the sections referred to in paragraph 6.7 above. We agree with the respondents who considered that the provisions provide protection to shareholders and creditors in addition to that provided by the general law. If the Company Law Review takes forward our work on the re-writing of Part X, there may be scope to simplify the restrictions in sections 312-316 and 330-344. **Accordingly, we recommend that sections 312-316, 319, 320-322 and 330-344 should not be repealed.**

### **LIMITED REPEALS**

- 6.14 In the Paper we also discussed the option of more limited repeals of particular statutory provisions. We expressed the provisional view that four sections or subsections could be repealed. These provisions were sections 311, 318(5), 318(11) and 323. Discussion of the repeal of these sections can be found in the text dealing with general improvements to these sections or related sections, and in particular at paragraphs 7.96 to 7.99, 9.12-9.17 and 11.3 to 11.7. We consider that sections 311, 318(5) and (11) and 323<sup>19</sup> may safely be repealed.

<sup>19</sup> And s 327 insofar as its purpose is to extend s 323 to minor children and spouses.

# **PART 7**

## **PAYMENTS TO DIRECTORS FOR LOSS OF OFFICE (SECTIONS 312-316) AND REPEAL OF SECTION 311**

### **INTRODUCTION**

- 7.1 In this Part we are concerned with the regulation of payments made by companies to directors for loss of office.<sup>1</sup> The sections deal with three situations: (i) payment by the company on a director's retirement, resignation or removal (section 312); (ii) payment by the company or a third party in the event of a transfer of the whole or part of the company's undertaking or property (section 313); and (iii) payment by any person in connection with certain specified types of share offer, primarily general offers or offers for control (section 314). In cases (i) and (ii), the Act requires disclosure to all the members and approval by the company in general meeting. In case (iii), the director is required to take all reasonable steps to secure disclosure of the payment in the offer document. Under (i) no specific statutory sanction is prescribed; under (ii) amounts received in breach of the section are held in trust for the company;<sup>2</sup> under (iii) breach attracts a fine,<sup>3</sup> and (unless the payment is approved before the transfer by a meeting of holders of the relevant shares) sums received by the director are held in trust for those who have sold their shares as a result of the offer.<sup>4</sup> Section 316(3) excludes from the scope of all these sections "any bona fide payment by way of damages for breach of contract or by way of pension for past services".
- 7.2 In the Paper, we set out 12 options for reform, including a "no change" Option 1. Options 2 and 3 were alternatives, directed to the application of section 316(3) and Option 11 considered additional disclosure requirements. Other options suggested extension to the scope of the provisions (Options 4, 5, 7, 9, 12). Options 6 and 8 concerned the manner in which shareholders should approve (or be deemed to approve) transactions and Option 10 addressed the consequences of breach. We asked a series of 14 questions directed to these issues, and to reform of the sections generally.<sup>5</sup> We also asked consultees whether section 311, which prohibits a company from making tax-free payments to directors, should be repealed.<sup>6</sup>
- 7.3 In considering these options, we have had regard in particular to the general principles discussed in Part 3 of this report, which put the emphasis on "efficient disclosure" to ensure that each organ of the company receives the information

<sup>1</sup> Paper, para 4.13, where the history and effect of the provisions are explained.

<sup>2</sup> Section 313(2).

<sup>3</sup> Section 314(3).

<sup>4</sup> Section 315.

<sup>5</sup> Paper, pp 319-22, Questions 9-22.

<sup>6</sup> Paper, paras 9.30-9.32.

needed to carry out its functions, but confine requirements for shareholder approval or absolute prohibition to cases of special risk.<sup>7</sup> We have also attached weight to the separate but interdependent roles for shareholders and directors discussed in Part 2 of the Paper.<sup>8</sup>

#### **WHETHER, IF RETAINED, SECTIONS 312-316 SHOULD BE RETAINED WITHOUT AMENDMENT? (OPTION 1 - QUESTION 10)**

##### **Consultation issue**

- 7.4 We asked consultees if the section should be retained without amendment. This option assumed that the sections provide sufficient and appropriate protection as they stand, and that there are no problems requiring to be addressed by legislation.

##### **Summary of respondents' views and recommendation**

- 7.5 The predominant view was that these sections should be amended in one form or another, a view which we share, as will be apparent from our conclusions on the other options. **Accordingly we do not recommend this option.**

#### **QUESTIONS RELATING TO SECTION 316(3)**

##### **Consultation issues**

- 7.6 This group of issues is concerned with what the Paper described as “covenanted payments”, that is, payments which a company is bound to pay to a director on his retirement or other loss of office because it has made some prior agreement to that effect or otherwise is under a legally binding obligation to do so, for example because he has a claim under a quantum meruit.<sup>9</sup> As we explained in the Paper, it was held by the Privy Council in the case of *Taupo Totara Timber v Rowe*<sup>10</sup> that such covenanted payments were excluded from the scope of similar provisions in the New Zealand Companies Act. We considered that that decision was likely to be followed in this country, and expressed the provisional view that provided section 316(3) is properly applied in practice, as a matter of policy the effect of the *Taupo* decision is right.<sup>11</sup> We also explained in the Paper that the Hampel Report had recommended the use of pre-determined compensation clauses, and so the question of the application of section 312 to these payments is now more important in practice.
- 7.7 The consultation questions were directed to three issues: first, whether section 316(3) was being properly applied (Question 9); secondly, whether covenanted payments should be brought within the control of sections 312-6 (Option 2 and

<sup>7</sup> See also section 9, “The balance between disclosure and approval”, of the empirical research report in Appendix B.

<sup>8</sup> Paper, para 2.17.

<sup>9</sup> Paper, para 4.15.

<sup>10</sup> [1978] AC 537.

<sup>11</sup> Paper, para 4.20. *Taupo* has been followed in Scotland in *Lander v Premier Pict Petroleum* 1997 SLT 1361.

Question 11); thirdly, if not, whether the sections should be amended to make clear that they do not apply to such payments (Option 3 and Question 12).

#### **Summary of respondents' views (Question 9)**

- 7.8 The balance of view among those who responded to this question was that section 316(3) is being properly applied in practice. The tenor of many of the answers was that the section was being stretched, but not abused. However, there were comments that the exception is liberally interpreted; that the approach to the quantification of "a bona fide payment by way of damages", or of the damages reasonably referable to breach of a service contract, is sometimes very generous; and that the duty to mitigate is sometimes disregarded. On this basis there are grounds for concluding that payments are not always confined to payments in good faith by way of damages for breach of contract. It was noted by one respondent that if a payment is over generous there are likely to be good commercial reasons for it, including the need to avoid expensive litigation and to procure the removal of the director as quickly as possible to avoid further damage.

#### **Summary of respondents' views (Option 2 - Question 11)**

- 7.9 The majority of respondents agreed with our provisional view that sections 312-316 should not apply to covenanted payments. It was pointed out that covenanted payments should appear in the service contract or contract for services, which should have been approved by the board and is available for inspection by members. Given that shareholders are not required to approve the terms of an executive director's service contract before he takes up his office, it was thought to be anomalous that approval of a payment should only be required when liability to make the payment had arisen. To make covenanted payments subject to shareholder approval could result in a company being liable in damages to the director if shareholders failed to approve the contractual payments.
- 7.10 Others disagreed with our provisional view, seeing no fundamental point of distinction between covenanted and non-covenanted payments. It was asked why, if directors are not allowed to agree compensation for loss of office when the director resigns (beyond the limits permitted by section 316(3)), they should be free to do so when the director is appointed. There was obvious scope for abuse.

#### **Summary of respondents' views (Option 3 - Question 12)**

- 7.11 A large majority of respondents agreed with our provisional view that sections 312-316 should be amended to make clear that they do not apply to covenanted payments. Those who opposed our provisional view did so because they favoured extending these sections to cover covenanted payments, rather than because they opposed clarification.

#### **Recommendation (Options 2 and 3 - Questions 9, 11 and 12)**

- 7.12 In line with our provisional view, and the majority of respondents, we conclude that sections 312-316 should not apply to covenanted payments. A number of points lead to this view.
- 7.13 There would be little benefit to shareholders in a requirement for approval of payments for which there is an existing legal liability, since if they refuse to approve

the company will be sued for breach of contract. This could only be avoided if shareholder approval were required before the contractual liability was incurred. However, it is difficult to see any justification for requiring this aspect of a service agreement alone to be so approved, when the remainder is not subject to such control. Prior approval by shareholders would be inefficient and impractical. It would be costly, in terms of the costs of calling a meeting. It would cause delay, which might put the appointment at risk. It could also be damaging to the company to have to reveal information as to the terms on which a director was prepared to be appointed.

- 7.14 If the director has not yet been appointed when the terms of his service contract are negotiated, there is no conflict of interest. If he is an existing director, there are other controls. The board ought to know about the conflict of interest. They will have to disclose the amount of the remuneration in the next accounts. The service contract will have to be made available for inspection. We consider this to be sufficient: prior shareholder approval is simply not practical.
- 7.15 We accept, however, that if covenanted payments are outside sections 312 to 316 altogether, it will be possible for a company to agree to pay a significant sum to a director, for example on giving him summary notice or on a change of control, without any sanction under the Act.<sup>12</sup> A shareholder could find out about such a clause by exercising his rights under section 318 (directors' service contracts to be open to inspection), but the existence of the liability would probably not be disclosed in the annual accounts.<sup>13</sup> The question whether such payments should be disclosed in the annual accounts falls outside this project, but we recommend that it be considered by the Company Law Review.
- 7.16 Subject to that point, **we recommend therefore that sections 312 to 316 should not apply to covenanted payments. Since the point has not been conclusively established by the general law, we also recommend that the section be amended to make the position clear.**
- 7.17 If section 316(3) is not correctly applied, the board may be in breach of its fiduciary duties, and the shareholders will have remedies against them. We consider below whether this could be reinforced by additional disclosure requirements. We considered in the Paper whether section 316(3) should also be reinforced by a criminal sanction.<sup>14</sup> There was some support for this, but not a majority. As we are not making recommendations about criminal sanctions in this report, we have not pursued this question further.

<sup>12</sup> See *Lander v Premier Pict Petroleum Limited* 1997 SLT 1361. See further paras 7.45 and 10.12 n 16 below.

<sup>13</sup> It would only be required to be disclosed in the annual accounts if paragraph 50(2) of Schedule 4 to the Act applied; for this purpose, the liability would have to be material in relation to the company (Schedule 4, para 86).

<sup>14</sup> Paper, para 10.40.

**REINFORCE SECTION 316(3) BY REQUIRING DISCLOSURE OF PARTICULARS OF COMPENSATION PAYMENTS IN THE ANNUAL ACCOUNTS?  
(OPTION 11 - QUESTION 20)**

**Consultation issue**

- 7.18 A bona fide payment of damages for breach of contract may be made to a director without shareholder approval under section 316(3). In the Paper we raised the issue of whether that subsection is being properly applied in practice (see above).<sup>15</sup> We referred to the further evidence of this in paragraph B.1.10 of the Combined Code, which advises listed companies when determining damages payments “to take a robust line on reducing compensation to reflect departing directors’ obligations to reduce loss”.<sup>16</sup>
- 7.19 Our thinking was that one way of encouraging directors to take a robust line with payments was to require companies to disclose in their annual accounts the details of an individual compensation payment (as against the aggregate amount paid to all directors for loss of office which is currently required under paragraph 8 of Part I of Schedule 6 to the Act). Accordingly, we asked consultees whether particulars of a payment of damages for breach of contract to a director should be included in the annual accounts and, if so, what in their view those particulars should cover and when the disclosure requirement should arise.<sup>17</sup>

**Summary of respondents’ views**

- 7.20 Most respondents were in favour of disclosure on an individual basis. One commented that it was a quid pro quo for disclosure and shareholder approval not being required prior to payment. The predominant view was that disclosure should include the basis of calculation of the compensation payment. For example, one respondent suggested that particulars should state (i) the gross amount and the element attributable to (a) damages and (b) pension (the distinct elements in the section 316(3) exemption) and (ii) that the payment contains an element which reflects mitigation prospects taken into account in the calculation.
- 7.21 It was also proposed that information should be given about the compensation package as a whole, especially as it may involve more than just a cash payment. It was suggested, for example, that the following should be disclosed: all associated compensation payments, any additional liabilities or increases in existing liabilities taken on by the company (such as increased or accelerated pension entitlements) and other non-financial benefits to the director (such as continued use of company assets or the transfer of ownership of company assets - usually cars to the directors).
- 7.22 It was suggested that the model for disclosure might be Schedule 6, Part I, paragraph 8(2) (disclosure in the notes to the annual accounts of the aggregate amount of compensation to directors). There were also calls for disclosure of deferred payments.

<sup>15</sup> Paper, paras 4.25-4.27 (Question 9), 4.60.

<sup>16</sup> Paper, para 4.30.

<sup>17</sup> Paper, para 4.60.



- 7.23 As for timing, of those respondents that expressed a view, most suggested disclosure in the next annual accounts following the loss of office. Some respondents called for disclosure at the earliest possible moment after the compensation package has been agreed and said it should not be left to the annual accounts; it was important to inform the market and to prevent speculation as to the reasons for departure.
- 7.24 A few respondents were against disclosing particulars of individual compensation payments. Several commented that Listing Rule 12.43A(c)(ii)<sup>18</sup> was sufficient. This requires disclosure, in the annual accounts of listed companies, of each element in the remuneration package of each director, including the amount of compensation for loss of office and payments for breach of contract or other termination payments. Some respondents commented that disclosure would be of little practical benefit, for example, because the accounts may be published a considerable time after the departure of the director, and the disclosure may therefore attract little interest. Another comment was that in the absence of information about the contract and surrounding circumstances, disclosure would not enable a meaningful judgment about the compensation to be formed.

### **Recommendation**

- 7.25 We accept that disclosure to shareholders will not guarantee compliance with section 316(3). Disclosure of the sum paid to an individual director would not show that there had been compliance with section 316(3). This could not be done without very detailed information as to the director's circumstances. Realistically any additional disclosure would have to be in the next annual accounts, by which time interest may have waned. Reliance on Listing Rule 12.43A(c)(ii) alone would not be sufficient as it does not apply to non-listed companies.
- 7.26 On balance, however, we think that the prospect of such disclosure would be likely to make directors think carefully before approving any individual compensation package, and would encourage compliance with the Act. To that end, we think that a company should disclose some of the components of the compensation package. We suggest that the sums paid (a) as damages for breach of contract and (b) by way of pension should be separately identified. Within the sums paid as damages we favour disclosure of the following components:
- (1) damages relating to loss of office as director;
  - (2) damages relating to loss of other offices;
  - (3) damages for loss of pension rights; and
  - (4) the extent to which the damages were mitigated by the prospect of obtaining alternative employment.

<sup>18</sup> Paper, Appendix E.

- 7.27 **We recommend that the compensation for loss of office which by virtue of paragraph 8(2) of Schedule 6 to the Act<sup>19</sup> must be shown in the notes to the annual accounts should be shown for each director separately.<sup>20</sup> We recommend that the components of the compensation package set out in paragraph 7.26 above should be shown in the notes to those accounts.**

#### **SUGGESTED EXTENSIONS**

##### **EXTEND SECTIONS 312-316 TO FORMER DIRECTORS? (OPTION 4 - QUESTION 13)**

###### **Consultation issue**

- 7.28 The Paper explained that in 1962 one of the recommendations of the Jenkins Committee was that the predecessor provisions of what are now sections 312 to 316 should be amended to cover payments to former directors.<sup>21</sup> Our provisional view<sup>22</sup> on this matter was, however, that if the sections were extended to former directors, they might unfairly catch proper transactions such as, for example, ex gratia payments made to directors who have had to retire because of illness, to relieve financial hardship. We observed that there was no evidence of abuse, for example by directors resigning before they make an arrangement to receive compensation. Accordingly, we asked consultees whether they agreed with our provisional view that sections 312 to 316 should not be amended so as to apply to payments to former directors.

###### **Summary of respondents' views**

- 7.29 Most of those who responded to this question supported our provisional view that sections 312-316 should not be amended to apply to former directors. Some commented that they were not aware of any abuses of the sections by way of payments to former directors, but it was thought by one respondent that in practice directors sometimes resign (or are removed) before the exact amount of their compensation is agreed. Several respondents suggested that, to avoid the risk of abuse, the sections should be extended to cover payments to directors who ceased to hold office within the previous six or twelve months.

###### **Recommendation**

- 7.30 We note that there appears to be no evidence of actual abuse. In practice, we doubt if the application of the section could be avoided simply by the device of resignation prior to payment. We would expect the court to treat the resignation and the payment as part of a single operation, and the payment accordingly as "made to a director" for the purpose of section 316(3). Therefore, consistently

<sup>19</sup> Payments in kind and payments to connected persons of the director are included: para 8(3) and 10(4) of Sch 6.

<sup>20</sup> Since this report was delivered to the DTI on 19 July, the DTI has itself made a similar proposal in a consultative document on directors' remuneration. In this document, the DTI proposes that details of compensation paid to directors for loss of office should be set out in the remuneration report to be included with the annual report and accounts.

<sup>21</sup> Paper, para 4.13.

<sup>22</sup> Paper, para 4.48.

with the views of the majority of respondents, **we recommend that no amendment be made to sections 312 to 316 to make express reference to former directors.**

**EXTEND SECTIONS 312-316 TO COVER PAYMENTS TO CONNECTED PERSONS?  
(OPTION 5 - QUESTION 14)**

**Consultation issue**

- 7.31 The Paper drew attention to the fact that sections 312 to 316 do not in terms apply to payments to connected persons occasioned by a director ceasing to hold office, although in other sections of Part X, transactions or arrangements involving connected persons are included.<sup>23</sup> We asked consultees whether sections 312 to 316 should cover payments made to connected persons, and, if so, in what circumstances.
- 7.32 We noted, however, that we were not aware that such payments were made in practice. Furthermore, depending on the basis on which the payment was made, the company would be likely to have a remedy. Thus, if the payment were made to the connected person as a nominee for the director, the courts would be likely to hold that the sections apply. If it were made on some other basis (for example, to the spouse of a retiring director who retires from some other position in the company), the company would be protected by the directors' duty to act in good faith in the best interests of the company.

**Summary of respondents' views**

- 7.33 Views on this issue were closely balanced. Respondents who addressed this question were fairly evenly split as to whether to extend sections 312-316 to connected persons. Those against extending the sections emphasised that there was no evidence to suppose that the sections are being avoided by payments to connected persons. Those in favour argued that it would ensure consistency with other provisions in Part X.
- 7.34 Other suggestions made were: to limit the extension to public companies only; to provide an exception where neither the payer nor the recipient had knowledge of the connection; and to restrict payments to persons connected with directors who ceased to hold office within one year of the payment. Some proposed as an alternative that the sections should apply to payments made at the director's direction. It was thought that this would clarify an otherwise grey area and avoid the difficulties caused by any definition of "connected person".

**Recommendation**

- 7.35 We note the argument that the more modern, or more recently reviewed, provisions of Part X apply not only to transactions with directors but also to transactions with persons connected with directors. Thus, in section 320, a substantial property transaction in favour of a connected person requires prior approval by the company in general meeting just as much as it would if it were a transaction with a director.

<sup>23</sup> See ss 317(6), 322A(1)(b) and 328(3)(b) for example.

- 7.36 However, the same considerations do not necessarily apply to payments on loss of office. A payment to someone other than the director would need to be justified, and, if it was for the purpose of evading the Act or some other improper purpose, the company would be likely to have a remedy against the directors who authorised it. As we have said we are not aware of any evidence of abuse in practice.
- 7.37 **Accordingly, we do not recommend that sections 312 to 316 be extended so that they apply to payments to connected persons.** We note the suggestion that the section could be clarified by making it clear that it applies to payments at the director's direction. We doubt if this is necessary, since we would expect the section to be interpreted as applying to such payments in any event.

#### **SECTIONS 312-316 TO APPLY TO PAYMENTS RECEIVED FOR LOSS OF OTHER OFFICES? (OPTION 7 - QUESTION 16)**

##### **Consultation issue**

- 7.38 Another recommendation by the Jenkins Committee was that sections 312-315 be amended to cover payments for the loss, while a director of the company or on the occasion of or in connection with loss of office as a director of the company, of any other office in connection with the management of the company's affairs or of any office as director or otherwise in connection with the management of the affairs of a subsidiary.<sup>24</sup>
- 7.39 The Paper observed that payments for loss of other offices would appear to be caught by section 316(2)(b) for the purposes of sections 313 and 314, but not of section 312. Section 312 may therefore allow some scope for avoidance by, for example, the company making a payment to the director in connection with his loss of a position other than as director. We also observed that it was anomalous that the Act considers payments of compensation for loss of other positions sufficiently important to be the subject of aggregated disclosure<sup>25</sup> but does not require approval of it.
- 7.40 Our questions to consultees were:
- (1) whether they considered that section 312 should require approval of uncovenanted payments made to a director in respect of the loss of some other position in the company, or its group, apart from that of director (a) if he loses that position at the same time as he loses his office as a director, or (b) whenever he receives such a payment;
- (2) whether they considered that sections 312-316 should apply to any such payments which are covenanted as well.

<sup>24</sup> Paper, para 4.13, 4.51.

<sup>25</sup> See para 8 of Sch 6 to the Act.

## Summary of respondents' views

### *Uncovenanted payments made for loss of other positions*

- 7.41 A large majority of the respondents who answered this question said that section 312 should require approval of uncovenanted payments made to a director in respect of the loss of some other position in the company, or its group, apart from that of director. Contrary views were that there was no evidence that payments to the director in another capacity were being used to circumvent the section; and that approval of such payments was a matter for the board, which would be subject to the pressure of the current requirement for disclosure of the aggregate amount.

### *Covenanted payments made for loss of other positions*

- 7.42 There was almost unanimous agreement among respondents that sections 312-316 should not apply to any covenanted payments to directors for loss of some other position in the company or group. No contrary reasons were given.

## Comment

- 7.43 In the Paper we said that where a director, in addition to being a director holds some other position in a company or its group, it is possible for a company to circumvent the requirement for approval of uncovenanted payments by making such payment to the director in connection with his loss of that position.<sup>26</sup>
- 7.44 The Paper did not give examples. At first sight it might be thought unlikely that a director would have any position with the company other than that of a director but this issue is connected with a further point decided in the *Taupo*<sup>27</sup> case to which we referred in our summary of that decision. We explained that in that case the Privy Council decided that the New Zealand section comparable to Section 312 of the Act did not apply to any payment made to a director in respect of his executive position with the company. We noted the criticism in *Gower's Principles of Modern Company Law* of the decision.<sup>28</sup> The effect of the decision, if it is followed in this country, is section 316(3) does not apply to any payments of damages to a director in respect of his executive position whether they were bona fide damages for breach of contract or not.<sup>29</sup> On this basis, section 316(3) is limited to payments of damages to which a director is entitled by reason of his being a director e.g. where he agrees to serve as a non-executive director for an agreed sum per year.

<sup>26</sup> Paper, para 4.52.

<sup>27</sup> *Taupo Totara Timber v Rowe* [1978] AC 537.

<sup>28</sup> Paper, para 4.19.

<sup>29</sup> In *Gooding v Cater*, 13 March 1989, Chancery Division, unreported, Edward Nugee QC sitting as a Deputy High Court Judge held that such payments were outside ss 312-316 because they were covenanted payments. However, we doubt whether this is correct since damages are a sum paid for breach of contract, rather than in pursuance of the contract. However, if the payment is not a bona fide payment by way of damages for breach of contract then (irrespective of whether or not s 316(3) applies), the company may, depending on the circumstances, have a remedy for damages for breach of fiduciary duty or breach of the duty of care.

- 7.45 This limitation exposes a considerable gap in the protection provided to shareholders under section 312.<sup>30</sup> Our question related to uncovenanted payments to a director in respect of the loss of some other position in the company or its group, other than that of director, and thus covers payments to a director in respect of his executive position but in the text accompanying this question we did not refer back to our summary of the *Taupo* case. Most of the responses did not give reasons. It is apparent from the responses that we received on Question 9 that most respondents assumed without objection that section 316(3) applied to the loss of the director's executive position, thus disregarding this part of the decision in *Taupo*.
- 7.46 Our recommendation is that compensation for loss of some executive position which the director holds with the company or any company in its group should require approval unless it is a bona fide payment by way of damages for breach of the contract under which he holds that position. We appreciate that there is no similar constraint on the amount of a covenanted payment, but for the reasons that we have already explained it is impractical for shareholders to be asked to approve a service contract with such a payment at its inception. An alternative might be to consider whether a statement of the company's policy with respect to agreeing the amount of such payments and their method of calculation would be placed before shareholders at the annual general meeting.<sup>31</sup> But this issue is connected with the amount of directors' pay and it is therefore outside this project although it may be an issue to which the DTI or the Company Law Review may wish to give attention.
- 7.47 Some respondents expressed the view that section 316(3) should in effect be widened to include payments that went or might go beyond what was genuinely considered to be a sum payable for damages for breach of contract e.g. because it was a compromise. We do not recommend any such amendment. Section 316(3) protects the good faith judgment of the directors as to the appropriate contractual entitlement of the outgoing director but does not empower them to add a further payment e.g. for "going quietly", even if this is considered by the directors to be in the company's commercial interests.<sup>32</sup> We think that section 316(3) as presently enacted draws an appropriate balance between the interests of the shareholders and those of the directors, and that to give the directors more discretion without shareholder approval would merely lead to outgoing directors asking for more.

<sup>30</sup> We explained that the same problem did not appear to exist under ss 313-315 because of the provisions of s 316(2)(b). The Faculty of Advocates took the view that the position should be the same under each of ss 312-316. We agree.

<sup>31</sup> This is part of the debate about how directors' pay should be linked to performance: see Paper, para 4.45; and see generally the DTI's consultative document on directors' remuneration (see n 20 above).

<sup>32</sup> One respondent suggested that the directors should be required to deduct any cross-claim. We take the view that if it is clear that the company has a cross-claim against the outgoing director the directors must deduct this if the payment of the balance is to be a bona fide payment within s 316(3).

## **Recommendation**

- 7.48 **We therefore recommend that where a director receives a payment for the loss of some office with the company in the context of the loss of office as a director, sections 312 to 316 should apply to that payment. However, in line with our earlier recommendations, sections 312 to 315 should not apply to any such payment which is a covenanted payment.**

## **WHETHER TO AMEND SECTIONS 314 AND 315 TO COVER ACQUISITIONS BY WAY OF CANCELLATION OF SHARES UNDER A SCHEME OF ARRANGEMENT ETC.? (OPTION 9 - QUESTION 18)**

### **Introduction**

- 7.49 In the Paper we discussed sections 314 and 315. These sections apply to a payment to a director as compensation for loss of office, or as consideration for his retirement, in connection with certain share offers. The sections require a director of a company subject to an offer to ensure that the selling shareholders are given particulars of the proposed payment in any notice of the offer. If no particulars are given, or if the selling shareholders and other shareholders of the same class do not approve the proposed payment, the director is deemed to hold the payment on trust for the selling shareholders.
- 7.50 We noted that sections 314 and 315 do not apply to takeovers by way of a scheme of arrangement under section 425, which is a common method of executing an agreed takeover. Section 426(2) requires that the explanatory statement which accompanies the notice summoning a court meeting should state the effect of the arrangement on any material interests of the directors of the company, (which may include compensation payments). However, there is no provision which makes a compensation payment to a director unlawful if the scheme is a cancellation scheme or imposes on him any trust for the benefit received for former shareholders. We therefore asked consultees whether they considered that sections 314 and 315 should be amended to cover acquisitions by way of a cancellation of shares under a scheme of arrangement.<sup>33</sup>
- 7.51 Furthermore, we noted that section 314(1) appears to apply only to offers conditional on acceptance, because of the wording of section 314(1)(d) which speaks of “any *other* offer which is conditional on acceptance to a given extent”. It is common for offers to be conditional on, say, acceptances being received which would result in the offeror holding shares carrying more than 50 per cent of the voting rights. However, some offers, such as offers to acquire outstanding minority shareholdings, are unconditional. We considered that it was questionable whether section 314 should be restricted to conditional offers and accordingly asked consultees whether sections 314 and 315 should be amended to cover unconditional offers.<sup>34</sup>
- 7.52 We also drew consultees’ attention to the fact that the offeror and his associates are permitted to vote at the meeting convened pursuant to section 315 (for

<sup>33</sup> Paper, para 4.55.

<sup>34</sup> Paper, paras 4.37 and 4.55.

shareholders to approve the compensation payment to director) if they hold shares of the same class as the offeree shares. We noted that for schemes of arrangement a holder of shares of the same class could be excluded if the court convened a meeting under section 425.<sup>35</sup> Accordingly, we asked consultees whether sections 314 and 315 should be amended to prevent the offeror or his associates from voting at the meeting convened pursuant to section 315.<sup>36</sup>

- 7.53 Finally, we asked consultees whether sections 314 and 315 should be amended in any other way to remove deficiencies in their application to takeovers in accordance with modern practice. We had mentioned, for example, that there is no remedy at all under the section unless the offer becomes unconditional. Also, if the offer does become unconditional the selling shareholders get the whole of the benefit even if the offer was only a partial one.

## **Summary of respondents' views and recommendations**

### ***(1) Schemes of arrangement***

- 7.54 **Responses** The majority of respondents were in favour of amending sections 314 and 315 to cover acquisitions by way of a cancellation of shares under a scheme of arrangement. The Panel Executive of the Panel on Takeovers and Mergers noted that it seeks, wherever possible, to apply the City Code on Takeovers and Mergers to offers made by cancellation of shares under a scheme of arrangement and, by analogy, suggested that sections 314 and 315 should be amended to apply to takeovers by scheme of arrangement. It also suggested that consideration could be given to extending the provisions to other legal structures, such as arrangements under the Insolvency Act 1986 section 110.<sup>37</sup> However, some respondents expressed contrary opinions. There were comments to the effect that section 426 would normally require disclosure of proposed severance payments and that the machinery for a scheme of arrangement was sufficient. One respondent said the amendment would make the provisions more complex.
- 7.55 **Comment** We see force in the argument that existing legislation protects shareholders by requiring disclosure of the effect of the arrangement on any material interests of directors and that there is therefore no need to extend section 314(2) to schemes of arrangement.<sup>38</sup> The main difference, therefore, between the regime under section 426 and our proposed amended sections 314 and 315 is that under section 426 there is no provision for the director to hold the sums received

<sup>35</sup> *Re Hellenic & General Trust Ltd* [1976] 1 WLR 123.

<sup>36</sup> Paper, paras 4.38 and 4.55.

<sup>37</sup> As for the suggestion regarding s 110 of the Insolvency Act 1986, our view is that arrangements under that section are already within s 313, and so no amendment is required in respect of them. Section 313 applies to transfers of the whole or any part of "the undertaking or property" of a company. Section 110 applies to transfers of whole or part of the company's "business or property". It is difficult to think of a circumstance in which a transfer within one of these sections would not be within the other. We are not aware of other legal structures to be considered here.

<sup>38</sup> Section 426(2) of the Act. If the company breaches this section the company and every officer who is in default is liable to a fine (s 426(6)). Compliance is reinforced by s 426(7) which imposes a duty on directors to supply the relevant information to the company. If in default of that subsection, directors are liable to a fine.



on trust for the accepting shareholders if he fails to disclose the compensation.<sup>39</sup> However, we consider that the criminal sanctions for breach of section 426 probably provide a strong incentive to companies and directors to make the relevant disclosure.<sup>40</sup> Furthermore, where the payment is made by the company, as is usually the case, rather than the offeror, section 312 would offer additional protection to shareholders.

7.56 **On balance we consider that section 314 should not be amended to cover takeovers by scheme of arrangement and we therefore recommend against it.**

### ***(2) Unconditional offers***

7.57 **Responses** Doubts were expressed whether our interpretation of section 314(1) was correct, on the ground that each of the paragraphs in section 314 should be construed on a stand-alone basis, but most respondents thought that the sections should be amended to cover unconditional offers.

7.58 **Comment** There is a curious list of offers in section 314(1). Offers within (c) or (d) are rare. There is a more restricted definition of takeover offer in section 428. Presumably the policy behind section 314(1) is to catch any offer for which there should be disclosure of the director's interest under section 314(2). There are, however, many gaps in section 314(1) e.g. where an offeror makes an offer to all the shareholders other than those with registered addresses in the USA, without imposing any condition as to the minimum level of acceptances, or an unconditional offer to acquire minority shareholdings because the offeror has acquired by private treaty shares holding more than 50% of the voting rights. It is difficult to see how the section could ever be comprehensive. Nevertheless it would be helpful to remove the doubt about whether unconditional offers are included.

7.59 **We recommend therefore that section 314 be amended so as expressly to cover unconditional offers.**

### ***(3) Voting***

7.60 **Responses** Most respondents wished to prevent an offeror or his associates from voting at the meeting convened pursuant to section 315. One respondent said that any such meeting will necessarily result from the actions of the offeror and that the offeror cannot be seen as entirely independent in relation to the arrangements being made subject to shareholder approval.

7.61 The contrary view was that it would be an unfair restriction on the offeror's rights as a shareholder and there are other remedies available in the case of resulting prejudice. One respondent said that although it may be necessary in a scheme to distinguish between members of different classes,<sup>41</sup> the distinction is not relevant where there is an offer of the types in section 314. It was also argued that we had not suggested a similar prohibition in respect of section 313 (which contains

<sup>39</sup> As is the case under s 313(2).

<sup>40</sup> See n 38 above.

<sup>41</sup> Para 7.52, n 35 above.

similar provisions where the acquisition is of a company's undertaking, rather than its shares).

7.62 Another respondent doubted that the requirement for shareholder approval adds significantly to the protection afforded by the requirement to disclose proposed payments in the offer document. Shareholders can give or withhold acceptance of the offer in knowledge of the proposed payment. The respondent recommended instead that there should be an obligation on both the offeror and the director to disclose the proposed payment in the offer document.

7.63 **Comment** If the resolution approving the payment to the director is passed, accepting shareholders will lose any claim under section 315(1). In these circumstances, it is anomalous that the offeror or any of his associates should attend or vote at the meeting at which the resolution is to be considered. Moreover although the claim is limited to shareholders who sell their shares as a result of the offer, the resolution must be passed before the transfer of their shares occurs. To meet this requirement, it is probably necessary for all the shareholders who have shares to which the offer relates and who are therefore capable of accepting the offer to have the right to attend and vote, even though they may in the event decline the offer and not transfer their shares to the offeror.

7.64 It is correct that under section 313 the person to whom the undertaking or property of the company is to be transferred may also hold shares conferring the right to vote on the approval of the payment, but if the effect of the resolution is to confer a benefit on the majority who cause it to be passed at the expense of the minority, the resolution is likely to be ineffective on the grounds that it is a fraud on the minority.<sup>42</sup> Section 313 is distinguishable from sections 314-315 because no group of shareholders has a proprietary claim to the payment as they do under sections 314-315 if it is not disclosed and approved in accordance with the section.

7.65 **We recommend that the offeror or an associate of his should not be entitled to vote at a meeting convened pursuant to section 315.**<sup>43</sup>

#### ***(4) Other improvements***

7.66 **Responses** Of those respondents who answered our final question, several said they did not suggest any further amendments. One said it was illogical that under section 315(1)(b) approval must be given not only by selling shareholders but also by other holders of that class, especially as they would not be entitled to any payment if it is not approved. Another recommendation was that section 314(1)(a) should track the definition of takeover offer in Part XIII of the Act. One respondent argued for an amendment to remedy the case where a partial offer becomes unconditional and the selling shareholders get the whole benefit of the payment.

7.67 **Comment** It would not be appropriate for us to recommend any further amendments to sections 312-316 without further consultation. Accordingly, we

<sup>42</sup> See Shareholder Remedies (1996) Law Commission Consultation Paper No 142, paras 4.7-4.18.

<sup>43</sup> A useful definition of "associate" for this purpose can be found in s 430E(4).

suggest that the DTI may wish to consider the views of respondents recorded above as part of its Company Law Review.

**EXTEND SECTION 312 TO COVER PAYMENTS MADE BY A COMPANY TO A DIRECTOR OF ITS HOLDING COMPANY IN CONNECTION WITH LOSS OF OFFICE AS SUCH DIRECTOR? (OPTION 12 - QUESTION 21)**

**Consultation issue**

- 7.68 In the Paper<sup>44</sup> we observed that section 312 does not deal with the situation where a payment is made by, say, a wholly-owned subsidiary to a director of its parent company. The director may have been employed as a director of the holding company by the subsidiary, especially if the subsidiary is the company which employs all employees in the group. We noted that by contrast, where the company enters into a substantial property transaction with a director of a parent company, both the subsidiary (unless wholly-owned) and the parent company must approve the transaction.
- 7.69 We therefore asked consultees whether section 312 should apply to payments made by a company to a director of a holding company in connection with his loss of office as such director and, if so, whether the requirement for disclosure and approval should be satisfied in both companies (other than a wholly-owned subsidiary).

**Summary of respondents' views**

- 7.70 Respondents were nearly unanimous in their view that section 312 should apply to payments by a company to a director of a holding company in connection with his loss of office as such director. This was to ensure consistency with other provisions of Part X and to avoid abuse. A contrary view was that it would add an unnecessary complication to the section and that there is no reason to believe that this method is being used to avoid the requirements of section 312.

**Recommendation**

- 7.71 We consider that as a general matter Part X should recognise that many companies are today organised in groups. Although the proposed amendment would add a further complication, we think it is justified to reflect that reality and prevent avoidance. To an extent we have already covered this point under Question 16 above.<sup>45</sup>
- 7.72 **We recommend that the directors to whom sections 312 to 316 apply should include directors of holding companies.** If the subsidiary is wholly-owned, shareholder approval should be required in the holding company<sup>46</sup> even though it is not itself proposing to make the payment. In those circumstances shareholder approval by the wholly-owned subsidiary should not be required.<sup>47</sup>

<sup>44</sup> Paper, para 4.61.

<sup>45</sup> Para 7.38ff.

<sup>46</sup> Provided that it is a company for the purposes of the Act.

<sup>47</sup> Compare s 321(1).

## **METHOD OF OBTAINING SHAREHOLDER APPROVAL**

### **APPROVALS IN GENERAL MEETING UNDER SECTIONS 312 TO 316 TO BE BY SPECIAL RESOLUTION AND DISCLOSURE TO COVER PAYMENTS MADE ON THE SAME OCCASION? (OPTION 6 - QUESTION 15)**

#### **Consultation issue**

7.73 The Jenkins Committee had recommended that:

- (1) the predecessor provisions of sections 312, 313 and 315(1)(b) should be amended to require the approval of a special resolution or equivalent majority of the members concerned; and
- (2) where approval was required under those sections, the circular to members should include disclosure of any other payments for which approval was not required.<sup>48</sup>

Our provisional views were (1) that a special resolution was inappropriate because that procedure should be reserved for fundamental corporate changes; and (2), that in view of the general law requiring full and proper disclosure,<sup>49</sup> there was no need for any special statutory rules as to disclosure of other payments in the circular for members. We asked consultees whether they agreed with our provisional views.

#### **Summary of respondents' views**

##### ***Special resolution***

7.74 Respondents who addressed this question were almost unanimous in supporting our provisional view that approval of compensation payments in general meeting should not be by special resolution. Those dissenting did not give a reason.

##### ***Disclosure of payments made on the same occasion***

Similarly, a large majority of respondents to this question supported our provisional view that there was no need for a statutory rule requiring disclosure of other payments. There was a wide measure of agreement that there was already sufficient protection in the general law.<sup>50</sup> Those who disagreed emphasised the need for members to have the full facts before them.

#### **Recommendation**

7.75 **We recommend, in line with our provisional views, as follows:**

- (1) there should be no change to the majorities required for such approvals; and**

<sup>48</sup> Paper, para 4.13. The Jenkins Committee was concerned that a director might receive contractual damages as well as an ex gratia payment: Paper, para 4.50.

<sup>49</sup> *Kaye v Croydon Tramways Co* [1898] 1 Ch 358.

<sup>50</sup> Reference was made to cases such as *Kaye v Croydon Tramways Co* [1898] 1 Ch 358 and *Pacific Coast Gold Mines Ltd v Arbuthnot* [1917] AC 607; and, in the case of listed companies to Listing Rules 14.1(a) and (b).

- (2) **sections 312 to 316 should not be amended to require disclosure of details of other payments being made to the director.**

**DEEM PAYMENTS APPROVED IF NOTIFIED TO MEMBERS AND MEMBERS RAISE NO OBJECTION TO THE PROPOSED PAYMENT WITHIN A STIPULATED PERIOD? (OPTION 8 - QUESTION 17)**

**Consultation issue**

- 7.76 In the Paper we commented that shareholder approval may be costly, cumbersome and create uncertainty. For this reason, we asked consultees for views on whether to deem the payment approved if the company gives notice to shareholders of the intention to make the payment and there is no objection from a specified proportion of shareholders within a stipulated period. If an objection is received, the company would have to call a meeting to approve the payment. The procedure could be in addition to, or in lieu of, the additional requirement for a meeting.
- 7.77 Our provisional view was against such a procedure, principally because shareholder apathy might mean that the period passed without effective scrutiny, and, if a meeting were required, the time taken for the whole procedure would be even longer than at present.<sup>51</sup> We asked consultees whether they agreed with our provisional view that it should not be incorporated into sections 312-314.<sup>52</sup>

**Summary of respondents' views**

- 7.78 Respondents almost unanimously supported our provisional view that a negative approval procedure should not be incorporated into sections 312-314.<sup>53</sup> Several respondents were strongly against the principle of negative approval in general. The IoD described allowing companies to gain approval by silence as a dangerous and unwelcome precedent. Others said that if a particular course of action is thought to be sufficiently important to need shareholder approval, the requirement should be for positive approval in advance. Convening a meeting allows shareholders to consider the proposal in advance and to question the board about it.
- 7.79 Several respondents commented that the proposed procedure could be too slow. This is because many payments are required as part of a commercial operation under a tight time schedule. It could also cause anomalies. For example, a company may have removed a director before the payment is approved in the general meeting, thus potentially removing the need for such a meeting.

**Recommendation**

- 7.80 **We do not recommend introduction of a mechanism for deemed shareholder approval into sections 312 to 315.**

<sup>51</sup> Paper, paras 4.54, 4.171.

<sup>52</sup> We also asked consultees for views on whether this procedure should apply in some other circumstances where shareholder approval is required, namely under ss 319 and 320.

<sup>53</sup> The response to our questions regarding use of this procedure in ss 319 and 320 was very similar.

## CIVIL REMEDIES IN SECTIONS 312, 313 AND 315 (OPTION 10 - QUESTION 19)

### Consultation issue (1)

- 7.81 Sections 312-315 seek to prevent payments of compensation for loss of office to directors unless the payment has been disclosed to and/or approved by shareholders. However, unlike section 315, section 312 does not provide for recovery of an unlawful payment, while section 313(2) provides that the unlawful payment should be held in trust for the company.
- 7.82 Our provisional view was that the same civil remedy should be inserted into sections 312 and 313 for the sake of consistency and in order to assist users in understanding the effect of a breach. We proposed that these sections should provide that the director is liable to account to the company for the benefit of the payment<sup>54</sup> and the directors who authorised it are liable to indemnify the company against any loss.<sup>55</sup> We also proposed that if the provisions are extended to cover payments to connected persons they should be liable in the same way as recipient directors.<sup>56</sup>
- 7.83 Our view was that under sections 312 and 313 recovery should be by the company of which the director was a director since (a) in the case of section 312 the company was the payer, and (b) in the case of section 313, regardless of whether the company was the payer, the company (or the totality of its members) would be the loser.
- 7.84 We asked consultees whether they agreed with our provisional view that sections 312 and 313 should be amended to provide for civil remedies on the lines described above.

### Summary of respondents' views

- 7.85 The overwhelming majority of respondents agreed with our provisional view. In a joint response, three respondents commented generally with regard to Part X that it is important that in each case, where there has been a breach of the relevant statutory provision, there should be a clear and adequate remedy available to the company and therefore to its liquidator, administrative receiver or administrator. It was also suggested that breaches of the sections should be expressly mentioned as being conduct for consideration under Schedule 1 to the Company Directors Disqualification Act 1986.<sup>57</sup>

### Recommendation

- 7.86 **We recommend that there should be statutory remedies as suggested in paragraphs 7.81 and 7.82 above, where a payment is received in breach of sections 312-6, and section 315 does not apply. We also recommend that a**

<sup>54</sup> This would correspond to the remedy in s 315.

<sup>55</sup> This would correspond to the remedy in s 322(3).

<sup>56</sup> Paper, paras 4.56 - 4.59.

<sup>57</sup> We do not think it is necessary to amend Sch 1 to the Company Directors Disqualification Act 1985, since receiving or retaining a payment in breach of these sections would, in our view, be a breach of duty covered by para 1 of Sch 1.

**provision similar to section 313(2) should for consistency be inserted into section 312. In addition, we recommend that there should be a separate section or group of sections setting out in one place the statutory civil remedies for breach of the provisions of Part X.<sup>58</sup>**

### **Consultation issue (2)**

- 7.87 Under Option 10 (Question 19) we also asked consultees for their views on another issue. We noted that if a company makes a payment which breaches section 312 in connection with a takeover offer, not only might the former shareholders have a claim under section 315, but the company might also have a claim under section 312 against relevant directors. We thought that a claim by the company in general should not take priority over a claim by former shareholders because, if so, the former shareholders might recover nothing. Accordingly, we suggested that section 315 might be amended so as to provide that, unless the court otherwise orders,<sup>59</sup> the claim of former shareholders under that section should prevail over that of any of the company under section 312 in respect of the same payment.<sup>60</sup>

### **Summary of respondents' views**

- 7.88 Almost all respondents agreed that the claim of former shareholders under section 315 should prevail over a section 312 claim by the company. No substantive arguments were put forward against that suggestion.

### **Comment**

- 7.89 The company might begin its proceedings first but we do not envisage that this would give rise to a practical difficulty. The court could be empowered to direct the company to give notice to the shareholders who would be entitled to bring a claim under section 315(1) to see if they in fact wish to bring any claim.

### **Recommendation**

- 7.90 **We recommend that, if the offeree shareholders seek to enforce their claims under section 315, their claim should prevail over any claim to which the company may be entitled arising out of the same facts, unless the court otherwise orders.**

## **FURTHER REFORMS OF SECTIONS 312-316 (QUESTION 22)**

### **Consultation issue**

- 7.91 We asked consultees whether any further reforms of sections 312-316 should be considered.

<sup>58</sup> See our discussion of a single code of remedies and effects in Part 15 below.

<sup>59</sup> The court might order otherwise if for instance the price paid to the offeree shareholders was calculated by reference to the company's assets, including this sum.

<sup>60</sup> Paper, para 4.59.

### **Summary of respondents' views**

- 7.92 A number of additional suggestions and comments were made in the course of the comments on other options. For example, it was suggested that sections 312-316 should be part of a broader statutory provision restraining uncovenanted benefits. One respondent weighed up the arguments for and against shareholder approval of directors' remuneration: on the one hand, that approval was needed because there was a conflict between the directors' duty to act in the best interests of the company and their interest in seeing that they are engaged on terms that are favourable to themselves; and, on the other hand, that directors must have some flexibility to be able to negotiate with potential executives in order to be able to secure the services of the "right person" at the "right time". On balance, the respondent concluded that directors' remuneration should not, generally, be subject to shareholder approval.
- 7.93 Another, general, suggestion was that the sections needed clarifying, and simplification. One respondent suggested that in considering together the questions on sections 312-316, a key feature was that all forms of compensation should be made the subject of disclosure under Part I of Schedule 6.
- 7.94 There was also a call for clarity in section 316(3) as to what might be a bona fide pension to a former non-executive (as against executive) director, as it was often difficult to find a yardstick. Another respondent questioned why section 316(3) excluded pension payments to which there is no pre-existing entitlement. The respondent suggested that pension payments of this nature should be treated in the same way as any other payment to which there is no legal entitlement.

### **Recommendation**

- 7.95 **Our general conclusion is that the basic principle in these sections is sound, but the sections need to be amended in accordance with our recommendations above.** We agree on the desirability of simplification. This, and the other suggestions, will be matters to be considered by the Company Law Review.

### **REPEAL OF SECTION 311 (PROHIBITION ON TAX-FREE PAYMENTS TO DIRECTORS) (QUESTION 92)**

#### **Consultation issue**

- 7.96 We also concerned ourselves as to whether there was a need for section 311 of the Act and, if not, whether it might be repealed.
- 7.97 Section 311 prohibits a company from paying a director remuneration free of income tax. It originated in a recommendation of the Cohen Committee that shareholders should be able to estimate the total amount of remuneration paid to a director before deduction of tax. We stated that it was difficult to follow the Cohen Committee's concerns as the tax which the company agreed to pay is itself taxed as part of the emoluments of a director and as the company is required to disclose in its annual accounts an estimate of the tax which it has undertaken to pay.<sup>61</sup> We

<sup>61</sup> Paper, para 9.30.



expressed the provisional view that section 311 should be repealed as we considered that shareholders were adequately protected by the disclosure provisions of Schedule 6 to the Act.<sup>62</sup>

#### **Summary of respondents views**

- 7.98 Respondents generally supported the repeal of section 311 although one respondent did not on the basis that they thought it undesirable that companies should enter into agreements to pay directors' remuneration which would vary according to income and tax liability of the director.<sup>63</sup>

#### **Recommendation**

- 7.99 **Our provisional view that section 311 may safely be repealed has not changed through consultation and accordingly we recommend its repeal.**

<sup>62</sup> Sch 6, para 1(3)(a).

<sup>63</sup> Faculty of Advocates.

# **PART 8**

## **SECTION 317: DISCLOSURE BY DIRECTORS**

### **INTRODUCTION**

- 8.1 In this Part we consider what is arguably one of the most important provisions in Part X for regulating conflicts of interest. Section 317 imposes a duty on a director of a company to disclose to the board of the company the nature of any interest, whether direct or indirect, which he has in a contract or proposed contract with the company. Failure to comply is a criminal offence, subject to a fine, but does not render the contract voidable or attract any other civil remedy.<sup>1</sup>
- 8.2 This means of regulation, involving disclosure rather than shareholder approval, is consistent with the “efficient disclosure” principle, as we have explained it,<sup>2</sup> and is supported by the results of the empirical research generally, which demonstrates the role which the law can play in encouraging disclosure.<sup>3</sup> In this case the disclosure is to the board rather than to shareholders. This is justifiable under the same principle, since declaration of interests in prospective contracts may often involve the disclosure of confidential commercial matters which should not be brought into the public domain through shareholder disclosure. In the economic analysis, this provision was categorised as a “penalty default rule”, the purpose being not necessarily to bar self-dealing, but to encourage the disclosure of information by the more knowledgeable party.<sup>4</sup>
- 8.3 In the Paper,<sup>5</sup> we summarised the effect of the provision and its history. As we explained, the section has to be seen in the context of other statutory and non-statutory rules relating to disclosure of directors’ interests. Of particular relevance is the rule under the general law that a director cannot vote on any matter in which he is interested without the informed consent of the shareholders.<sup>6</sup> This consent is given by articles of association in the form of Table A, provided any “material interest” is disclosed to the directors.<sup>7</sup> Failure to comply with this general rule in relation to a contract may lead to the contract being voidable at the instance of the company, but breach of section 317 probably does not lead to any remedy in damages for breach of statutory duty.<sup>8</sup>

<sup>1</sup> Paper, paras 4.78-80.

<sup>2</sup> Part 3 above.

<sup>3</sup> Section 9 of the empirical research report in Appendix B.

<sup>4</sup> Paper, paras 3.32-3.40.

<sup>5</sup> Paper, paras 4.62-4.82.

<sup>6</sup> *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cases 589; *Imperial Mercantile Credit Association v Coleman* (1871) 6 Ch App 558.

<sup>7</sup> Paper, paras 4.75-80.

<sup>8</sup> Paper, paras 4.77-8.

- 8.4 The Paper invited comments on 13 possible Options (Questions 23 to 35), Option 1 being “no change”. Particular issues addressed were the relationship between the section and other related rules, and the nature of any remedies. The latter issue necessarily overlaps with the general issue of “decriminalisation” of Part X, which has been omitted from the scope of our review.<sup>9</sup> To that extent our consideration of this issue must be provisional.

#### **NO CHANGE TO SECTION 317 (OPTION 1 - QUESTION 23)**

##### **Consultation issue**

- 8.5 We gave consultees the opportunity to express the view that the disclosure requirements were operating satisfactorily in practice, and that section 317 accordingly should be retained as it is.

##### **Summary of respondents’ views**

- 8.6 Although the responses generally supported the objectives of the section, and the need for a clear statutory rule, a large majority of respondents favoured amendment of one form or another.

##### **Recommendation**

- 8.7 **This general view accords with our own opinion (as reflected in the recommendations made below) and accordingly we do not further consider the “no change” option.**

#### **LIMITATION OF THE MATTERS REQUIRING DISCLOSURE (QUESTIONS 24, 25, 27-30 AND 33)**

- 8.8 In the Paper we asked a series of questions related to the same general theme: whether some limitation could be placed on the matters required to be disclosed, without prejudicing the objectives of the section.

#### **LIMITING THE DUTY OF DISCLOSURE TO MATERIAL INTERESTS ONLY? (OPTION 2 - QUESTION 24)**

##### **Consultation issue**

- 8.9 The issue is whether, as at present, a director should be under an obligation to disclose any interest, however trivial; and, if not, how any limitation should be defined.
- 8.10 As we explained in the Paper, the Jenkins Committee in 1962 recommended that disclosure be limited to “material interests”.<sup>10</sup> This recommendation was not implemented in the section; but it is reflected in Table A, the current version of which refers to disclosure of “the nature and extent of any material interest”.<sup>11</sup>

<sup>9</sup> Para 1.36 above.

<sup>10</sup> Paper, para 4.64.

<sup>11</sup> Paper, para 4.76.

Other common law jurisdictions have adopted similar limitations.<sup>12</sup> Similarly, the Listing Rules (in the context of restrictions on voting) refer to an interest of the director which “to his knowledge is a material interest”.<sup>13</sup> We also considered the problem of finding an acceptable definition of the term “material”.<sup>14</sup>

- 8.11 Accordingly, we asked consultees whether they considered that section 317 should only apply to material interests in a contract; and if so (a) whether “material” should be defined by statute, and (b) if so, whether it should mean those interests whose disclosure might reasonably be expected to affect the decision of the board or some other meaning.<sup>15</sup>

### **Summary of respondents’ views**

- 8.12 The balance of view among respondents was in favour of a limiting the obligation under section 317 to disclosure of material interests. Most of those supporting this view favoured a statutory definition, but there was no consistent view as to what that definition should be.
- 8.13 The most common reason given by those opposing the introduction of a materiality threshold was the difficulty of definition, particularly in the context of a section imposing a criminal penalty. The term “material” was said to be too vague;<sup>16</sup> and much would depend upon the individual circumstances of the company in question. Even some of those respondents in favour doubted whether a satisfactory definition was achievable, having regard to the variety of forms which an interest may take. There was also a view that such a limitation would leave too much discretion to the company and directors; it would be left to the director to decide whether such an interest is material and to disclose or not accordingly. This discretion could be abused by the unscrupulous.
- 8.14 Views were also expressed that the present scope of the section did not appear to have given rise to any difficulty in practice; and that the suggested amendment would not achieve its purpose, because the threat of prosecution would, in practice, induce directors to disclose all interests, whether material or not.
- 8.15 As to part (b) of the question, there was some support for the definition suggested by the Commissions, by reference to interests “whose disclosure might reasonably be expected to affect the decision of the board”.<sup>17</sup> Others thought that reference to the decision of the board was too narrow, since many relevant issues would not

<sup>12</sup> For example, “material personal interest” under the Australian Corporations Law s 232A (Paper, p 94 n 158) and s 191 as proposed to be substituted by clause 3 of the Corporate Law Economic Reform Programme Bill 1998. Similarly, the New Zealand Companies Act 1993 s139 (Paper, p 406), in a comparable context, defines “interested” by reference to phrases such as “material financial benefit” and “material financial interest”.

<sup>13</sup> Paper, para 4.81.

<sup>14</sup> Paper, paras 4.96-4.97.

<sup>15</sup> Paper, para 4.98.

<sup>16</sup> One respondent (John P Lowry (Brunel University)) referred to “covering the simplicity of [the section’s] orthodoxy under a crepuscular haze of conditional disclosure”.

<sup>17</sup> One of these respondents would only be in favour of introducing the proposed definition if s 317 were amended to include civil remedies.

reach board level. Alternative proposals were that the issue of materiality should be left to the courts; that it should be judged by reference to the positions of both company and director, or of the board and the director; or that a monetary threshold should be used.

### **Comment**

- 8.16 Disclosure under section 317 is an essential element in the statutory scheme for regulating conflicts of interest. We consider that there are two main aims of the section. The first is to ensure that the board is properly informed about any transaction it may be considering or for which as the board it has a supervisory responsibility. The second is to facilitate the monitoring by the board, as the organ of the company responsible for day-to-day management of the company's business, of conflicts of interests which directors may have. Those aims are not served by disclosure of interests which are immaterial to the board's consideration, and create no realistic possibility of conflict. In principle, therefore, it seems to us, as it did to a majority of the respondents, that the present section goes further than is necessary for the purpose of efficient disclosure.
- 8.17 On the other hand any limitation on the obligation in section 317(1) is open to abuse by an unscrupulous director and moreover the consequences of his failure to disclose may be very serious since the existence of the interest may not be discovered by the rest of the board until it is too late. Accordingly it seems to us that any limitation on the obligation of disclosure will have to be very restricted. That inevitably means that there will not be many cases where the director can be satisfied that he need not disclose. Indeed in some cases directors are likely to take the view that it is more cost-effective to disclose than to take advice on whether there is a need to disclose.
- 8.18 Another factor is that the limitation on the circumstances in which disclosure was required could not simply be left to the uninstructed judgment of the director in question. Some guidance has to be given<sup>18</sup> and it is to that question that we turn below. We do not think that it would be satisfactory to have a situation in which the opinion of the director could be challenged only if it was so unreasonable that no reasonable director could have concluded that the interest was not disclosable. The courts have to have power to hold that an interest was material and that the director breached the section by not disclosing it even if he acted in the mistaken belief that he was not bound to disclose it. It would however be open to the director to apply for relief under section 727 of the Act.<sup>19</sup>
- 8.19 We therefore turn to consider how materiality could be defined. Consideration of this issue cannot be wholly separated from the issue of remedies. As appears below we favour a civil rather than a criminal remedy for breach of section 317. If a criminal remedy is retained, more weight may need to be attached to the definition of an interest which needs to be disclosed.

<sup>18</sup> Although it is not defined in Table A or in the Australian legislation to which we refer in n 12 above.

<sup>19</sup> Section 727 empowers the court to grant relief in certain circumstances.

### **Defining materiality**

- 8.20 In the Paper we suggested that materiality could be defined in a number of ways without expressing any view as to which method would be appropriate. We agree with those consultees who considered that attention must be given to whether the interest was material in relation to the director as well as whether it was material in relation to the company. An example will illustrate the point. Suppose that the director wants the company to buy a small asset that he owns. The price may be insignificant when compared with other transactions normally considered by the board. However the transaction may be very important to the director when the price payable is compared with his personal net worth. That fact is relevant to the possibility of conflict, and therefore to the monitoring role of the board, whether or not it could be expected to affect the board's decision to proceed with the transaction itself.
- 8.21 In principle, therefore, the obligation should apply to all interests which are material in relation to either the company or the director. In reaching a decision as to materiality regard should be had to related transactions collectively so that the obligation cannot be avoided by dividing up a transaction into several different parts.
- 8.22 But how then is the materiality of the interest to the director and the company actually to be assessed? We do not think that materiality in these ways can be satisfactorily defined in purely financial terms. Nor do we think that any definition in purely financial terms would be easy for a director to apply. Difficulties would arise with the valuation of assets such as his pension policies and his home and with the quantification of liabilities under guarantees. In the case of a very high net worth individual, the court may form the view that his interest ought to be treated as material even though it did not reach the level in relation to his net worth that it would have to reach in relation to the net worth of others. In short materiality cannot be exhaustively defined.
- 8.23 Who should then be the judge of whether an interest is material or not? For the reasons explained above the approach to any limitation on the obligation of disclosure has to be a cautious one. In those circumstances, we consider that the court will have to be the final arbiter of whether an interest should have been disclosed or not. Moreover we consider that the burden of showing that an interest need not be disclosed should lie on the director.
- 8.24 The test of materiality has been used in other contexts in the Companies Acts, such as section 152(1)(a)(iv) (meaning of "financial assistance") and Schedule 6 which we consider in paragraphs 13.2-13.11 below. It has given rise to difficulty and we therefore consider that in the context of section 317 it would be better not to attempt to define "material", but instead to provide that the obligation of disclosure should not apply if, by reason of the nature or extent of the interest or any other factor which the court thought relevant, the court was satisfied that the interest was such that it did not give rise to any *real* risk of an *actual* conflict of interest.
- 8.25 To confine the duty of disclosure of interests to situations where there was a real risk of actual conflict would for example exclude theoretical or fanciful risks or risks that could result in an actual conflict in a very remote contingency. In this

connection we adopt the words of the Lord Millett in *Prince Jefri Bolkiah v KPMG (a firm)*<sup>20</sup> in reference to the duty of a solicitor not to act in a way that might appear to put confidential information at *risk* of coming into the hands of someone with an adverse interest. Lord Millett said:

Many different tests have been proposed in the authorities. These include the avoidance of 'an appreciable risk' or 'an acceptable risk'. I regard such expressions as unhelpful: the former because it is ambiguous, the latter because it is uninformative. I prefer simply to say that the court should intervene unless it is satisfied that there is no risk of disclosure. It goes without saying that the risk must be a real one, and not merely fanciful or theoretical. But it need not be substantial.<sup>21</sup>

8.26 Some examples may be given of the type of case where the provision would apply. A director may have a very minor interest in another company. The company of which he is a director then decides to enter into a contract with this company. No disclosure under section 317 is made. The new provision would enable the court to disregard this small interest if it was satisfied that it would have had no influence on him. Another example is where he is a director of say a charitable trust which has delegated the management of its investments to a professional financial intermediary. The director may as such trustee have shares in a company with which the company of which he is a director decides to contract. The court may take the view that, because responsible investment managers had discretion and in practice the director would not have sought to interfere with that discretion and would not have been influenced in his actions as a director by the fact that he was entitled as a trustee to these shares, the interest did not create any real risk of conflict between his duties as a charitable trustee and his duties as a director.

8.27 The limitation of the disclosure obligation in this way seems to us a practical way to exclude from section 317 trivial interests. It would, however, mean that section 317 did not in relation to disclosure by a director to his board go as far as the law is traditionally said to go in relation to the disclosure of conflicts of interests by a trustee.<sup>22</sup> For example in *Bray v Ford*,<sup>23</sup> Lord Herschell said:

It is an *inflexible* rule of a Court of Equity that a person in a fiduciary position, such as the respondent's, is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict. It does not appear to me that this rule is, as has been said, founded upon principles of morality. I regard it rather as based on the consideration that, human nature being what it is, there is danger, in such circumstances, of the person holding

<sup>20</sup> [1999] 1 All ER 517.

<sup>21</sup> *Ibid*, at p 528.

<sup>22</sup> There is however controversy about the extent of the rule on conflicts of interest: see *Boulting and Another v Association of Cinematograph, Television and Allied Technicians* in para 8.28 below and *Queensland Mines Ltd v Hudson* (1977-1978) 3 ALCR 176, in which the Privy Council expressed the view that there had to be a sensible possibility of conflict between a director and his company for a director to be liable to account for a corporate opportunity which he had diverted to himself. On this case generally see *Gower's Principles of Modern Company Law*, (1997) 6 ed, page 620.

<sup>23</sup> [1896] AC 44, 51-52.

a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those whom he was bound to protect. It has, therefore, been deemed expedient to lay down this positive rule. But I am satisfied that it might be departed from in many cases, without any breach of morality, without any wrong being inflicted, and without any consciousness of wrongdoing. (emphasis added)

- 8.28 On the basis of authorities such as these it will be objected to any lessening of the disclosure obligation in section 317 that it runs dangerously counter to the policy in the rule of equity and that the rule of equity is a strict one so as to ensure compliance by a fiduciary with this obligation to disclose. However the rule of equity has not always been regarded as inflexible. For instance it has also been said from time to time the conflict must be a real one. In *Boulting and Another v Association of Cinematograph, Television and Allied Technicians*,<sup>24</sup> Lord Justice Upjohn said of this rule:

[A] broad rule like this must be applied with common sense and with an appreciation of the sort of circumstances in which over the last 200 years and more it has been applied and thrived. *It must be applied realistically to a state of affairs which discloses a real conflict of duty and interest and not to some theoretical or rhetorical conflict.* It is quite unnecessary to invoke the rule in the case of a director who takes too long a holiday or stays at too expensive an hotel; that is just a plain breach of his duty to serve the company faithfully. So in the case of a director who negotiates too high a salary, the rule does not come into play, for I assume, of course, that the articles permitted the appointment of a managing director at a salary; the company have pro tanto relaxed the rule and are prepared to let the director negotiate a salary and, perhaps, even to vote on its amount in the board room. If the articles do not so permit, of course he must disgorge. But it would be quite wrong to attempt any definition of the ambit of the rule. It is there, firm and untrammelled, waiting to be applied to the changing times and conditions of the times as circumstances may require...<sup>25</sup> (emphasis added)

- 8.29 Later, in the celebrated case of *Phipps v Boardman*,<sup>26</sup> Lord Upjohn, dissenting on the facts, after citing *Bray v Ford*<sup>27</sup> said:

It [the rule of equity] is perhaps stated most highly against trustees or directors in the celebrated speech of Lord Cranworth LC in *Aberdeen Railway v Blaikie* ([1843-60] All ER Rep at p 252) where he said:

“And it is a rule of universal application, that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect.”

<sup>24</sup> [1963] 2 QB 606, 637-8.

<sup>25</sup> At p 638.

<sup>26</sup> [1967] 2 AC 46, 124.

<sup>27</sup> [1896] AC 44.



The phrase “possibly may conflict” requires consideration. In my view it means that the reasonable man looking at the relevant facts and circumstances of the particular case would think that there was a real sensible possibility of conflict; not that you could imagine some situation arising which might, in some conceivable possibility in events not contemplated as real sensible possibilities by any reasonable person, result in a conflict.

- 8.30 Thus the departure from the disclosure obligation which we recommend is not as revolutionary as might at first appear. It seems to us to have the advantage of enabling a realistic and more flexible view to be taken of conflicts of interests.
- 8.31 In addition to this limitation on the disclosure obligation we also consider that there should be no obligation to make disclosure in accordance with the section where all the directors already know of the nature and extent of the director’s interest. This was the basis on which, as we explained in the Paper,<sup>28</sup> the court in *Runciman v Walter Runciman plc*<sup>29</sup> held that there was no requirement for disclosure in the manner required by section 317. Thus we recommend the obligation to make disclosure would not apply in this situation either. Again we recommend that the burden of proof should be on the director.
- 8.32 In paragraphs 8.55 to 8.57 below we consider a further case in which in our view the disclosure obligation should not apply, that is where the director had no knowledge of his interest and could not reasonably have been aware of it. Again the burden of proof would be on the director.

### **Recommendation**

- 8.33 **Accordingly, we recommend that we exclude from the disclosure obligation in section 317 immaterial interests by providing that the section should not apply where:**
- (1) the director satisfies the court that the interest did not give rise to a real risk of an actual conflict of interest between his position as the holder of that interest and his position as a director of the company; or**
  - (2) the director satisfies the court that the rest of the board were aware of the nature and extent of his interest before the directors approved the transaction.<sup>30</sup>**

<sup>28</sup> Paper, paras 4.88 to 4.90.

<sup>29</sup> [1992] BCLC 1084.

<sup>30</sup> It occurred to us that there is a further situation where prima facie a defence ought to be available, that is where a director knows of his interest, but not that the company is proposing to enter into the transaction (e.g. because he is posted abroad and under the company’s articles is not entitled to receive notices of board meetings). However we do not make any recommendations on this as it arose only at a late stage in the preparation of our report. As we do not have any views from respondents on this point, we draw it to the attention of the Company Law Review and request them to consider it. This example highlights the possibility that there may be other cases where the disclosure obligation in s 317 should be qualified. In the Paper we asked consultees for their view on a suggestion

- 8.34 In many companies the articles permit the directors to vote at board meetings on transactions in which they are interested if they have disclosed their interests in accordance with section 317.<sup>31</sup> For this reason in our view it is important that any legislation to enact our recommendations should be drafted on the basis that in these situations the obligation to disclose does not arise.

#### **EXEMPTION FROM DISCLOSURE OF TRANSACTIONS WHICH ARE NOT CONSIDERED BY THE BOARD? (OPTION 3 - QUESTION 25)**

##### **Consultation issue**

- 8.35 We noted that the director's duty to disclose an interest in a contract under section 317 has been held to be a general obligation applying to all contracts and not only those that come before the company's board.<sup>32</sup> In many large companies only contracts of very high value or policy importance require board approval. Limiting the duty of disclosure to contracts that come before the board only might result in insufficient protection or information for creditors or members.
- 8.36 We therefore asked consultees whether they agreed with our provisional view that section 317 should *not* exempt directors from the need to disclose their interests in transactions or arrangements which either do not come before the board, or a committee of the board, or do not require approval by the board, or a committee of the board.<sup>33</sup>

##### **Summary of respondents' views**

- 8.37 All of those who responded to this question agreed with the Commissions' provisional view.<sup>34</sup> Some suggested that, where a contract is not considered by the full board, a director should be allowed to give written notice of his interest as an alternative to disclosure at a full board meeting. It was suggested that such a notice might be given to the company secretary, who would be under an obligation to distribute it to all directors. It was also suggested that notification to the secretary should suffice for directors abroad.

that, to meet this sort of situation, a transaction or arrangement should only be voidable unless the court otherwise directs. As we explain below this was supported by the majority of respondents and we refer to it in para 8.99 below. However this would still leave the director and connected person liable to account for profits or to indemnify the company for any loss though under our recommendation this would only be to the extent that the court thought fit and (in the case of a director) if this recommendation was not adopted the director could apply for relief under s 727 of the Act. We think that the better solution for the situation where the disclosure obligation ought to be qualified would be to include a residual category of case where the obligation of disclosure would not apply if the court for some other reason thought fit.

<sup>31</sup> See e.g. Table A, article 85. This article refers to material interests, and it may be appropriate to bring this article into line with s 317 if our recommendations are implemented.

<sup>32</sup> See *Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald* [1995] 1 BCLC 352, *per* Lightman J at p 359f-h.

<sup>33</sup> Paper, paras 4.98-4.101.

<sup>34</sup> As one respondent observed, disclosure to the board of a potential conflict might in fact lead them to require the matter to be brought before the board or a committee of the board.

### **Recommendation**

- 8.38 **In accordance with those views, we recommend that section 317 should continue to require disclosure of interests, whether or not the transaction comes before, or requires the approval of, the board or a committee of the board.**
- 8.39 We agree with the suggestion that, in the absence of a board meeting, section 317 should permit notice to be given to the secretary for circulation to directors.<sup>35</sup> By analogy with the time-limits in section 317(2), notice should be given so as to reach directors not later than the first board meeting after the director becomes aware that the contract is under consideration, or, if later, after he becomes interested in it. The declaration of interest should be included in the minutes of that board meeting.
- 8.40 The giving of notice to directors who are abroad is a matter to be regulated by the articles of association.

### **EXEMPTION FROM DISCLOSURE OF INTEREST IN DIRECTOR'S OWN SERVICE AGREEMENT? (OPTION 5 - QUESTION 27)**

#### **Consultation issue**

- 8.41 A director's interest in his own service agreement falls squarely within section 317, but it might be thought that the interest is so obvious as to make disclosure unnecessary.<sup>36</sup> Other protections are provided by existing law, which requires that a director's service contract is made available for inspection by members<sup>37</sup> and which regulates its length<sup>38</sup>. Our provisional view was that section 317 should exempt directors from the need to make formal disclosure of their interest in their own service contracts and we asked consultees for their opinion on this.<sup>39</sup>

#### **Summary of respondents' views**

- 8.42 Most of those who responded to this question agreed with our provisional view that a director should not need to disclose an interest in his own service contract. One such response was conditional on changes being made to sections 318 and 319. Some suggested extending the exemption to any contract to which the director is a named party or where his interest is clear from the face of the contract.
- 8.43 A few disagreed with our provisional view. The view was expressed that section 317 provides a necessary degree of formality, in a situation where the company is likely to be at a disadvantage compared to an arms' length bargain. Such formality is achieved by ensuring that service contracts have to be an item of business at a

<sup>35</sup> Para 8.37 above.

<sup>36</sup> That was the view taken in *Runciman v Walter Runciman plc* [1992] BCLC 1084.

<sup>37</sup> Section 318.

<sup>38</sup> Section 319.

<sup>39</sup> Paper, para 4.102.

board meeting. This safeguard should not be abandoned without considering a suitable replacement.

### **Recommendation**

- 8.44 In accordance with our provisional recommendation, supported by a clear majority of respondents, **we consider that section 317 should be subject to an exception for the interests of directors in their own service agreements.** The exception should apply to any contract of service or services where the other contracting party is the director himself. It should not, for example, apply where the contract is made with a company which agrees to supply the services of the director, since in such a case the director's interest might not be so obvious.
- 8.45 We accept, however, that the exception needs to be qualified in cases where the board may be unaware that a service contract is being granted. Thus, if the chief executive approved the terms of the contract without a resolution of the board, the board might not hear about it (although the benefits payable under it would have to be disclosed in the next annual accounts). Accordingly, we recommend that the exception should be limited to interests in service agreements which are considered by the board or a duly authorised committee of the board.

### **EXEMPTION FROM DISCLOSURE OF INTEREST IN ARRANGEMENTS FOR BENEFIT OF ALL EMPLOYEES? (OPTION 6 - QUESTION 28)**

#### **Consultation issue**

- 8.46 In the Paper we said that where a director is an employee of the company and the benefit under consideration by the board is one which is ordinarily made to the company's employees and on terms no less favourable, there seems little point in that director disclosing his interest to the board. Indeed, all of the company's executive directors are likely to be interested in the same contract and their interests will be obvious to all.
- 8.47 Accordingly, we asked consultees whether there should be an exemption from disclosure under section 317 for benefits which a director receives which are ordinarily made to employees on terms no less favourable. We did not express a provisional view.<sup>40</sup>

#### **Summary of respondents' views**

- 8.48 There was only marginal support for this proposal. There were suggestions that such arrangements might be covered by the exemptions already considered for immaterial interests, or for contractual entitlements under the director's service contract; or by a general exemption for contracts where the existence of the director's interest was clear from their face. Some thought that "no less favourable" was too vague a criterion, or that whether the benefit was available to *all* employees might be a difficult fact to determine.

<sup>40</sup> Paper, para 4.103.

## **Recommendation**

- 8.49 We accept that such an exception could be difficult to apply in some cases. For example, would a benefit which was available only to full-time employees qualify? Given these potential difficulties, and in view of the lack of clear support, **we do not recommend exemption from disclosure of interests in arrangements for the benefit of all employees.**

## **EXEMPTION OF INTERESTS BY REASON OF A DIRECTORSHIP OF, OR NON-BENEFICIAL HOLDING IN, ANOTHER GROUP COMPANY? (OPTION 7 - QUESTION 29)**

### **Consultation issue**

- 8.50 The next issue concerns disclosure of a director's interests in another group company. In the Paper we mentioned the suggestion that an exemption would be useful where cross-guarantees are being taken from several members of a group in connection with banking facilities. The suggestion was intended to avoid the need for disclosure where, for example, a holding company was intending to make a contract with a subsidiary with common directorships. However, we were provisionally against such an exemption, because of the possible divergence between the interests of the different companies, and the consequent risk of detriment to creditors.<sup>41</sup>
- 8.51 We asked consultees:
- (1) whether they agreed with our provisional view that there should *not* be excepted from disclosure under section 317 interests which a director has by reason only that he is a director of another company in the same group or has a non-beneficial shareholding in it?
  - (2) if consultees disagreed, whether they considered that this exception should only apply to directorships and shareholdings in (a) wholly-owned subsidiaries, of (b) all subsidiaries (whether or not wholly-owned)?<sup>42</sup>

### **Summary of respondents' views**

- 8.52 The majority of those who responded to this question agreed with our provisional view. Those taking a different view considered that, in relation to transactions between connected companies, the interests ought to be well known to the board. As to the second part of the question, most respondents considered that the exception should apply to all subsidiaries whether or not wholly-owned, although some would limit it to wholly-owned subsidiaries. There were also proposals to limit the nature of the interests to which the exception would apply: for example, to interests held by reason only of the directorship of a wholly-owned company in the same group, or solely in relation to the director's shareholding in the holding company.

<sup>41</sup> Paper, para 4.104.

<sup>42</sup> *Ibid.*

### **Recommendation**

- 8.53 In the light of the responses, we stand by our provisional view. Although in many cases the interests may be well known to the boards of all the companies concerned, the possibility of conflict between the interests of the different companies justifies a specific obligation on a common director to report separately to each.<sup>43</sup> The second suggestion does not therefore arise.
- 8.54 **Accordingly, we do not recommend that there should be exempted from disclosure under section 317 interests which a director has by reason only that he is a director of another company in the same group or has a non-beneficial shareholding in it.**

### **EXEMPTION OF INTERESTS OF WHICH DIRECTOR HAS NO KNOWLEDGE? (OPTION 8 - QUESTION 30)**

#### **Consultation issue**

- 8.55 We considered that a director should not be at risk for failure to disclose interests of which he could not be expected to be aware. Table A Art 86(b) excludes from the definition of interests those of which the director has no knowledge and of which it is unreasonable to expect him to have knowledge. Our provisional view was that such interests should be exempt from disclosure under section 317.<sup>44</sup> We asked consultees for their opinion.<sup>45</sup>

#### **Summary of respondents' views**

- 8.56 Almost all those who responded to this question agreed with the Commissions' provisional view that there should be an exemption in these circumstances. One respondent agreed with the provisional view provided that the interest is disclosed immediately the director knows of it, or could have reasonably found out. Another respondent warned against those cases where a director may deliberately set up an arrangement such as a "blind" trust or some financial instrument in association with a connected person.

### **Recommendation**

- 8.57 **In the light of the strong support from respondents, we recommend an exemption from disclosure under section 317 of interests of which the director has no knowledge.**<sup>46</sup> We agree that the exemption should only apply so long as the lack of knowledge or opportunity for knowledge continues. Artificial arrangements of the kind mentioned would be open to challenge in any event.

<sup>43</sup> However, the defences which we recommend in para 8.33 may be available.

<sup>44</sup> This is the same as a recommendation made by the Jenkins Committee in 1962 (Paper, para 4.64).

<sup>45</sup> Paper, para 4.105.

<sup>46</sup> The burden of proof would be on the director: para 8.32 above.

**DISCLOSURE OF MATERIAL INTERESTS OF CONNECTED PERSONS?  
(OPTION 11 - QUESTION 33)**

**Consultation issue**

- 8.58 Section 317 recognises that a director's judgment may be affected by the interests of those connected with him.<sup>47</sup> Section 317(6) makes it clear that where the transaction is a loan, or some other transaction to which section 330 applies, the director is always treated as interested in it if a connected person of his is interested in it. The position in relation to other forms of transaction is less clear. The provision which allows general notices by a director of his interests in contracts with specified companies,<sup>48</sup> also provides for such notices in relation to contracts with specified connected persons;<sup>49</sup> but it is not clear from the remainder of the section if a director would be taken to be interested in a transaction merely because of such an interest of a connected person.<sup>50</sup> It may be that it will depend on the circumstances whether a director is to be regarded as indirectly interested in, say, a contract in which his wife is interested.
- 8.59 We provisionally considered that, to resolve the uncertainty, section 317 should be amended to provide that a director should disclose the interests of connected persons if he is aware of them and if they would have to be disclosed if they were interests of his.<sup>51</sup> We asked for views on this proposal.

**Summary of respondents' views**

- 8.60 Nearly all of those who responded to this question agreed with the Commissions' provisional view. One suggested that the director's obligation should be limited to "any interest of which he might be reasonably aware".
- 8.61 A contrary view was that the proposed clarification might have the effect of limiting the scope of the section. It was suggested that the reference in section 317 to directors who are "in any way, whether directly or indirectly, interested" was already wide enough to require a director to disclose the interests of connected persons, and probably wider than the specific disclosure as proposed. Enforcement was also thought to be a possible problem, since it would be difficult to show what a director knew about the interests of connected persons.

**Recommendation**

- 8.62 **In line with the majority of responses we confirm our provisional recommendation that section 317 should provide that a director should disclose the interests of connected persons if they would have to be disclosed if they were interests of his.** We agree that the obligation should be limited to interests of which the director is aware or should reasonably be aware, but this would be achieved by the recommendation in response to Question 30

<sup>47</sup> Section 346 contains a list of connected persons.

<sup>48</sup> Section 317(3).

<sup>49</sup> Section 317(3)(b).

<sup>50</sup> Paper, para 4.115.

<sup>51</sup> *Ibid.*

above.<sup>52</sup> There may be problems of enforcement in particular cases, but these are no different to those which may already arise in relation to indirect interests. We accept that the drafting would need to say that it is without prejudice to the existing obligation in respect of indirect interests.

## **SHOULD THERE BE A REGISTER OF DIRECTORS' INTERESTS? (OPTION 13 - QUESTION 35)**

### **Consultation issue**

- 8.63 In the Paper we discussed the possible merits of a move towards a general principle of disclosure to shareholders of information concerning self-dealing and directors' contracts. We discussed the advantages of a more consistent approach towards the imposition of disclosure and ratification requirements in cases of self-dealing, and the beneficial effects on standards of corporate behaviour.<sup>53</sup> We noted, however, that some of the same ground is covered by existing requirements for disclosure in the annual accounts.<sup>54</sup> It was also desirable to avoid disclosure of information which is not useful to shareholders in performing their monitoring function, and unwarranted cost burdens.
- 8.64 Accordingly, we asked consultees whether there should be disclosure of section 317 interests to shareholders by means either of (i) a register of directors' interests which would be open to inspection by shareholders, or (ii) a report in the annual accounts of the nature of interests which directors had disclosed. We envisaged that the register would be available for inspection by members at the same times and in the same places as the section 318 register, but that, as not every member would wish to or be able to inspect the register, it might also be desirable to report to members on the interests declared. We also asked consultees whether, if there were to be a register or report, there should be an exemption from disclosure for information which the directors reasonably consider it would be harmful to the company to disclose and whether any information disclosed in the register or report should be audited.<sup>55</sup>

### **Summary of respondents' views**

#### ***(1) Register of directors' interests***

- 8.65 The balance of responses was in favour of a register of directors' interests. It was thought it would improve transparency and discipline, and help good housekeeping. However, there was a general view that the register should not be available for inspection by members, in the interests of commercial confidentiality.
- 8.66 Among those who were against the proposal, there was a view that disclosure of directors' interests is a matter of management, often confidential, and should not involve the shareholders except to the extent already required by Schedule 6 to the

<sup>52</sup> Para 8.57 above.

<sup>53</sup> Paper, paras 3.71-3.72 and 4.117.

<sup>54</sup> Schedule 6, Part II, paras 15(c) and 16(c). We also referred to disclosure requirements in the Listing Rules and FRS 8 (Paper, para 4.118).

<sup>55</sup> Paper, para 4.118.



Act. It was thought that it would be yet another register rarely inspected by shareholders, and that, as it would have to exclude confidential information, it would be a patchy register that would not serve the purpose of disclosure. Another respondent described the proposals for disclosure to shareholders as over-cumbersome, burdensome and undesirable.

***(2) Report in annual accounts of the nature of interests disclosed***

- 8.67 Opinion was divided as to whether there should be a report to shareholders in the annual accounts of the nature of interests which directors had disclosed. An alternative suggestion was to require the inclusion of a statement drawing attention to the register and setting out the right of members to inspect it. The contrary view was that the general law, requiring disclosure of all information material to shareholders' decisions, taken with other existing disclosure requirements (such as Schedule 6 and FRS 8) was adequate. There was concern that any disclosure should be limited to material interests and to actual (rather than proposed) contracts.

***(3) Exemption from disclosure for information which may be harmful to company to disclose***

- 8.68 The majority of respondents to this question were in favour of an exemption from disclosure if the directors reasonably considered it would be harmful to the company. To avoid abuse, it was suggested that shareholders might be able to challenge non-disclosure in court proceedings and that there could be a role for audit in ensuring that directors act reasonably. It was also suggested that guidance would be needed as to what could be exempted from disclosure, and that "harm" would need to be defined.

***(4) Audit of information in register or report***

- 8.69 Most respondents were against the idea of auditing the information disclosed in the register or report, some on grounds of cost, others of feasibility. It was thought impractical to audit the completeness and accuracy of the information given in the register.

**Recommendation**

- 8.70 We are in favour of the introduction of a requirement to keep a register of directors' interests; but not of any further requirement for disclosure in the annual accounts, which we think would add unnecessarily to the burden of existing requirements. Such a register, as well as encouraging discipline and good housekeeping, would allow other directors, including non-executive directors, access to reasonably comprehensive information on the interests of fellow directors.<sup>56</sup> Access to this information from previous accounts or past board minutes may be difficult and the disclosure of interests will not be comprehensive.
- 8.71 The arguments as to whether the register should be open to shareholders are finely balanced. On the one hand, we are influenced by the view of the majority of

<sup>56</sup> Although we have not in this review dealt in detail with the position of non-executive directors, we anticipate that they may have an increased monitoring role in the future.

respondents who think that a register would be useful for shareholders, who will not have access to board minutes containing notices of interests by directors under section 317. Disclosure in the accounts (under Schedule 6, Part II) is retrospective; further, it relates to disclosure of interests in existing contracts only and not proposed contracts as under section 317.

- 8.72 On the other hand, the proposal may be said to blur the distinction between the separate roles of directors and shareholders. The purpose of disclosure to the board under section 317 is to inform the *board* that the interested director's views may be influenced by an interest in a contract or proposed contract. We see force in the views expressed that disclosure to the board is a matter of management, and that the declarations are, in effect, part of the proceedings of the board rather than a matter for shareholders. Disclosure in the annual accounts enables shareholders to monitor the board's stewardship of the company.
- 8.73 We are also impressed by the views of several respondents that much of the information would be confidential and would have to be excluded from a register. Interests in proposed contracts are likely to be particularly commercially sensitive. This calls into doubt whether a register would provide any additional substantive information beyond the disclosures in the annual accounts required by Schedule 6, Part II. We also note the concern of some respondents that exemptions for confidential information may involve subjective judgment and may be open to abuse.
- 8.74 On balance, and for the reasons expressed, we think the register should not be open to inspection by shareholders.
- 8.75 **Accordingly, we recommend the introduction of a requirement to keep a register of directors' interests but do not recommend that the proposed register should be open to inspection by shareholders.<sup>57</sup> We also recommend against any further requirement for disclosure in the annual accounts.** In view of our recommendations, the questions on exempting information which may be harmful to the company and whether to audit information disclosed are no longer relevant.

#### **HOW SHOULD SECTION 317 DEAL WITH SOLE DIRECTOR COMPANIES? (OPTION 4 - QUESTION 26)**

##### **Consultation issue**

- 8.76 The obligation under section 317 of a sole director to disclose his interests to himself was considered and confirmed by Lightman J in *Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald*.<sup>58</sup> He saw the object of the section as being to ensure that the declaration was "a distinct happening at the meeting which therefore must be recorded in the minutes"; the reminder and record would have "enhanced value

<sup>57</sup> The Company Law Review may wish to consider generally the creation of a new shareholder right to some inspection of a company's books. See for example ss 319 and 320 of the Australian Corporations Law.

<sup>58</sup> [1995] 1 BCLC 352 (See Paper, paras 4.91-4.92 and 4.100).

and importance in case of a sole director, where there are no other directors to witness or police his actions”.<sup>59</sup>

- 8.77 In the Paper we asked whether this obligation served any useful purpose and referred to criticisms by some academics of the *Neptune* case. We saw force in these criticisms. We considered that the obligation was unlikely to have any practical effect on the decision itself, but acknowledged that it might facilitate record keeping and thus the process of liquidation, in the event of insolvency.<sup>60</sup>
- 8.78 Our provisional view was that in a sole director company there should be no obligation on a director to make any disclosure to the board. On the other hand, we considered that it would be appropriate for this information to be made available to shareholders. We proposed that this should be by way of a register of directors’ interests and a report in the annual accounts (a proposal which would apply to all companies, and is considered above).<sup>61</sup> If that proposal were not to be adopted, we proposed a requirement for the sole director to disclose interests to the company in general meeting, subject to a power to waive or vary this duty by resolution or in the articles.
- 8.79 Accordingly, we asked consultees to comment on our provisional views:
- (1) that section 317 should not apply where there is only one director; and
  - (2) that if our proposal for a register of directors’ interests were not to be accepted, there should be a requirement for a sole director to disclose interests to the company in general meeting (subject to waiver or variation by resolution or in the articles).

### **Summary of respondents’ views**

#### ***(1) Should section 317 apply to sole directors?***

- 8.80 Most of the respondents to this question agreed with our provisional view that section 317 should not apply to a sole director. A contrary view was that it was wrong to dispense with a legal duty merely because a company has in place an inadequate number of directors to discharge its obligations as intended. The comment was also made that in *Neptune*,<sup>62</sup> where the sole director was not a controlling shareholder, the obligation proved a useful additional weapon to attack a transaction that was clearly against the company’s interests.
- 8.81 There was agreement, among supporters and opponents, that there should be some record of the interest (whether by written resolution, minutes, or a register). This information might be important for a number of purposes, such as for a

<sup>59</sup> *Ibid*, at p 359.

<sup>60</sup> Paper, para 4.101.

<sup>61</sup> Para 8.63ff above.

<sup>62</sup> See para 8.76 above.

section 459 petition,<sup>63</sup> in a liquidation, in disqualification proceedings, or for other future directors.

***(2) Should a sole director disclose his interests to the company in general meeting?***

- 8.82 Most of the respondents to this question agreed with our provisional view that, if there is to be no register of directors' interests, the sole director should disclose his interests to the company in general meeting.
- 8.83 Some respondents questioned the practical benefit of such disclosure, since it is probable that the single director will also command a majority of the company's shares. Another view was that disclosure to shareholders would not assist the function of section 317, seen as being to ensure that the board is aware of interests which may influence decisions of one of their number. Other comments were that there should be no need to disclose to members in cases where their prior or subsequent approval is not required; that, if shareholders allow a sole directorship, they should accept the consequences; and that the proposal drew an unwelcome distinction between sole director companies and those with several directors.
- 8.84 Questions were raised about the timing of the disclosure to shareholders. Waiting until the next general meeting might be too late. On the other hand premature disclosure of proposed contracts might breach commercial confidence. Problems of premature disclosure could be met by limiting disclosure to interests in actual (rather than prospective) contracts; or by allowing the obligation to be disapplied by explicit resolution of shareholders in advance combined with retrospective disclosure.
- 8.85 There were a number of comments on our proposal that shareholders might waive or vary the requirement. It was suggested that, if such a provision could be excluded by the articles, it would be excluded by most standard forms. Others proposed that there should be no power to make such exceptions to the requirement, or that the power should be restricted. One respondent thought that, if section 317 remained a criminal provision, the requirement could not be waived, except by statute.

**Comment**

- 8.86 There is a wide measure of agreement that section 317 should not apply to directors who are sole directors.<sup>64</sup> We do not think that the retention of the requirement for disclosure in such a case can serve any useful purpose as it provides no new information to the director. The mere possibility that a director's non-compliance will afford possible ammunition in a future liquidation seems an inadequate basis for the requirement. On the other hand we accept that there

<sup>63</sup> Petition by a member on the grounds of unfairly prejudicial conduct of the company's affairs.

<sup>64</sup> Section 191(5) of the Australian Corporations Law as proposed to be substituted by the Corporate Law Economic Reform Programme Bill 1998 states that the director's duty to disclose material personal interests to the board does not apply to a proprietary company with only one director. Our recommendation, however, would apply to all companies, whether public or private.

should be a record of the interest, which should be recorded in a written memorandum or in the minutes of the next director's meeting,<sup>65</sup> or (if our recommendation above<sup>66</sup> is accepted) in the register of directors' interests.

- 8.87 As to the second part of the question, our preference is for a register of interests but we recommend that it should not be available to shareholders.<sup>67</sup> For the same reasons that we recommend against making a register of interests available to shareholders, we recommend against a sole shareholder disclosing his interests to the company in general meeting. These are that disclosure under section 317 is to the remainder of the board (if any), as a matter of management. Disclosure to shareholders, on the other hand, is to enable them to monitor the board's stewardship of the company and it is already required to be disclosed in the annual accounts under Schedule 6, paragraphs 15(c) and 16(c). Further, disclosure of prospective contracts to shareholders may breach confidence and would therefore have to be excluded. This calls into question whether disclosure in general meeting would provide any additional substantive information beyond disclosure in the annual accounts.

### **Recommendation**

- 8.88 **To summarise, our recommendation is that a sole director should be exempt from the requirements of section 317, but that the director's interest should be recorded in the register of directors' interests which we recommend above, or, if that recommendation is not accepted, in a written memorandum or minutes of the next director's meeting. We do not recommend that a sole director should disclose his interests to the company in a general meeting.**

### **DISQUALIFY DIRECTORS OF PUBLIC COMPANIES FROM VOTING ON MATTERS IN WHICH THEY HAVE AN INTEREST OR A MATERIAL INTEREST? (OPTION 10 - QUESTION 32)**

#### **Consultation issue**

- 8.89 We raised for consideration whether directors of a public company should be prevented from voting on matters in which they are interested. We observed that this is the case in Australia, although this prohibition may be lifted by the board.<sup>68</sup> We noted that, in the United Kingdom, this matter is left to be dealt with by the articles, which, in the case of a listed company, must prohibit (subject to specified exceptions) an interested director from voting in respect of matters in which he has a material interest. In relation to smaller companies, we noted evidence of difficulties in recruiting non-executive directors, which might be exacerbated by further voting restrictions.

<sup>65</sup> As under s 322B, which requires such a record of contracts of sole members who are directors.

<sup>66</sup> Para 8.75 above.

<sup>67</sup> *Ibid.*

<sup>68</sup> Paper, para 4.93, referring to s 232A of the Australian Corporations Law.

- 8.90 The question we put to consultees was whether they consider that the Act should prohibit directors of public companies from voting on matters in which they have a material interest and, if so, whether there should be any exceptions to the general rule.

#### **Summary of respondents' views**

- 8.91 The balance of opinion was marginally against this proposal, on the grounds that the issue should be left to the general law, the rules of any relevant investment exchange (such as the Listing Rules) and the company's articles of association. On the other side, one respondent suggested that the prohibition should apply to all companies and not just public companies. Some respondents supported the proposal subject to exemptions, comparable to those in the Listing Rules.

#### **Recommendation**

- 8.92 For the reasons given in the Paper and expressed by respondents, **we do not recommend disqualifying directors of public companies (or companies generally) from voting on matters in which they are interested.** The position of listed companies appears adequately covered by the Listing Rules. In relation to other companies, a general disqualification might create unnecessary burdens. Disclosure should ensure that potential conflicts are taken into account.

#### **REQUIRE THAT GENERAL NOTICES UNDER SECTION 317(3) INCLUDE DETAILS OF THE INTEREST CONCERNED? (OPTION 12 - QUESTION 34)**

#### **Consultation issue**

- 8.93 Subsection 317(3) at present enables a director to give general notice of his interest in any contracts with specified parties, but does not require further details.<sup>69</sup> The equivalent provision in Table A Article 86(a) requires the "nature and extent" of the interest to be specified. In the Paper<sup>70</sup> we suggested that the present requirement does not give sufficient information to enable the board to assess the weight to be given to the views of the director having the interest.
- 8.94 Accordingly, we asked consultees whether they agreed with our provisional view that a general notice under section 317(3) should be required to state the nature and extent of the interest, and that the director should give notice amending these particulars if they change. Although the question was directed to the general notice under section 317(3), similar considerations apply to the obligation to disclose under section 317(1).

#### **Summary of respondents' views**

- 8.95 Most respondents agreed with our provisional view that the nature and extent of the interest should be stated. However, there was a concern that the requirement would unnecessarily complicate an area of law which is achieving the desired result

<sup>69</sup> In 1962, the Jenkins Committee recommended that the predecessor section to s 317(3) should require the nature of the interest to be stated, but this recommendation was not adopted.

<sup>70</sup> Paper, para 4.116.

at the moment, and create the risk of minor inaccuracies in the description giving rise to technical default. It was suggested that, if further details were required, other members of the board could pursue the matter with the relevant director on a case by case basis.

### **Recommendation**

- 8.96 **In line with the views of the majority of respondents and Table A, Article 86(a), we recommend that section 317 should be amended so as to require a director to disclose the nature and extent of his interest.** Such information is needed if the board's consideration of the issue is to be of any value, and the requirement should not impose an undue burden. We see no reason why minor inaccuracies in the information disclosed should be treated as invalidating the disclosure, but if necessary this concern could be covered in the drafting of the amendment.

### **WHAT SHOULD BE THE SANCTIONS FOR BREACH AND SHOULD THEY BE SET OUT IN STATUTE? (OPTION 9 - QUESTION 31)**

#### **Consultation issue**

- 8.97 In the Paper<sup>71</sup> we asked consultees for their views on possible changes to the sanctions for non-compliance with section 317. At present, the section merely creates a statutory duty of disclosure and imposes a fine for non-compliance. By contrast, where the director ought under the *general law* to have disclosed his interest, the consequence is that the contract is voidable.<sup>72</sup>
- 8.98 We drew consultees' attention to the scheme which applies in relation to substantial property transactions under sections 320-322. An arrangement contravening section 320 is voidable at the instance of the company, but the company's right to avoid the arrangement is lost in the circumstances set out in section 322(2), that is where (in summary):
- (1) restitution is no longer possible or the company has been indemnified;
  - (2) rights acquired by a third party (not a party to the contravening transaction) would be affected; or
  - (3) the arrangement is affirmed by the company within a reasonable period.
- 8.99 We asked whether consultees considered similar provisions ought to be included in section 317. As regards the rights of other parties, we suggested that, in the present context, it might not be fair to exclude parties to the contravening transaction (as under (2) above), since the director's interest may be indirect, and the other party may have no reason to know of it. It should be sufficient if the other party has acted in good faith, for value, and without actual notice of the breach of section 317. As a further protection, we suggested that the court might have a discretion

<sup>71</sup> Paper, paras 4.106 to 4.113.

<sup>72</sup> See the discussion and cases cited in Paper, paras 4.78 to 4.80.

to disapply any new provision rendering the contract voidable where disclosure would have served no useful purpose.<sup>73</sup>

- 8.100 We asked consultees whether they agreed with our provisional views that:
- (1) a breach of section 317 should automatically result in the contract or arrangement being voidable unless the court otherwise directs;
  - (2) the contract or arrangement should cease to be voidable in the same circumstances as those set out in section 322(2).
  - (3) a breach of section 317 should result in the director being personally liable to account for any profit or indemnify the company for loss.<sup>74</sup>
- 8.101 We asked whether, if the sanction in (1) was not adopted, section 317 should be amended so as to include expressly a statement that a breach of the section has no effect on the contract or arrangement.<sup>75</sup> We also asked for comments on whether (and subject to what defences) the liability should be extended to connected persons, if our recommendation for disclosure of the interests of connected persons were to be adopted.<sup>76</sup>

#### **Summary of respondents' views**

##### ***(a) should a breach of section 317 result in the contract being voidable?***

- 8.102 The majority of respondents supported our provisional view that section 317 should automatically result in the contract or arrangement being voidable unless the court otherwise directs. It was considered that this would end the inconsistency between the statutory provision and the general law.
- 8.103 However, others saw the remedies available under the general law as a reason for not needing "this complex addition" to section 317. The provision could lead to uncertainty in commercial relationships and to adverse effects on innocent third parties. It was also thought that, unlike contravention of section 320, non-compliance with section 317 could be highly technical and it would be inappropriate that the contract should automatically be avoided.

##### ***(b) should the contract cease to be voidable in the circumstances in section 322(2)?***

- 8.104 A large majority of those who responded to this question were in favour of the contract or arrangement ceasing to be voidable in the circumstances set out in section 322(2). There was some difference of view as to whether the other party need be a stranger to the transaction for his interest to be protected. One respondent considered that the protection should extend to a party to the

<sup>73</sup> So far as the liability of the director was concerned, s 727 would be available to provide relief.

<sup>74</sup> Paper, para 4.113.

<sup>75</sup> Paper, para 4.113.

<sup>76</sup> Option 11 - Question 33, para 8.58 above.



arrangement where it was unaware of the director's interest or of the failure to disclose.

***If a sanction is not introduced, should the section state that it has no effect on the contract?***

- 8.105 Although few responded specifically to this question, there was support for our view that (assuming the remedies under section 317 are not altered) the section should state that a breach has no effect on the contract or arrangement.

***(c) Should the director (a) account for any profit made and (b) indemnify the company for any loss resulting from the breach?***

- 8.106 A large majority of respondents to this question agreed with our provisional view that a breach of section 317 should result in the director being personally liable (a) to account for any profit he makes, and (b) to indemnify the company for any loss it incurs as a result of the breach.<sup>77</sup> It was also suggested that any other director knowingly involved in the breach should be made liable to indemnify the company for any loss suffered as a result of the breach.<sup>78</sup> Some favoured an obligation to account for profit, but not to indemnify for loss, since it would be unfair for a director to have to bear the loss from an improvident transaction which may not have been caused by his non-disclosure.
- 8.107 Some of the responses linked this issue to the question of the nature of interests required to be disclosed (Question 24);<sup>79</sup> if the interest is not material, in the sense that disclosure might reasonably be expected not to affect the decision of the board, it seemed wrong that the director should have to account for profit and indemnify for loss in relation to a transaction which would have gone ahead in any event. There was also a question how this proposal would relate to subsisting arrangements. It seemed wrong that a director should be liable in respect of a decision made before he became a director, merely because he failed to declare an interest on being made a member of the board.

***Should the liability in (c) above be extended to connected persons and should a defence be available to them?***

- 8.108 Most respondents to this question were in favour of our suggestion that, if section 317 is amended to require the disclosure of the interests of connected persons, the liability to account for gains or compensate the company for loss should extend to connected persons if the director fails to disclose the interest of his connected person. A number expressly agreed with our suggestion that a defence should be available to connected persons. It was also suggested that the defence should also be available where the connected person did not know of the connection, e.g. that the director was a director.

<sup>77</sup> The IoD's support assumed the introduction of an exemption from disclosure for interests of which a director has no knowledge.

<sup>78</sup> This would be in line with s 322(3).

<sup>79</sup> Paras 8.9ff above.

8.109 The contrary view was that the obligation to disclose is that of the director, and that it is his direct or indirect interest with which the section is concerned; rather than that of the connected person as such; secondly, that, under the present law, anybody who obtained a benefit with a knowledge of the breach would be liable to account as constructive trustee; and thirdly that the extension to connected persons would lead to difficulties of definition.

### **Comment**

8.110 A conclusion on the appropriate sanctions for breach of section 317 is dependent on the issue of decriminalisation,<sup>80</sup> which is a matter for the Company Law Review. The following comments are therefore subject to that review.

8.111 As the authorities stand, there are *no* civil remedies for breach of section 317.<sup>81</sup> There is simply a criminal offence which is rarely enforced. However, the empirical research shows that the mere possibility of criminal sanctions may be useful in persuading directors to avoid transactions of dubious legality.<sup>82</sup> Another important factor is the need for any criminal offence to be sufficiently certain to satisfy the requirements of the Human Rights Act 1998.<sup>83</sup> This is particularly relevant to the issue whether to introduce a limitation on the obligation of disclosure where there is no real risk of conflict. This may introduce a element of imprecision which might make a breach of section 317 unsuitable for a criminal offence.

8.112 On balance we favour introducing defences to the duty of disclosure, and replacing the criminal sanction with a civil remedy. We think that the interests of the company which the section is designed to protect are essentially civil law interests, as is recognised by the remedies already available under the general law. A corresponding statutory remedy for breach of section 317 would confirm the importance of full disclosure, and strengthen the company's remedies for default. We are not concerned that there would be some overlap with the general law. This is not uncommon in other areas of the law,<sup>84</sup> and does not appear to cause problems. Nor do we think that the result would be unduly complex. The circumstances giving rise to the remedy under section 317 would be clearly defined by the statute, and within those limits would be seen as supplementing the general law. If anything it would simplify the present regime, by bringing the section and Table A into line, and avoiding an awkward relationship between civil and criminal remedies.

8.113 For the reasons explained below, we recommend the following remedies for breach of the disclosure obligation in section 317. They are based on those in section 322 of the Act with modifications:

<sup>80</sup> The economic and legal arguments for and against criminal penalties are discussed in Paper, paras 3.79-3.84, and 10.37-10.39.

<sup>81</sup> Paper, paras 4.77-4.80.

<sup>82</sup> Section 9 of the empirical research report in Appendix B.

<sup>83</sup> See paras 4.44-4.47 above.

<sup>84</sup> For example, the overlap between the laws of tort or delict and breach of statutory duty in the context of safety at work.

- (1) the arrangement or transaction in which the director or his connected person had an interest should be voidable at the instance of the company unless**
  - (a) one of the conditions in section 322(2)(a) or (c) apply;**
  - (b) any rights acquired in good faith for value and without actual notice of the contravention by any person (whether or not a party to the transaction or arrangement) would be affected by its avoidance; or**
  - (c) the court otherwise directs; and**
- (2) the director who failed to make disclosure and any person connected with him whose interest ought to have been disclosed and who knew of the failure to make disclosure should be liable to the extent that the court thinks just and equitable to account for any gain made directly or indirectly by the arrangement or transaction and to indemnify the company for any loss resulting from the arrangement or transaction.**

#### **Avoidance of the transaction**

8.114 We take the view that the Act should specify the circumstances in which a transaction should cease to be voidable against other parties. There was general support for the view that (in line with section 322(2)(b)) third parties who are not parties to the transaction, who are dealing bona fide for value and without notice, should be protected. However, on reconsideration, we believe that the exclusion of parties to the transaction - including connected persons - could create unnecessary unfairness. As we said in the Paper,<sup>85</sup> it should be sufficient that the third party acted in good faith, for value and without actual notice. The same is true about a person, including a connected person, who is a party to the transaction. There is no reason to penalise him for non-disclosure of a director's interest of which he is unaware.

#### **Remedies for account and indemnity**

8.115 The remedies that we propose here are the same as those in paragraphs (a) and (b) of section 322(3) but they are available only against the defaulting director and any connected person whose interest ought to have been disclosed and who knew of the non-disclosure (and thus not against the directors who authorised the transaction)<sup>86</sup> and are subject to the further new limitation that the extent of the remedies are to be a matter for the discretion of the court.<sup>87</sup> In introducing this

<sup>85</sup> Paper, para 4.107.

<sup>86</sup> Because these directors would not have had the interest duly disclosed to them.

<sup>87</sup> See also the Law Commission report *Aggravated, Exemplary and Restitutionary Damages*, (1997) Law Com No 247 which recommends the wider availability of restitutionary damages for civil wrongs that are committed in deliberate and outrageous disregard of the claimant's rights.

limitation we are concerned to avoid unduly draconian consequences for the parties who may be liable.

- 8.116 An obligation to indemnify the company against “any loss resulting from the transaction”<sup>88</sup> in which the director or the connected person had an interest would have wide-reaching implications. In the recent case of *Re Duckwari plc (No 2)*,<sup>89</sup> the company had bought a property without the requisite shareholder approval under section 320 and it had fallen in value due to a fall in the property market. The Court of Appeal held that the director was liable for the full extent of the loss. The court recognised that the obligation was strict and sometimes harsh<sup>90</sup> but as the loss had to fall somewhere it held that it was not unfair that it fall on the director.
- 8.117 It is not appropriate that a director or a connected person should in all circumstances be liable to indemnify the company for losses which result from the transaction. The cases which might arise could be very different. At one end of the scale there will be cases where directors deliberately conceal their personal interest in a transaction from their fellow directors and deceive their fellow directors into approving the transaction. It would seem right as a matter of policy to impose the same liability on the director of breach of section 317 in this case as was imposed on the director in the *Duckwari* case. But at the other end of the scale there may be a case where a director does not know about the transaction and has no opportunity to disclose his interest.<sup>91</sup> His colleagues approve the transaction and would have done so even if the board had known of his interest. In such a case we doubt whether the director or a connected person should be liable to indemnify the company at all. In the middle there may be cases where a director has an opportunity to disclose his interest but omits to do so through oversight. Again, his colleagues approve the transaction and would have done so if he had disclosed his interest. It does not seem just to impose on the director or a connected person an unlimited obligation to indemnify the company for any loss resulting from the transaction. The obligation to indemnify should not exceed the loss which the transaction caused to the company at the date on which it was entered into.
- 8.118 In order to enable the court to take account of these policy considerations, we see benefit in giving the court a discretion with respect to the company’s right to indemnity. In our view the company should have a right to indemnity from a director or a connected person only to such an extent as the court thinks just and equitable.
- 8.119 The question is then whether the remedy of account of profits should be subject to the court’s discretion in the same way. Again, although this limitation results in the loss of some certainty in the law, we think it is necessary on the grounds of fairness to introduce the same limitation here as well. The profits may have been produced not simply as a result of the transaction or arrangement which contravened section

<sup>88</sup> These words appear in s 322(3)(b) which we suggested in the Paper should be mirrored in s 317.

<sup>89</sup> [1998] 2 BCLC 315. See Paper, para 4.108.

<sup>90</sup> *Ibid*, at p 324 g-h.

<sup>91</sup> But see n 30 to para 8.33 above.

317 but also partly as a result of the use of some other property of the accounting party. In addition the court may consider that the defendant (defender) (at least if he is not himself a director)<sup>92</sup> should be entitled to some equitable allowance for his skill in making the profits<sup>93</sup> and the language of section 322(3)(a) may exclude this. **We therefore recommend that any person against whom this remedy lies should be liable to account for profits which he has made directly or indirectly as a result of the arrangement or transaction and to indemnify the company for any loss or damage resulting from the arrangement or transaction *only to the extent that the court thinks just and equitable* that he should be so liable.**

### **Recommendation**

8.120 In summary, our conclusions on this issue are subject to consideration, as part of the Company Law Review, of the general issue of decriminalisation. **Our current view, however, is that**

- (1) **the criminal penalty for breach of section 317 should be replaced by a civil remedy, by which the contract or transaction would be voidable at the instance of the company unless the court otherwise directs;**
- (2) **the contract or transaction would cease to be voidable in circumstances analogous to those set out in section 322(2), save that the protection of third parties (under section 322(2)(b)) would extend to parties to the contract or transaction including connected persons;**
- (3) **whether the transaction is voidable or not the liability of a director and/or a connected person would be:**
  - (a) **to account for any profits from the transaction; and**
  - (b) **to indemnify the company for loss resulting from the transaction**

**in either case to the extent that the court thinks just and equitable; and**
- (4) **the connected person would incur no liability under either head unless he knew of the failure to disclose.**

<sup>92</sup> As to the position of a director, see *Guinness plc v Saunders* [1990] 2 AC 663.

<sup>93</sup> See generally *Phipps v Boardman* [1967] 2 AC 46.

## **PART 9**

# **SECTIONS 318-319: DISCLOSURE AND DURATION OF DIRECTORS' SERVICE CONTRACTS**

### **INTRODUCTION**

- 9.1 In this Part we consider reforming the current statutory provisions which regulate directors' service contracts – sections 318-319. Section 318 requires copies of directors' service contracts to be available for inspection by members at the company's registered office. Section 319 places a statutory limit of 5 years on the duration of service contracts which are not terminable by the company (or are terminable only in certain circumstances) where shareholder approval has not first been obtained. Before these sections were enacted,<sup>1</sup> directors were able to agree to long and well-remunerated service contracts for themselves and their fellow directors without fear of shareholder intervention. At most, shareholders would receive limited information in the annual accounts but this was not thought to be satisfactory for the disgruntled shareholder who regarded the payments being made to his directors as excessive. Sections 318 and 319 were therefore introduced to curb the board's discretion and to require some level of accountability to the company's shareholders.
- 9.2 We identified a number of deficiencies of these sections in the Paper.<sup>2</sup> In relation to section 318 we noted that it is restricted to contracts of service only and does not require disclosure of any collateral terms or documents to the contract. It differs from the equivalent regulations in the Listing Rules. Subsections (5) and (11) contain exemptions which appear no longer to be appropriate. Empirical research suggests that shareholders rarely use this right of inspection particularly in small owner-managed companies where payments to directors may not be set out in writing but rather decided on an ad hoc basis. In considering section 319, we referred in the Paper<sup>3</sup> to the corporate governance initiatives which have occurred since section 319 was enacted. In particular, the recommendations of the Cadbury, Greenbury and Hampel Committees<sup>4</sup> have reduced the threshold for shareholder approval of service contracts to as low as one year for listed companies.<sup>5</sup> We also stated that, in practice, "rolling contracts" are used to circumvent section 319. These contracts<sup>6</sup> do not appear to fall within the section as they are for a period of less than 5 years but they are effectively replaced, for

<sup>1</sup> Section 318 was introduced in the Companies Act 1967 (as s 26). Section 319 is derived from ss 47 and 63(1) of the Companies Act 1980.

<sup>2</sup> Paper, paras 4.131, 4.162.

<sup>3</sup> At paras 4.157-4.160.

<sup>4</sup> The Greenbury Committee was the Study Group on Directors' Remuneration, chaired by Sir Richard Greenbury. The Hampel Committee was the second Committee on Financial Aspects of Corporate Governance, chaired by Sir Ronald Hampel.

<sup>5</sup> This approach was followed by the Stock Exchange in its recently published Combined Code.

<sup>6</sup> Described in more detail at para 9.31 below.

example at the end of the first year, by a new fixed term contract. The director thus continues to enjoy a long term service contract without breaking the statutory limit.

- 9.3 In identifying proposals for reform, we considered whether these sections should be repealed in relation to listed companies, leaving them to be governed by self-regulation, or whether they should be repealed completely, leaving these matters to be regulated by the common law and by self-regulatory rules where applicable. We do not favour either approach and this was a view shared by the vast majority of respondents. Instead, we recommend a number of substantive amendments to these provisions which are designed to improve their effectiveness and increase efficiency. The “efficient disclosure” principle, as we have explained it above,<sup>7</sup> supports the retention of section 318 and the limited reforms which we propose. The empirical research undertaken in the consultation period has provided a valuable insight into current practice in this area. This has influenced the recommendations on these provisions.
- 9.4 We invited consultees’ views on options to reform section 318 in order to deal with possible deficiencies which we had identified.

#### **SECTION 318 - DISCLOSURE OF DIRECTORS’ SERVICE CONTRACTS**

##### **NO CHANGE (OPTION 1 - QUESTION 36)**

- 9.5 A significant majority of respondents thought that section 318 required amendment or clarification. A number of respondents, however, preferred to retain section 318 as it is. The Law Society of Scotland in particular noted that the provision had gained acceptance in practice and generally worked.

##### **SHOULD THE SECRETARY OF STATE HAVE POWER TO DISAPPLY SECTION 318 WHERE THE COMPANY IS ALREADY BOUND BY SUFFICIENT DISCLOSURE UNDER THE LISTING RULES? (OPTION 2 - QUESTION 37)**

##### **Consultation issue**

- 9.6 We explained in the Paper<sup>8</sup> that if section 318 were disapplied in respect of listed companies they would be subject only to comparable obligations under the Listing Rules. We considered that any cost savings from this measure would be small. The removal of statutory control would mean that the criminal sanctions under section 318 would not apply to listed companies. We asked consultees whether the Secretary of State should be able to disapply section 318 where, in his opinion, a company is already bound by sufficient comparable disclosure obligations under the Listing Rules.

##### **Summary of respondents’ views**

- 9.7 The majority of respondents did not support this option. A number of respondents argued that the core rules for all companies should remain statutory and that self-regulatory rules should complement these. One respondent emphasised that statutory rules make the law more accessible to both directors and other parties. Concern was expressed that the Listing Rules could be changed without public

<sup>7</sup> Part 3 above.

<sup>8</sup> Paper, para 4.135.

input while the statutory disclosure regime could be altered only with proper parliamentary sanction. On the other hand those respondents in favour of the option including the IoD argued that there was little benefit in duplicating regulations, particularly when the Listing Rules were more stringent, and welcomed deregulation.

### **Recommendation**

- 9.8 We agree with the majority of respondents who rejected the proposal to disapply section 318 in relation to listed companies. The principle that self-regulatory rules should be in addition to, and not instead of statutory rules generally is a sound one. We also agree that statutory provisions are more accessible and readily apparent to both directors and third parties. **We therefore recommend that the Secretary of State should not be able to disapply section 318 where the company is already bound, in his opinion, by sufficient disclosure under the Listing Rules.** We recognise however, that the Company Law Review may be considering the general problem of duplication between self-regulatory rules and the Companies Acts and that this recommendation may have to be reconsidered in the course of that review.

### **EXTEND SECTION 318 TO CONTRACTS FOR SERVICES AND NON-EXECUTIVE DIRECTORS' LETTERS OF APPOINTMENT? (OPTION 3 - QUESTION 38)**

#### **Consultation issue**

- 9.9 At present, only contracts of service require to be disclosed under section 318 and not contracts for services or non-executive directors' letters of appointment. We suggested that this was anomalous and our provisional view was to extend section 318 to cover these two categories of contract.

#### **Summary of respondents' views**

- 9.10 A significant majority of respondents supported our provisional view. One respondent suggested that it would help clarify which documents should and should not be disclosed. Another respondent supported the proposal on the basis that the Listing Rules require the disclosure of all details of a director's remuneration. The IoD thought that it was important that non-executive directors are subject to the same level of disclosure as executive directors - at least in terms of their conditions of appointment. Of the respondents who disagreed with this proposal, one made the point that non-executive directors usually have a standard form letter of appointment which rarely gives rise to any problems on termination.

#### **Recommendation**

- 9.11 **We remain of the view that there is no good reason why contracts for services and letters of appointment should not be disclosed. As our provisional view was strongly supported on consultation we therefore recommend the extension of section 318 so as to include contracts for services and non-executive directors' letters of appointment.**



## **REPEAL OF SUBSECTION (5) (DIRECTOR TO WORK ABROAD) (OPTION 4 - QUESTION 39)**

### **Consultation issue**

- 9.12 This subsection exempts from disclosure service contracts which require the director to work wholly or mainly outside the UK. In lieu of such disclosure the subsection provides that the company should make available for inspection in the appropriate place a memorandum giving the director's name and setting out the provisions of the contract which relate to duration. We noted in the Paper that the reasons for introducing this exemption are unclear. In any event, we pointed out that this provision is no longer of consequence to directors of listed companies who are subject to the more stringent Listing Rules requiring disclosure of all contracts, regardless of where the director primarily works. The only benefit of this provision would be for directors of non-listed companies. We saw no reason why directors of unlisted companies should require protection in this area if directors of listed companies do not. We therefore provisionally recommended that subsection (5) should be repealed. If there was concern about the disclosure of certain information<sup>9</sup> the Secretary of State could be given power to exempt it from disclosure. If it were not to be repealed, we considered that the question of whether a director works mainly abroad should be clarified in the case of contracts which require a director to work abroad and in the UK for different periods so that the exemption only applies in relation to the period for which he was working mainly abroad.

### **Summary of respondents' views**

- 9.13 There was unanimous support among respondents for the repeal of subsection (5). However, most respondents did not support the Secretary of State being given the power to exempt prescribed information although the IoD thought that the prescribed information should be limited to the minimum details necessary. Almost all respondents supported clarification of the provision in any event so that the exemption was limited to those periods for which the director mainly worked abroad.

### **Recommendation**

- 9.14 **Our provisional view was unanimously supported on consultation and therefore we recommend the repeal of section 318(5).**

## **REPEAL OF SUBSECTION (11) (CONTRACTS WITH LESS THAN 12 MONTHS TO RUN) (OPTION 5 - QUESTION 40)**

### **Consultation issue**

- 9.15 This provision exempts from disclosure contracts which have less than 12 months to run or contracts which are terminable with less than 12 months' notice. We noted in the Paper that this exemption might be used in practice to keep the pay of directors in unlisted companies secret. We also considered that the pressure to

<sup>9</sup> Such as kidnap and ransom policies.

reduce the length of fixed term contracts could increase the significance of this exemption. We therefore provisionally proposed that it be repealed.

#### **Summary of respondents' views**

- 9.16 Virtually all respondents agreed with our provisional view that subsection (11) should be repealed. PIRC noted that it is undesirable that companies can give their directors notice periods of 364 days to avoid the disclosure requirements. The CBI, however, thought that there was no need to end the exemption so long as it was not abused.

#### **Recommendation**

- 9.17 Our provisional view was supported by most respondents. We remain of the view that the exemption is now too wide, and that it is open to abuse. **It is our recommendation, therefore, to repeal section 318(11).**

#### **AMEND SECTION 318 TO REQUIRE DISCLOSURE OF PARTICULARS OF TERMS COLLATERAL TO THE SERVICE CONTRACT? (OPTION 6 - QUESTION 41)**

#### **Consultation issue**

- 9.18 We stated in the Paper that, under section 318, it is only the service contract or a memorandum of its terms which requires to be made available to the shareholders for inspection and not collateral terms or documents referred to. We noted that, as a consequence of this, shareholders would often be unable to assess the full value of directors' remuneration. However, we recognised that to require the disclosure of all such collateral documents would be a significant administrative burden. In any event, we recognised that listed companies already undertake extensive disclosure. We therefore asked consultees whether section 318 should be amended to require disclosure of terms collateral to the service contract. We envisaged that documents which, for example, provide details of pension schemes or of D&O insurance would be disclosed. We also asked whether the Secretary of State should have the power to exempt certain information from disclosure (where for example, there may be a risk in releasing such information, such as D&O insurance).

#### **Summary of respondents' views**

- 9.19 The views of respondents were more divided on this proposal. A slight majority of respondents agreed that there should be disclosure of collateral terms. A few respondents supported the exemption of certain information (particularly D&O insurance) by the Secretary of State. Most of those respondents who were against this proposal thought that it would be too burdensome and would offer little benefit. These included the IoD, the Law Society (Company Law Committee), the Law Reform Committee of the General Council of the Bar and the Faculty of Advocates. One respondent made the point that listed companies were already under a similar obligation under the Listing Rules but he could see no reason further to complicate section 318, particularly if there required to be exemptions from such additional disclosure. The Law Society made an important point about increases in salary which occur in accordance with a variation procedure or formula provided for in the service contract. There is doubt whether such increases are "variations" requiring disclosure under section 318(10).

### **Recommendation**

- 9.20 On balance, we agree with those respondents who were against the proposal to require disclosure of terms and documents collateral to service contracts. Such a requirement would be an additional burden on companies while offering only limited benefit. We are of the view that this would unnecessarily complicate section 318, contrary to our remit to simplify and modernise the provisions of Part X. **We therefore recommend that section 318 should not be amended to require the disclosure of particulars of terms collateral to service contracts.**

### **ALLOW PUBLIC INSPECTION OF DIRECTORS' SERVICE CONTRACTS? (OPTION 7 - QUESTION 42)**

#### **Consultation issue**

- 9.21 Under section 318 it is only members, and not potential investors, creditors or employees who have a right to inspect service contracts. However, the widening of the right of inspection to include such persons would impose increased administrative costs on unlisted companies. We asked consultees whether the statutory register under this section should be open for public inspection in the case of all companies or in the case only of companies listed on the Stock Exchange or AIM.

#### **Summary of respondents' views**

- 9.22 Respondents' views were again divided on this. There was very little support for giving the public a general right to inspect contracts of directors in all companies. Views were divided between introducing a public right of inspection in relation to listed companies on one hand and confining the statutory right to members of companies on the other, leaving the Stock Exchange to provide for wider disclosure by listed companies. One respondent expressed concern about the increasing number of investors who had their shares in the name of nominees.

#### **Recommendation**

- 9.23 After considering respondents' views, we agree that the public should not have a general right to inspect service contracts of directors of non-listed companies. The arguments for a right of inspection being available to the public in relation to listed companies are more finely balanced. It can be argued that, if the right of inspection is conferred by statute, it can be enforced by the courts and persistent non-compliance might be a ground for seeking a remedy from the court under section 459 of the Act. We also recognise the argument that the terms on which a director of a listed company is engaged are a matter of legitimate public interest. On the other hand, such a provision could be seen as essentially an investor and stakeholder protection measure which belongs in self-regulatory rules and not statute. In our view, this issue impinges upon the issues of duplication between statute and self-regulatory rules and the wider stakeholder debate. Both of these matters will now be dealt with by the wider Company Law Review and are therefore outside the remit of this project. Subject to a fuller consideration of these issues in the course of the Company Law Review, **we make no recommendation on whether to allow public inspection of directors' service contracts.**

## **SECTION 319 - PERIOD OF SERVICE CONTRACT**

- 9.24 Section 319 prohibits any term in a contract which provides that a director is to be employed by a company for more than five years where the contract is not terminable by the company by notice or is terminable only in specified circumstances, unless that term is first approved by the shareholders. The prohibition extends to the employment within a corporate group of a director of a holding company. Failure to obtain shareholder approval renders the term void and the company may terminate the agreement by giving reasonable notice. We observed in the Paper that the purpose of the provision was to prevent directors arranging for themselves long-term service contracts by providing that a company could not be required to employ a director for more than five years without shareholder approval. The provision does not regulate the length of notice which a company may be required to give.

### **NO CHANGE (OPTION 1 - QUESTION 46)**

- 9.25 Nearly all respondents favoured the reform of section 319. A few respondents including the IoD and the Federation of Small Businesses preferred to retain section 319 as it stands.

### **REDUCTION OF THE STATUTORY PERIOD IN SECTION 319(1) FROM 5 YEARS TO 1, 2 OR 3 YEARS? (OPTION 2 - QUESTIONS 3 AND 44)**

#### **Consultation issue**

- 9.26 We discussed in the Paper how the recent initiatives on corporate governance have led to the reduction of the length of fixed term contracts. This is particularly evident in listed companies where the Stock Exchange, through its adoption of the Combined Code, now advocates notice or contract periods being set at one year or less, although it accepts that longer periods may be acceptable when attempting to recruit new directors. We considered the position of smaller listed companies and unlisted companies which were more likely to have service contracts for longer periods in order to attract directors. However, longer service contracts would still be possible by obtaining shareholder approval, although this process would involve delay and cost. We identified no good reason why listed companies and unlisted companies should be treated differently under section 319. We therefore asked for consultees' views on whether the statutory period set out in section 319 should be reduced to one, two or three years and whether such a reduction should apply to listed companies or to all companies.

#### **Summary of respondents' views**

- 9.27 Reduction of the statutory limit set by section 319 was generally favoured on consultation with slightly more respondents supporting a reduction to three years. There were few detailed reasons given for this view other than the feeling that the present limit was out of step with recent corporate governance developments. Nearly a quarter of respondents, however, preferred to retain the status quo on the basis that a longer period allows the company more flexibility in order to suit its particular circumstances and needs. Several respondents, including the IoD, also made the point that longer contracts were often required in order to attract well-qualified directors, particularly when in competition with the overseas market. A number of representative organisations emphasised that any reduction in this

limit for public listed companies should come as a recommendation from organisations rather than statute. Most respondents thought that whatever the reduction in the statutory period, it should apply to all companies. Only a few respondents disagreed with this, favouring a one year limit in relation to listed companies with a two or three year limit applying to unlisted companies.

### **Case law developments**

- 9.28 Since the Paper was issued there has been a welcome decision of the Court of Appeal in *Atlas Wright (Europe) Ltd v Wright*.<sup>10</sup> This deals with the point whether shareholders can *informally* give approval under section 319(3), without having a meeting and passing a resolution. There are indications in section 319 that the unanimous approval of shareholders might not have been enough. Section 319(3) requires approval by “a resolution of the company” and subsection (5) states that a resolution shall not be passed at a general meeting unless the term is made available for inspection in the manner prescribed by that subsection. Moreover, subsection (6) provides that a term as to the duration of a director’s service contract which is inserted in breach of section 319 is void. In the light of these provisions, the Paper expressed the view<sup>11</sup> that the company “probably cannot approve the term by means of an informal unanimous consent, even if members see a subsection (5) memorandum before giving consent.”<sup>12</sup> The Court of Appeal has now held that unanimous informal approval can suffice, provided the shareholders are fully informed. The Court held that section 319 was limited to protecting the shareholders of the company so that they could effectively waive the protection it gave.

### **Economic and empirical research**

- 9.29 The discussion in Part 3 of the Paper on economic considerations and the empirical research undertaken in the consultation period<sup>13</sup> throw useful light on the question whether the statutory period in section 319(1) should be reduced. The principal points that emerge are the following:

- (1) Although section 319 allows companies to enter into contracts in excess of five years if shareholders give their approval, larger companies very rarely take this step, because of perceptions of the high costs involved. In practice, then, the section has the effect of placing a *de facto* bar on the duration of directors’ service contracts.
- (2) However, it is not clear what purpose section 319, as presently constituted, is seeking to achieve by placing such a bar on the length of service contracts. If its aim is to limit large payments of compensation to directors whose service is ended prematurely, it would appear to be ineffective, since it does nothing to prevent directors’ pay being increased to compensate for the imposition by law of a limit on the duration of their service contracts.

<sup>10</sup> [1999] BCC 163.

<sup>11</sup> Paper, para 4.156, n 251.

<sup>12</sup> Cf *Re RW Peak (Kings Lynn) Ltd* [1998] 1 BCLC 193.

<sup>13</sup> And not therefore available to consultees.

- (3) Directors in larger and listed companies are more likely to have rolling contracts than directors in smaller companies. They are also likely to have longer notice periods in their contracts. This lends weight to the suggestion that section 319 is ineffective in curbing large pay-offs.
- (4) Accordingly, directors in larger and listed companies are probably no worse off as a result of section 319, and shareholders are probably no better off.
- (5) Section 319 may be justified as a device to ensure that shareholders are not deterred from exercising their power to remove directors by a majority vote in general meeting. The possibility of very high pay-offs for directors removed in this way could be seen as discouraging the exercise by shareholders of this right. However, for this to work, stricter regulation of the practice of rolling contracts would have to be introduced.
- (6) About 30% of the smallest category of companies and 17% of companies in the next band have directors with contracts for three years or more. This suggests that any reduction in the period specified by section 319 could have a substantial impact on smaller firms.

### **Recommendation**

- 9.30 The consultation responses were in favour of a reduction in the statutory period set by section 319. In our view, there are few good reasons to retain the present limit. If directors believe that such a long contract is in the best interests of the company then they should be able to persuade shareholders of this and obtain their approval. We are also aware of the argument that there has been no substantial increase in the remuneration of directors in the listed sector as a result of the reduction in the length of their contracts. However, having regard to the economic considerations and the empirical research we recognise that reduction in the limit set by this provision might adversely affect smaller companies. We believe that more research is required on the effect which a reduction might have on small companies. Subject to such research, we support a reduction in the statutory limit imposed on the length of directors' service contracts by section 319. **Subject as stated we therefore recommend that the statutory limit in section 319 should be reduced to three years for all companies. We would also suggest that further consideration should be given to the position of small companies, perhaps through additional empirical research, in the course of the Company Law Review.**

### **AMEND SECTION 319 SO AS TO PROHIBIT (WITHOUT SHAREHOLDER APPROVAL) THE CREATION OF ROLLING CONTRACTS HAVING A NOTICE OR CONTRACT PERIOD IN EXCESS OF THE PERIOD PERMITTED BY SECTION 319? (OPTION 2 - QUESTION 45)**

#### **Consultation issue**

- 9.31 We explained in the Paper<sup>14</sup> that "rolling contracts" are contracts for periods up to five years which might be replaced at, for example, the end of the first year with a

<sup>14</sup> Paper, paras 4.161 to 4.162.

new fixed term contract. The contract may be replaced either by agreement or automatically, subject to the company not giving notice that the replacement was not to take place. We said in the Paper that, in practice, these contracts are viewed as being outside of section 319, as the old contract is viewed as being brought to an end and replaced by a new contract and there is therefore no period of the old contract which is unexpired for the purposes of section 319(2).<sup>15</sup> We also said that contracts for an indefinite period terminable by the company, for example, on two years' notice are also included within this category. These contracts can thus avoid the statutory limit placed on contracts with no shareholder approval. To prevent this we suggested that prior contracts could be aggregated with the new contracts as is currently the requirement under section 319(2)(b) for a further agreement entered into while the contract has more than six months to run. However, we realised that this might inadvertently cover situations where, for example, a director with an existing five year service contract as an executive director is promoted to finance director and offered a new five year contract. We did not think that this type of situation should require shareholder approval. We noted that there was a risk that remuneration may increase if rolling contracts are commonly used in practice but regulated in future. We therefore asked consultees whether section 319 should be amended to prevent "rolling contracts" for a period exceeding the maximum term permitted under section 319 unless they are first approved by shareholders.

### **Summary of respondents' views**

- 9.32 The predominant view of respondents who answered this question was that they supported an amendment to section 319 to cover "rolling contracts" so that they were subject to the statutory maximum term. Many respondents did not specify particular reasons for this support. The only arguments put forward were that any reduction in the statutory limit would be far less effective if the section did not cover rolling contracts, which at present are used as a device to avoid the statutory policy. It was also emphasised that rolling contracts are, in practice, far more common than fixed contracts. Of those respondents who did not want rolling contracts to be subject to this maximum, most felt that these contracts can offer a certain degree of security to both the director and the company. It was also thought to be administratively more convenient to issue rolling contracts than a new contract each year. One or two respondents qualified their view by stating that rolling contracts should not be prohibited where the company retains the right to terminate the contract on notice. One respondent considered that if section 319 is reduced and drafted tightly there would be no need to expressly prevent rolling contracts.

### **Recommendation**

- 9.33 The empirical research suggests that rolling contracts appear to be used regularly in practice as a device to circumvent the statutory policy.<sup>16</sup> **Consequently, we believe that as a matter of necessity, these contracts should be subject to**

<sup>15</sup> This provides for the aggregation of contracts periods where a further contract is entered into more than 6 months before another contract finishes.

<sup>16</sup> Para 9.29 above.

**the statutory limit in section 319 so that they cannot be used to avoid the statutory restriction.**

**DEEM TERMS APPROVED IF MEMBERS RAISE NO OBJECTION TO THE PROPOSED TERM WITHIN A CERTAIN PERIOD? (OPTION 3 - QUESTION 46)**

- 9.34 We asked consultees whether to introduce a system of “negative approval” into section 319. Any term requiring approval under section 319 could be made subject to an obligation on behalf of the company to give notice to shareholders who would then have the right to object within a set time limit. Respondents supported our provisional view that this procedure should not be introduced and **we therefore recommend against it.**

**SUMMARY OF RECOMMENDATIONS UNDER THIS PART**

- 9.35 To summarise, **we recommend that:**
- (1) the Secretary of State should not be able to disapply section 318 where the company is already bound, in his opinion, by sufficient disclosure under the Listing Rules;**
  - (2) disclosure under section 318 be extended to contracts for services and non-executive directors’ letters of appointment;**
  - (3) section 318(5) and (11) be repealed as they are no longer appropriate;**
  - (4) section 318 should not be amended to require the disclosure of particulars of terms collateral to service contracts;**
  - (5) the statutory limit on the duration of directors’ service contracts without shareholder approval should be reduced from five years to three years although we suggest that further consideration should be given to the position of small companies in the course of the Company Law Review. We also recommend that the three year limit should be applied to rolling contracts; and**
  - (6) no mechanism for deemed shareholder approval should be introduced into section 319.**
- 9.36 **We make no recommendation on whether to allow public inspection of directors’ service contracts.**



# **PART 10**

## **SECTIONS 320-322: SUBSTANTIAL PROPERTY TRANSACTIONS**

### **INTRODUCTION**

- 10.1 In this Part we consider proposals to improve the statutory provisions which regulate transactions between a company and its directors involving the acquisition or disposal of substantial “non-cash assets”. We explained in the Paper<sup>1</sup> that the main provisions in sections 320-322 were introduced by the Companies Act 1980 as a response to DTI inspectors’ reports of fraudulent asset stripping by directors in the late 1970s. These sections were enacted to address the conflict of interest which arises when directors (or a company in which they have an interest) buy assets from, or sell them to, their company or a company in which they have an interest.<sup>2</sup> Such conflicts of interests involve the risk of distorting a director’s judgment and the risk that the company may acquire the assets at an inflated value or dispose of them at an under value.
- 10.2 These sections require shareholder approval for acquisitions or disposals between companies and their directors (and connected persons) of “non-cash assets” above a certain value.<sup>3</sup> A non-cash asset is defined in section 739(1) as any property or interest in property<sup>4</sup> other than cash. An asset is “of the requisite value” if at the time the arrangement is made its value exceeds £100,000 or 10% of the company’s net assets (if over £2,000). The use of the word “arrangement” is deliberately wide so as to catch transactions where an asset is transferred first to a third party and then on to a director. Discharge by the company of a liability for damages for breach of a director’s service contract or covenanted payments (such as golden “parachute” payments) made under such a service contract do not appear to be covered by this section.<sup>5</sup>
- 10.3 There are a number of exemptions to this general rule contained in section 321. Section 322 sets out certain liabilities which result from a breach of section 320. If the company’s approval is not obtained the transaction or arrangement is voidable at the instance of the company. The company’s right to avoid the transaction or arrangement will be lost if restitution is no longer possible, if the company has

<sup>1</sup> Paper, paras 1.9 and 4.172.

<sup>2</sup> See Carnwath J in *British Racing Drivers’ Club v Hextall Erskine* [1997] 1 BCLC 182.

<sup>3</sup> This approval is in addition to the requirement that the transaction be disclosed to the board under s 317.

<sup>4</sup> Such as the grant of a lease. The transfer or acquisition of an asset includes the creation of an interest in property. See s 739(2). In *Micro-Leisure Ltd v County Properties & Developments Ltd* (Court of Session, 19 January 1999, unreported), Lord Hamilton held that the transfer of a share of the profits in a proposed development could fall within s320 as s739(2) extends to subsidiary personal rights which materially affect a company’s exercise of its proprietary rights.

<sup>5</sup> See *Gooding v Cater* (unreported) 13 March 1989, Chancery Division and *Lander v Premier Pict Petroleum Ltd* 1997 SLT 1361.

been indemnified, if rights acquired by a third party in good faith and for value would be affected by the avoidance, or if the arrangement has retrospectively been approved within a reasonable time by the company.

- 10.4 Since the paper was published the Court of Appeal<sup>6</sup> has given further guidance on the measure of indemnity for loss or damage resulting from an arrangement or transaction<sup>7</sup> in breach of section 320. The Court held that to be recoverable the loss or damage had to result from the arrangement or transaction, each of which required to be identified. In that case the transaction was the acquisition of property and not the borrowing or use of funds to finance its acquisition. Thus the indemnity covered the difference between the cost of acquisition of the property and the proceeds of its sale, together with expenditure incurred in enhancing the property's value, but not the finance costs of the acquisition.
- 10.5 We said in the Paper<sup>8</sup> that we were not aware that sections 320-322 caused great hardship or inconvenience. However, we did consider a number of issues which we thought might improve the clarity and the effectiveness of these provisions. For example, we discussed whether the sections could be disapplied in relation to listed companies as the Listing Rules provide more comprehensive regulation for these transactions. We also looked at whether there was an effective alternative to the requirement for shareholder approval. We recognised in the Paper<sup>9</sup> that there is expense and delay involved in calling meetings to obtain this approval which may prevent a transaction being entered into which was legitimately in the company's interests.<sup>10</sup> Miscellaneous amendments were also considered such as clarifying section 320 so that it cannot be interpreted as applying to contractual payments under service agreements or to other payments covered by section 316(3) and the introduction of a new exemption for administrative receivers and administrators.
- 10.6 In assessing the options for reform, we considered and rejected the option of repealing these sections.<sup>11</sup> We then considered whether it would be more rational to disapply these provisions to listed companies who could be governed solely by self-regulatory rules. A large majority of respondents rejected this approach, a view with which we agree. We therefore recommend a number of individual amendments which are intended to improve the sections, but which do not tamper with the requirement for shareholder approval. Such approval helps retain the correct balance of power between the board and the shareholders and is an intrinsic safeguard available to members against directors' self-dealing. We considered some substitutes for the requirement for shareholder approval but considerations of efficiency and certainty in our view militate against the

<sup>6</sup> *Re Duckwari plc (No 3)* [1999] 1 BCLC 168. At an earlier stage in the proceedings, the Court of Appeal held that the indemnity should extend to depreciation in the market value of the asset acquired after the date of acquisition: [1998] 2 BCLC 315.

<sup>7</sup> Section 322(3)(b).

<sup>8</sup> Paper, para 4.172.

<sup>9</sup> Paper, para 4.197.

<sup>10</sup> Note that although the Listing Rules require shareholder approval also in such cases the AIM rules do not.

<sup>11</sup> Paper, para 9.22-9.28. This view was strongly endorsed by most respondents.

alternative to regulation by shareholder approval, a view supported by both economic considerations and the consultation responses. In our view, these provisions regulate transactions where there is a real danger of the depletion of corporate assets. The requirement of shareholder approval is consistent with the “graduated regulation” principle as we have explained it.<sup>12</sup>

#### **NO CHANGE (QUESTION 47)**

- 10.7 Respondents were asked whether they were aware of any difficulties in practice in the operation of these provisions. Some respondents had no experience of difficulties with these provisions in practice although other respondents identified problems in addition to those addressed by the Paper. Virtually all respondents were of the view that section 320-22 should be amended. The Faculty of Advocates, one of the few respondents in favour of retaining these sections unamended, identified consistency and certainty as reasons to keep the status quo, subject to no compelling difficulties being highlighted by respondents.

#### **AMEND SECTION 320 SO THAT IT ALLOWS THE COMPANY TO ENTER INTO CONTRACTS SUBJECT TO THE CONDITION PRECEDENT THAT THE COMPANY MUST OBTAIN SHAREHOLDER APPROVAL? (OPTION 2 - QUESTION 48)**

##### **Consultation issue**

- 10.8 We pointed out in the Paper<sup>13</sup> that section 320 does not allow a company to make a conditional arrangement to buy or sell an asset (which falls within the definition) subject to approval by shareholders. This may result in practical difficulties and could place the company at a commercial disadvantage. For example a company might lose out on an acquisition where the seller would not agree to wait until a shareholders’ meeting had been convened. We provisionally proposed that section 320 should be amended to enable a company to enter into a contract which is conditional to shareholder approval being obtained.

##### **Summary of respondents’ views**

- 10.9 Our provisional view was supported by all respondents who answered this question. Reasons put forward for this support were that it would offer more commercial freedom and flexibility and that it would allow the sections to work more fully.

##### **Recommendation**

- 10.10 Allowing a company to enter into such contracts would avoid the practical difficulties listed in paragraph 10.8 above. We do not envisage any significant disadvantages. Our provisional view was supported on consultation. **We therefore recommend that section 320 be amended so as to allow a company to enter into a contract which is conditional on the company first obtaining shareholder approval.**

<sup>12</sup> Part 3 above.

<sup>13</sup> Paper, para 4.192.

**AMEND SECTION 320 SO AS TO SPECIFICALLY EXCLUDE COVENANTED PAYMENTS AND PAYMENTS FOR DAMAGES FOR BREACH OF CONTRACT? (OPTION 3 - QUESTION 49)**

**Consultation issue**

- 10.11 In the Paper<sup>14</sup> we said that there was some doubt as to whether section 320 applies to damages for breach of contract or to covenanted payments if they are not covered by sections 312-316 (which deal with approval for payments for a director's loss of office). It was our view that it was not appropriate for payments which did not require shareholder approval under such specific provisions to require approval under a more general provision such as section 320.<sup>15</sup> We provisionally proposed that section 320 should be amended to clarify that it does not extend to entitlements to covenanted payments under service contracts or other payments to which section 316(3) applies.

**Summary of respondents' views**

- 10.12 Of the respondents who answered this question, all respondents, save one, supported our provisional proposal to amend section 320 in order to clarify that it does not apply to covenanted payments under service agreements or to other payments to which section 316(3) applies. Few reasons were given. However, a number of respondents made the point that sections 312-316 form the relevant regime for such payments. It was suggested that most companies already proceed on the basis that section 320 does not apply to such payments.<sup>16</sup>

**Recommendation**

- 10.13 Section 320 does not cover cash payments. But arguments have been advanced, for example, that the section applies to an entitlement to claim a golden parachute payment.<sup>17</sup> While the doubt may not be great, our provisional view was supported on consultation. **We recommend that section 320 be amended in order to clarify that it does not apply to covenanted payments under service agreements or to other payments to which section 316(3) applies.**

**AMEND SECTION 321 SO AS TO CREATE AN EXEMPTION FOR TRANSACTIONS WITH ADMINISTRATORS AND RECEIVERS? (OPTION 4 - QUESTION 50)**

**Consultation issue**

- 10.14 We recognised in the Paper<sup>18</sup> that there is currently no exemption for transactions between a director and administrators or receivers although one does exist for such transactions with liquidators. We stated the argument that previously,

<sup>14</sup> Paper, para 4.193.

<sup>15</sup> It follows that where the shareholder approach is already required under ss 312-316, it should not also be required under s 320.

<sup>16</sup> The Law Society raised the question whether covenanted payments of the requisite size should be subject to approval under s 319. We consider that question to be outside the project because it concerns the amount of directors' pay: see para 7.46 above.

<sup>17</sup> Paper, para 4.35.

<sup>18</sup> Paper, para 4.194.

administrative receivers might have been appointed by a director or connected person to facilitate the transfer of the assets of the insolvent company to a new company controlled by the directors so that they could resume trading. However, we recognised that administrative receivers must now be insolvency practitioners and administrators are court appointed, thus reducing the risk of such misconduct. On the other hand, administrators and receivers may be appointed where there is no insolvency. Members may therefore have a continuing interest in giving approval. We asked consultees whether they considered a safe harbour should be created for transactions with administrative receivers and court-appointed administrators.

### **Summary of respondents' views**

- 10.15 A significant majority of respondents who answered this question supported a new exemption in section 321 for administrators and administrative receivers. Support came from a cross-section of representative organisations and companies, practising lawyers, academics, and Government Departments. A few respondents, including the IoD, supported the exemption on the basis that administrators and administrative receivers owe their first duty to the creditors and the shareholders thereafter. A number of respondents seemed persuaded by the fact that administrators and administrative receivers are now insolvency practitioners and subject to legal duties and obligations under insolvency legislation and accordingly are in a better position than fellow directors to exercise an independent judgment.
- 10.16 The remaining respondents appeared to be against the introduction of such an exemption. Among these were practising lawyers, academics and representative bodies. One respondent stated that before the exemption was extended to administrators and administrative receivers there would need to be persuasive arguments that the current safeguard was not required. They were opposed to an exemption for receivers, other than administrative receivers, who were not required to be licensed insolvency practitioners.

### **Recommendation**

- 10.17 We consider that there is a case for introducing a new exemption in section 321 for administrators and receivers.<sup>19</sup> The conflict of interest which a director faces in substantial property transactions does not arise when an administrator contracts on behalf of the company. We consider that administrators should enjoy the statutory protection available to liquidators. We also consider that an extension of the exemption to administrative receivers in England and Wales and receivers in Scotland, who are within the definition of administrative receivers, may address concerns which have arisen from *Demite Limited v Protec Health Limited*.<sup>20</sup> In that case the court held that a company could invoke section 320 to invalidate a sale

<sup>19</sup> The proposed exemption would apply to administrative receivers in England and Wales and receivers in Scotland. It would not apply to non-administrative receivers and managers in England and Wales. Administrators and administrative receivers (and almost all receivers in Scotland) must be licensed insolvency practitioners but receivers need not be: see ss 251 and 388-390 of the Insolvency Act 1986.

<sup>20</sup> [1998] BCC 638.

entered into by an administrative receiver prior to liquidation with a company which was connected with one of its directors.

- 10.18 The *Demite* decision has caused concern because there may be circumstances in which the only persons who will pay a significant price for a company's assets are either the directors or connected persons. In these cases, it is unhelpful to give shareholders of a company in receivership a veto over such transactions which may be the best means of realising value for the security holder. There may be no expectation of a surplus for shareholders. Section 320 would not apply to the exercise by a debenture holder (in England and Wales) of his power of sale,<sup>21</sup> but it may be impractical to exercise that power. On the other hand, we have taken account of the concerns of some respondents that there is a risk of abuse particularly where the receiver is appointed by a director or a connected person.
- 10.19 In view of these concerns we have considered methods whereby the legitimate interests of shareholders, who may in some circumstances have a residual interest in the assets, may be appropriately balanced against those of the security holder. In particular we have considered whether section 320 might require the administrative receiver either to obtain shareholder approval or to apply to the court to obtain approval for the transaction. The receiver could obtain the approval of the court by applying for directions and producing evidence to satisfy the court that the price to be obtained was reasonable in the circumstances.<sup>22</sup> In our view, the necessary balance between the interests of shareholders and those of the security holder could be achieved in this way. Whether the receiver seeks approval from shareholders or from the court, the receiver should be allowed to enter into a contract which is conditional upon obtaining such approval. **We recommend, therefore, that section 321 be amended to introduce a new exemption for transactions with administrators. We also recommend that where there is reason to believe that the company's assets are insufficient to make a payment to shareholders, or for some other good reason, administrative receivers should have the option of applying to the court for approval of a transaction as an alternative to shareholder approval.**

#### **GIVE THE SECRETARY OF STATE POWER TO EXEMPT LISTED COMPANIES FROM SECTION 320? (OPTION 5 - QUESTIONS 3 AND 51)**

##### **Consultation issue**

- 10.20 We considered in the Paper<sup>23</sup> whether listed companies should be exempted from section 320 as the Stock Exchange's Listing Rules and the AIM rules provide protection to shareholders in relation to these types of transactions. We recognised the argument that these rules were more strict than sections 320-322 and therefore listed companies might be better regulated by these. However, we were also aware that, if regulated purely by the Listing Rules, the remedies under section 322

<sup>21</sup> A floating charge holder in Scotland has no such power of sale.

<sup>22</sup> In England and Wales receivers have power to apply to the court for directions under s 35 of the Insolvency Act 1986. In Scotland the court has power to give directions to a receiver under s 63 of the Insolvency Act 1986. An application to the court may be a quicker means of obtaining approval for the transaction but this is not the reason for our recommendation.

<sup>23</sup> Paper, para 4.195.

would no longer be available to listed companies. We asked consultees whether the Secretary of State should be given the power to exempt listed companies from section 320.

### **Summary of respondents' views**

- 10.21 Of those respondents who gave a view on this option, a considerable majority were opposed to the Secretary of State being given the power to exempt listed companies from section 320. These respondents included representative bodies, practising lawyers and academics. It was suggested that core rules should always be statutory and Stock Exchange rules supplementary. It was also noted that the Listing Rules are not identical to section 320. One respondent pointed out that the sanctions under the Listing Rules were not a satisfactory replacement, as a suspension of listing could damage many third parties connected to the company. The remedy under section 322 of avoiding the contract was considered preferable as it would normally affect only the parties to the arrangement. The respondents who favoured exempting listed companies from section 320 were mainly companies although some representative bodies such as the IoD and the Federation of Small Businesses and practising lawyers were also in favour.

### **Recommendation**

- 10.22 We agree with the majority of respondents who expressed the view that listed companies should not be exempt from section 320. We are persuaded by the argument put forward by many respondents that the basic regulatory regime should be in statute. We are not convinced that the restrictions imposed by the Listing Rules would offer the appropriate level of protection to all parties involved, nor would they offer satisfactory sanctions.<sup>24</sup> **We recommend therefore that section 320 should not be amended so as to give the Secretary of State power to exempt listed companies.**

### **ALTERNATIVES TO REGULATION BY SHAREHOLDER APPROVAL (QUESTIONS 52-54)**

- 10.23 We observed in the Paper<sup>25</sup> that there was inevitable cost and delay in calling a meeting to obtain shareholder approval and that this may prevent directors from entering into a transaction which would be in the company's interests. We considered three options which would enable the company to avoid these costs and delay.<sup>26</sup>

<sup>24</sup> However we note that clause 84 of the Financial Services and Markets Bill introduced on 17 June 1999 would enable the competent authority (currently the Stock Exchange) to impose fines on persons (including former and shadow directors) for breaches of the Listing Rules.

<sup>25</sup> Paper, paras 4.197-4.199.

<sup>26</sup> One of these options was whether payments could be deemed approved if shareholders did not object within a specified period. This is discussed at paras 7.76-7.80 above.

**DISPENSE WITH THE REQUIREMENT OF SHAREHOLDER APPROVAL WHERE THE INDEPENDENT NON-EXECUTIVE DIRECTORS APPROVE THE TRANSACTION? (OPTION 6 - QUESTION 52)**

**Consultation issue**

- 10.24 This option would replace the requirement of shareholder approval by requiring independent non-executive directors to approve the transaction. We recognised that this option might be problematic. It would be difficult to ensure that the directors were in fact “independent”. There may be other practical problems, such as a company having no non-executive directors, or where not all of them were willing to approve the transaction. We asked consultees whether they agreed with our provisional view that section 320 should not be amended so as to provide that alternative approval could be given by non-executive directors of the company.

**Summary of respondents’ views**

- 10.25 Our provisional view was supported on consultation. Respondents on the whole thought it would be extremely difficult to ensure that non-executive directors were truly independent. In practice they could be subject to a number of pressures, particularly, as one respondent pointed out, where executive directors are involved in their selection and removal. This option was not thought to provide the appropriate safeguard for shareholders.

**Comment**

- 10.26 The report on Empirical Research shows that non-executive directors increasingly perform the task of monitoring the directors in larger companies with a dispersed share structure. In such larger companies there is a reluctance to convene meetings of shareholders in particular because of the cost involved. Shareholder approval therefore becomes in practice an absolute bar to such transactions. This may not be beneficial. But, as the report on Empirical Research points out,<sup>27</sup> further research is needed to determine the accountability and independence of non-executive directors. Until there is clear evidence that non-executive directors are effective monitors and are accountable, we do not recommend the option of approval by non-executive directors as a substitute for or alternative to shareholder approval.

**DEEM PAYMENTS APPROVED IF NOTIFIED AND MEMBERS RAISE NO OBJECTION WITHIN A STIPULATED PERIOD? (OPTION 7 - QUESTION 53)**

- 10.27 We discussed this procedure in paragraphs 7.76 to 7.80 above. We have reached the same view in the context of section 320.

<sup>27</sup> Para 2.29 above.



**PROVIDE THAT SHAREHOLDER APPROVAL IS NOT REQUIRED IF AN EXPERT REPORTS THAT THE TRANSACTION IS FAIR AND REASONABLE?  
(OPTION 8 - QUESTION 54)**

**Consultation issue**

- 10.28 We drew attention to certain objections to this approach. First, we were concerned as to how shareholders could be satisfied that the expert was of sufficient standing and was independent. This would require his report to be inspected by members. We were not persuaded that the expert would have the expertise to determine whether the company should proceed with the transaction at all where there was a conflict of interest. We therefore asked consultees whether they agreed with our provisional view that companies should not be able to obtain an independent expert's report as an alternative to obtaining shareholder approval.

**Summary of respondents' views**

- 10.29 Few respondents favoured this approach as an alternative to shareholder approval. The Faculty of Advocates said that in their experience expert's reports were of variable quality and were often criticised for not being impartial or independent. Another saw the difficulty in defining and ensuring independence as an obstacle. The Law Society (Company Law Committee) noted that such an exemption exists under the Listing Rules but that real practical difficulties can arise with its application. Our provisional view was therefore supported on consultation.

**Recommendation**

- 10.30 Our provisional views in relation to these options were supported on consultation. We agree with the majority of respondents that it would not be appropriate to replace shareholder approval of transactions under section 320 with any of the proposed options. **We recommend, therefore, that section 320 should not be amended so as to displace the requirement of shareholder approval where:**
- (1) **independent non-executive directors approve the transaction;**
  - (2) **shareholders do not object within a specified period; or**
  - (3) **an expert reports that in his opinion the transaction was fair and reasonable.**

**PROVIDE THAT THE STATUTORY CONSEQUENCES OF BREACH APPLY ONLY WHERE THE COMPANY SUFFERS PREJUDICE? (OPTION 9 - QUESTION 55)**

**Consultation issue**

- 10.31 This option was intended to deal with the difficulties which might result where a company chooses to use one or more of its remedies under section 322, although it was not prejudiced by the transaction.<sup>28</sup> However, we pointed out that this option would require an assessment as to whether the transaction was prejudicial and this might affect its certainty. We asked consultees whether they agreed with our provisional view that section 322 should not be amended to the effect that the

<sup>28</sup> Paper, paras 4.203-4.204.

company would have no remedy where the defendant/defender shows that it was not prejudiced by the transaction.

### **Summary of respondents' views**

- 10.32 Respondents almost unanimously rejected this option. Some respondents were of the view that arguments as to whether or not prejudice existed would further complicate matters and might produce more litigation. Respondents therefore agreed with our provisional view.

### **Recommendation**

- 10.33 To require a company to prove prejudice would complicate the provision which was designed to prevent conflict of interest. Our provisional view was supported on consultation. **On the basis of the response received on consultation, we recommend that section 322 should not be amended to the effect that the company would have no remedy where the defendant/defender shows that it was not prejudiced by the transaction.** However, we recommend below<sup>29</sup> that the Company Law Review should consider a single code of remedies for breach of the provisions of Part X, and this recommendation should accordingly be seen in the context of that recommendation, which may lead to further review of those remedies for Part X as a whole.

<sup>29</sup> Part 15.

## SUMMARY OF RECOMMENDED AMENDMENTS TO SECTIONS 320 - 322

10.34 **In summary, we recommend that:**

- (1) **section 320 should be amended to allow a company to enter into a contract which is conditional on the company obtaining shareholder approval;**
- (2) **section 320 should be amended to clarify that it does not apply to covenanted payments under service agreements or to other payments to which section 316(3) applies;**
- (3) **transactions with administrators of a company should be exempted from the requirement of prior shareholder approval;**
- (4) **administrative receivers should have the option of applying to the court for approval of such transactions where there is good reason to believe that the company's assets are insufficient to make a payment to shareholders or where there is some other good reason why shareholder assent can be dispensed with; and**
- (5) **the other amendments to section 320 which were discussed in the Paper should not be introduced.**

### SECTION 322A: TRANSACTIONS BEYOND DIRECTORS' POWERS

#### DEFICIENCIES IN SECTION 322A (QUESTION 56)

10.35 We explained in the Paper that section 322A was inserted into the Companies Act 1989 in order to create civil liabilities in relation to transactions involving directors where they have exceeded their powers under their company's constitution. This provision makes any such transaction voidable at the instance of the company unless (i) restitution is no longer possible; (ii) the company has been indemnified; (iii) the rights of any person not a party to the transaction would be affected where they have given good value, have acted in good faith and have had no actual notice of the excess of powers or (iv) the transaction is ratified by the company. We pointed out that the other party to the transaction, and any directors authorising it, are liable to account for any profit to the company and to indemnify it against any loss – even if the transaction is not avoided.

10.36 We stated that we were not aware of any deficiency in section 322A but asked consultees for their views.

#### Summary of respondents' views

10.37 Respondents, generally, were not aware of any deficiencies in section 322A. However, one respondent suggested that a further exemption should be introduced for persons other than directors who do not know that they are connected. James Birrell (a member of the Scottish Law Commission's Advisory

Group) queried whether section 322A was consistent with the First Company Law Directive and suggested that this might be reviewed by the DTI in due course.<sup>30</sup>

### **Recommendation**

- 10.38 Respondents generally did not identify any deficiencies in section 322A. **Accordingly, subject to our recommendation that consideration be given to the introduction of a single code of remedies,<sup>31</sup> we recommend that it be retained as it stands.**

## **SECTION 322B: CONTRACTS WITH SOLE MEMBER DIRECTORS**

### **DEFICIENCIES IN SECTION 322B (QUESTION 57)**

- 10.39 In the Paper, we described how section 322B sought to implement the Twelfth Company Law Directive to harmonise the laws in member states permitting single-member private limited liability companies. The Directive envisaged that contracts between a sole member and his company would be recorded in writing. We suggested that such written records would be of most relevance in the context of a winding up or administration: where the contract was not in the ordinary course of business the liquidator would be likely to request written evidence of the contract. Section 322B, therefore, relates to oral contracts entered into between a company which has only one member, and that member, who is also a director. The terms of such a contract must be set out either in a written memorandum or recorded in the first minutes of the first directors' meeting following the making of the contract. The company and every officer in default is liable to a fine should there be a breach of this section.
- 10.40 We stated in the Paper that we were not aware of any deficiencies in this section but asked consultees for their views.

### **Recommendation**

- 10.41 Respondents did not point out any difficulties or deficiencies in section 322B. **Accordingly, subject to our recommendation that thought be given to the introduction of a single code of remedies,<sup>32</sup> we recommend that it be retained as it stands.**

<sup>30</sup> See also *Coöperatieve Rabobank v Minderhoud* [1998] 2 BCLC 507.

<sup>31</sup> See Part 15 below.

<sup>32</sup> See Part 15 below.

# **PART 11**

## **SECTIONS 323-329 AND SCHEDULE 13: OPTION DEALING AND SHAREDEALING**

### **INTRODUCTION**

- 11.1 We consider two topics in this Part. First we examine sections 323 and 327 which prohibit option dealing by directors and their near families. Secondly, we consider the provisions dealing with a director's duty of disclosure as regards his sharedealings (contained in sections 324-326, 328-329 and Schedule 13).
- 11.2 Section 323 was the first effort to address the problem of insider dealing by prohibiting directors from buying "put" and "call" options in listed shares or debentures in the company or another in the same group. This prohibition was extended to spouses and minor children of directors by section 327. However, directors are not prohibited from buying or selling the company's securities through other means. Where they have invested in the company (or any company in that group) through other means they must, under section 324, disclose these interests to the company, including the number and class of each shareholding. The company itself is under an obligation to record these interests in a register and disclose them to the relevant exchanges.

### **OPTION DEALING: SECTIONS 323 AND 327 (QUESTION 93)**

#### **Consultation issue**

- 11.3 Section 323 makes it a criminal offence for directors (including shadow directors) of a company to buy "put" and "call" options in listed shares or debentures in that company or a company of the same group. The prohibition extends to the spouses and minor children of directors. In the Paper<sup>1</sup> we expressed the provisional view that the principal mischief which section 323 addresses is adequately dealt with by the provisions of the Criminal Justice Act 1993 and the Model Code. The Criminal Justice Act 1993 makes it an offence for an individual who has inside information, to deal, on a regulated market or whilst acting as or through a professional intermediary, in price-affected securities in relation to that information. The Stock Exchange's Model Code imposes "closed periods" within which directors of listed companies cannot deal in the securities of their company. While, by contrast, section 323 applies to *off-market dealings* and to dealings *otherwise than on the basis of price-sensitive information*, we noted that it would be open to companies to impose contractual restrictions on directors to prevent such option dealing or for further self-regulatory rules to be introduced. We therefore expressed the provisional view that section 323<sup>2</sup> could be repealed completely.

<sup>1</sup> Paper, para 9.33.

<sup>2</sup> And also s 327 because it merely extends s 323 to spouses and minor children of the director.

### **Summary of respondents' views**

- 11.4 A significant majority of respondents supported the repeal of section 323. A minority of respondents, including the CPS, favoured its retention as it had a wider scope than the insider dealing provisions of the Criminal Justice Act 1993 and as such transactions were capable of giving rise to conflicts of interest. In their opinion a criminal sanction would be a more effective deterrent than, say, a civil remedy or a disciplinary sanction for breach of the Model Code, and would provide greater protection for small investors.<sup>3</sup>

### **Recommendation**

- 11.5 Sections 323 and 327 prohibit a director from purchasing options in his company's shares. But there is an area of duplication between section 323 and the Criminal Justice Act 1993, which also covers options and make it an offence for a director to purchase an option in shares on a regulated market if as an insider he has price-sensitive information in relation to those securities. The prohibition in section 323 is wider than that in the Criminal Justice Act 1993 because it applies to dealings on and off market and it is absolute. However, some dealings in options may fall within both statutes. This seems to us unsatisfactory.
- 11.6 We have considered the points expressed by the CPS and discussed their concerns with them. However, we remain unconvinced that there is any substantial policy reason for prohibiting those transactions which are caught by section 323 but not by the Criminal Justice Act 1993. A transaction within section 323 will be subject to the disclosure obligations in sections 324, 325 and 329.<sup>4</sup> We are not convinced that there is anything intrinsically objectionable to directors' dealings in options if there is full disclosure. Nor are we persuaded that there is any reason to outlaw off-market option dealing on the basis of price-sensitive information if dealings in other securities are not similarly so prohibited: the proper place for regulating dealings on the basis of inside information is the Criminal Justice Act 1993 and not the Companies Acts. If a company wishes to prohibit all such dealings in share options it can do so by contract. If the dealing is fraudulent then we would expect some other offence to have been committed such as the deception offences in England<sup>5</sup> and common law fraud in Scotland. A significant majority of respondents also supported the repeal of section 323.
- 11.7 **Accordingly, we see no reason to depart from our provisional view and therefore recommend its repeal. As a consequence of this, section 327 becomes obsolete and should therefore also be repealed.**

### **ALTERNATIVES TO REPEAL OF SECTION 323**

- 11.8 In the event that consultees might not support the repeal of section 323, we also put forward alternative suggestions. First, section 323 could be retained in its current form. Secondly, some minor improvements could be made to the section. We proposed two improvements: making the section consistent with the

<sup>3</sup> We have discussed the CPS' concerns with them. See para 11.6 below.

<sup>4</sup> Subject in the case of put options to our recommendation in para 11.44 below.

<sup>5</sup> Legislating the Criminal Code: Fraud and Deception (1999) Law Com No 155.

requirements of the Criminal Justice Act and Model Code; and exempting dealings in options under a scheme for the benefit of employees.

#### **NO CHANGE TO SECTION 323 (OPTION 1 - QUESTION 58)**

##### **Consultation issue**

- 11.9 One proposal was to retain section 323 on the basis that it was imprudent for directors to purchase put and call options which may involve the risk of huge losses as well as the chance of large profits on a small investment.

##### **Summary of respondents' views**

- 11.10 Only a handful of respondents preferred to retain section 323 as it stands. One or two respondents suggested that the section should be extended to cover cohabitants and children and other persons who may have used inside information such as friends of directors. KPMG opposed the blanket prohibition on directors buying put and call options in listed shares or debentures and preferred the treatment of options to be consistent with the treatment of shares which are subject to statutory rules on insider dealing.

##### **Recommendation**

- 11.11 We recommend above that sections 323 and 327 be repealed. However, if that recommendation is not accepted, we recommend below amendments to sections 323 and 327. **Accordingly, we do not support the “no change” option.**

#### **MAKE OFF-MARKET DEALINGS IN OPTIONS WITH INSIDE INFORMATION AN OFFENCE? (OPTION 2 - QUESTION 59)**

##### **Consultation issue**

- 11.12 Another proposal was to amend the section in line with those provisions of the Criminal Justice Act and the Model Code requirements. This would mean that it would be an offence under section 323 to deal in put and call options with inside information. This would have the disadvantage that section 323 would become a third source for prohibitions on insider dealing. It would also be illogical to restrict it to directors, when others, for example employees, could have access to inside information. We asked consultees whether, if section 323 is not repealed, it should be amended so as to apply only to off market dealings in options on the basis of inside information.

##### **Summary of respondents' views**

- 11.13 Respondents generally favoured this option if section 323 is not repealed. The Institute of Chartered Secretaries & Administrators, for example, supported the proposal but thought that it should be widened so as to include employees as well as directors. It was also suggested that criminal penalties for breach of this provision should be similar to those applying to insider dealing. A number of comments were made against this proposal. The CPS, for example, was of the view that this option would result in a requirement of proof of inside information in all cases of insider dealing against directors while KPMG thought that all dealings with inside information should be an offence.

### **Recommendation**

- 11.14 We consider, on balance, that, if section 323 is not repealed, it would not be appropriate to confine it to off market dealing in options with insider information while leaving the prohibition of other insider dealing to the Civil Justice Act 1993. There is force in the suggestion that if such off market dealing is to be prohibited, the prohibition should cover employees as well as directors. **We therefore recommend that, if section 323 is not repealed, the section should not be confined to a prohibition of off market dealing in options with inside information.**

### **NO CHANGE, BUT EXEMPT DEALINGS IN OPTIONS UNDER A SCHEME FOR THE BENEFIT OF EMPLOYEES? (OPTION 3 - QUESTION 60)**

#### **Consultation issue**

- 11.15 We suggested in the Paper that the purchase of options from the trustees of an employee share trust could be made exempt from any retained prohibition. We noted that section 323 does not extend to options to subscribe for shares and so it does not affect the employee incentive schemes which involve the granting of such options to subscribe. We observed that schemes which provide options to purchase shares do not result in the dilution of existing shareholdings since no new shares are actually being issued. Arguably therefore it is more appropriate to exempt such schemes. We noted that the exclusion would be limited to the purchase of options under schemes offering comparable benefits to directors and employees in general. We asked consultees whether, if section 323 is not repealed, it should be disappplied in relation to the purchase of options under a scheme for the benefit of employees.

#### **Summary of respondents' views**

- 11.16 The predominant view of respondents was to disapply section 323 in relation to the purchase of options under a scheme for the benefit of employees. The CPS opposed the proposal if the term "employees" were to cover directors, shadow directors, former directors and close relatives. Some respondents took the view that employee share schemes should not be able to benefit from inside information whether directors are beneficiaries or not. Another argument in favour of section 323 covering schemes for the benefit of employees was that pension funds may abuse inside information for reasons of self interest to the detriment of the market.

#### **Recommendation**

- 11.17 As section 323 does not regulate the purchase of options to subscribe for shares, we see little justification for a prohibition of the purchase of options to purchase shares under a scheme for the benefit of employees where comparable benefits are offered to directors and to employees in general. This view received support at consultation. **Therefore, if section 323 is not repealed, we recommend that dealings in options under a scheme for the benefit of employees be made exempt from section 323.**<sup>6</sup>

<sup>6</sup> And, in addition, that s 327 be extended to cohabitants as well as spouses: see generally Part 14 below. We do not accept the suggestion by the CPS that the employee share scheme should not apply to directors.



**SHAREDEALING: SECTIONS 324-326, 328-329 AND SCHEDULE 13**

- 11.18 Some of the main criticisms directed at the sections regulating disclosure of sharedealings are due to their length and complexity. However, a rewrite of these or any provisions of Part X is outside the scope of this review. Instead, therefore, we concentrate our approach on improving and rationalising these sections by recommending a number of technical amendments. In doing so, we have had regard to the core principles of certainty and graduated regulation.
- 11.19 We discussed the regime for disclosure of directors' sharedealings in some detail in the Paper.<sup>7</sup> These provisions play an important role in terms of monitoring whether directors are properly subordinating their personal interests to those of the company. We also suggested that, through disclosure, directors have an additional incentive to comply with the prohibitions which the law imposes on directors' share dealings. Our provisional view was that there appeared to be no reasonable ground for seeking to remove these provisions from the Act. However, we considered a number of issues such as
- (1) whether non-beneficial shareholdings should be exempt from section 324;
  - (2) the meaning of "interest" and the mechanics of disclosure (Schedule 13, Parts I-III);
  - (3) the company's register of directors' interests (sections 325 and 326); and
  - (4) notification to the exchanges (section 329).

**WHETHER NON-BENEFICIAL SHAREHOLDINGS SHOULD BE EXEMPT FROM SECTION 324? (QUESTION 61)**

**Consultation issue**

- 11.20 We noted in the Paper<sup>8</sup> that a director may be a trustee of a trust which holds shares or debentures in a company of which he is a director. Under section 324, a director (unless he is a bare trustee) must disclose his interest in those securities and any changes in the holding. We recognised the argument that where the director has no beneficial interest in the holding, this information has no value because it does not reveal any incentives on the director to improve the company's performance. Furthermore, although the law treats the director's entitlement as trustee to claim his expenses and remuneration and to be indemnified for liabilities properly incurred as a beneficial interest, we expressed the provisional view that such limited beneficial interests should not prevent a holding being treated as non-beneficial.
- 11.21 On the other hand, in certain cases, a director-trustee will have an influence on dealings by a trust and therefore it is likely that the market would be interested in this information unless the transaction is small in value.

<sup>7</sup> Paper, Part 5.

<sup>8</sup> Paper, para 5.19.

- 11.22 We asked consultees whether non-beneficial shareholdings should be exempt from section 324.

**Summary of respondents' views**

- 11.23 There was very little support among respondents for exempting non-beneficial shareholdings from section 324. One argument was that it would be easier for directors to comply with a requirement to disclose all holdings rather than requiring him to distinguish between holdings and risking accidental non-disclosure of beneficial holdings. However, some respondents, such as the IoD and the CBI, were in favour of this exemption although the CBI indicated that their support was subject to a satisfactory definition of what is "non-beneficial". The Institute of Chartered Secretaries & Administrators thought that "non-beneficial" should be interpreted in its natural meaning so as to remove any technical reason (such as the right to receive expenses, remuneration or indemnity) why the law treats a director's interest in an otherwise non-beneficial holding as beneficial.

**NATURE OF PROPOSED EXEMPTION FOR NON-BENEFICIAL SHAREHOLDINGS FROM SECTION 324**

- 11.24 We also asked consultees three questions about the nature of the proposed exemption for non-beneficial shareholdings from section 324. They were as follows.

**Consultation issue (1)**

- 11.25 The first question was whether non-beneficial holdings should be defined as excluding any beneficial interests which the director may have by reason of any right to expenses, remuneration or indemnity.

**Summary of respondents' views**

- 11.26 Almost all respondents agreed with the proposal to define non-beneficial holdings as excluding any beneficial interests which the director may have by reason of any right to expenses, remuneration or indemnity.

**Consultation issue (2)**

- 11.27 The second question was whether the exemption should apply irrespective of the size of the transaction or only if the transaction (when aggregated with other transactions in non-beneficial holdings) does not exceed a certain size.

**Summary of respondents' views**

- 11.28 Respondents' views were equally divided on the issue of whether the exemption should apply irrespective of the size of transaction or only if it exceeds a certain size. For example, the view was expressed that it should apply to all transactions, as introducing a threshold for disclosure would complicate the provisions and, in any event, would be arbitrary.

### **Consultation issue (3)**

- 11.29 The third question was whether, if consultees considered that the exemption should only apply if the transaction does not exceed a certain size, how should such a size be ascertained.

### **Summary of respondents' views**

- 11.30 Of those respondents who preferred the exemption to be dependent upon the size of the transaction, a number of suggestions were made. The Faculty of Advocates suggested that the aggregated transactions, in the case of shares, should not exceed a monetary amount of £10,000 or 1% of the total issued share capital, whichever is lower, and in the case of debentures, should not exceed a monetary amount of £10,000. The Commercial Bar Association and the ICAEW took similar views and proposed respectively that transactions over 1% and 3% of the issued share capital should be disclosed. The CPS preferred a monetary limit as they thought a small percentage of a large company's shares could amount to a large market movement.

### **Recommendation**

- 11.31 We are of the view that a director could be influenced by his obligations as a trustee in respect of substantial trust holdings and this is a relevant concern. We think that it would be difficult to find a satisfactory definition of non-beneficial shareholding which could safely be made exempt from disclosure. A de minimis exemption would be arbitrary and could add unhelpful complication. The majority of respondents preferred not to exempt non-beneficial shareholdings from section 324. This would have the benefit of simplicity. **Accordingly, we recommend that section 324 should not be amended to exempt non-beneficial shareholdings.** We therefore express no view on the issues raised in paragraphs 11.25, 11.27 and 11.29 above.

### **DEFICIENCIES IN SECTION 324 NOT CONSIDERED ABOVE (QUESTION 62)**

#### **Consultation issue**

- 11.32 We also asked consultees whether they were aware of any deficiencies in section 324 not considered above.

#### **Summary of respondents' views**

- 11.33 Although some respondents were not aware of any deficiencies, others made some comments. The most common criticism was that the provisions were very complicated and inconsistent and would benefit from redrafting in plain English. However, the redrafting of Part X is outside the scope of this report. Some respondents made more substantive points, for instance, that section 324 should not apply to a director's interests in shares of the parent company if the company was a wholly-owned subsidiary of that parent company. We see the force of this but information as to directors' interests in the parent company is required to be disclosed in the directors' report. It is appropriate therefore to keep the disclosure requirement and the section 325 register for this purpose. The point was also made that section 328 should include not only spouses but also cohabitants. Consistently with the recommendations that we have made elsewhere in this report we agree with that point.

**THE MEANING OF INTEREST AND THE MECHANICS OF DISCLOSURE:  
SCHEDULE 13, PARTS I-III**

**SHOULD THE SECRETARY OF STATE BE GIVEN POWER BY REGULATION TO VARY THE RULES IN PART I OF SCHEDULE 13 FOR DETERMINING WHETHER A PERSON HAS AN INTEREST IN SHARES OR DEBENTURES FOR THE PURPOSES OF SECTIONS 324-326 AND 346? (QUESTION 63)**

**Consultation issue**

- 11.34 Schedule 13, Part I contains complex provisions for determining when a person is interested in shares under sections 324-326, 328 and 346.<sup>9</sup> We pointed out in the Paper that although the Secretary of State has the power under section 324(3) to introduce exceptions to Schedule 13, Parts I and II, there is presently no power to enlarge the provisions of Schedule 13. There will be cases which are not covered but which ought to be. We asked consultees whether the Secretary of State should have power to vary the provisions of Part I of Schedule 13 by regulation so as to alter the rules as to what is to be treated as an interest in shares. We noted that a similar power is conferred by section 210A of the Act in relation to the meaning of interests in shares required to be notified under Part VI of the Act.

**Summary of respondents' views**

- 11.35 A significant majority of respondents supported the proposal to give the Secretary of State power to vary these rules. It was thought that this would add flexibility to the law so as to take account of changes in types of financial instruments and deal with any obvious omissions. Some respondents disagreed with the suggestion. The IoD took the view that it would introduce uncertainty to already complex provisions. The Law Society too thought this amendment would give rise to unnecessarily complex and even illogical legislation.

**Recommendation**

- 11.36 The Secretary of State has a similar power under section 210A to amend by regulation other provisions in the Act. In relation to section 324 itself, the Secretary of State already has the power to introduce exceptions from the notification requirements. Legal advisers therefore must already consult subordinate legislation when advising on these sections. On balance, and unusually, we are persuaded that amendment by subordinate legislation would be appropriate. **We recommend that the Secretary of State be given the power by regulation to vary the rules in Part I of Schedule 13 for determining whether a person has an interest in shares or debentures for the purposes of sections 324-326 and 346.**

**IMPOSITION OF A TIME LIMIT FOR COMPLIANCE WITH SECTION 325(2), (3) AND (4)? (QUESTION 64)**

- 11.37 We commented that Part II makes no provision for the time within which a company must fulfil its obligations under section 325(2)-(4). Our question on this issue is not relevant as paragraph 22 of Part IV of Schedule 13 already imposes a

<sup>9</sup> Paper, paras 5.20 to 5.26.

time limit of 3 days beginning with the day after that on which the obligation arises.

**OTHER ISSUES FOR REFORM ARISING UNDER SCHEDULE 13, PARTS I-III  
(QUESTION 65)**

- 11.38 We invited consultees' views generally on any other issues for reform arising under Schedule 13, Parts I-III.

**Summary of respondents' views**

- 11.39 Some respondents identified difficulties in practice in relation to these provisions. The Law Society, for example, suggested that Schedule 13 should simply state that the director's obligation of disclosure applies to "any interest of his in the company's securities, whether direct or indirect, or conditional or unconditional and whether or not beneficial." We consider that a more detailed definition is desirable in the interests of certainty. Another respondent pointed out that more than one director can be interested in the same shares under the current definition of "interest" in Schedule 13. These may often be disclosed in the annual accounts in aggregate rather than per individual director and thus it may not amount to useful disclosure. We are inclined to agree, but recommendations about disclosure of these matters in the directors' report are outside the scope of the project.

**THE COMPANY'S REGISTER OF DIRECTORS' INTERESTS: SECTIONS 325 AND 326 AND SCHEDULE 13, PART IV(QUESTION 66)**

**Consultation issue**

- 11.40 Section 325 requires companies to maintain a register to record notifications made to them by their directors under section 324. Particulars of rights to subscribe for shares or debentures of the company granted to a director must also be included although the director is not required to notify particulars of these. In 1996, the DTI issued a consultative document<sup>10</sup> in which it proposed changes to sections 324 and 329. In particular, it proposed the introduction of a disclosure threshold. Respondents to that document, however, were against the amendment of section 324 and therefore section 325 will not be affected by the DTI's proposals. We asked consultees whether section 325 and Schedule 13, Part IV raise any other issues for reform.

**Summary of respondents' views**

- 11.41 Very few issues were raised by respondents. The Law Society queried the logic of the relationship between paragraph 6(2) of Part I of Schedule 13 and paragraph 1 of that Schedule. They thought that the generally accepted view was that Schedule 13 only applies to allotted shares or debentures but that this is confused by the saving provision at the end of paragraph 6(2) which excludes rights to subscribe for shares from paragraph 6(1). We are not convinced that paragraph 6(1) throws doubt on the point that Schedule 13 applies to allotted shares but this point can if necessary be taken into account when new companies legislation is introduced.

<sup>10</sup> "Disclosure of Directors' Shareholdings – Proposal for an Order under the Deregulation and Contracting Out Act 1994".

PIRC noted that the DTI is looking at the impact of information technology on company registers and hoped that they will require disclosure of information by electronic form to allow shareholders to assess company developments on-line. **Accordingly this point does not call for any recommendations by us.**

## **NOTIFICATION TO THE EXCHANGES: SECTION 329 (QUESTION 67)**

### **Consultation issue**

- 11.42 Section 329 requires companies whose shares are listed or admitted to trading on a UK recognised investment exchange to pass the notification they receive from directors under section 324 or 328 to the relevant exchange for the listing or trading of those shares. We noted in the Paper<sup>11</sup> that the obligation imposed by this section extends only to information of which the company is itself notified by the director. It does not cover, for example, the grant of options to subscribe for securities to a director, which the company is obliged to put into the register but which the director is not bound to notify.<sup>12</sup> We pointed out that if section 329 were so amended, criminal sanctions would be available but that this may prove less important if the Financial Services Authority are given the power to impose civil penalties for breach of these requirements.<sup>13</sup> The DTI in its consultation document referred to above<sup>14</sup> proposed that section 329 be amended to clarify that a company need notify only one exchange, where its shares or debentures were quoted on more than one domestic exchange. There was strong support for this approach among respondents to the DTI consultation document and we did not seek any further views on this issue. We asked consultees whether section 329 itself should be amended to clarify that the company is obliged to transmit to the relevant exchange details entered into the register of directors' interests under section 325(3) and (4) without notification by the director.

### **Summary of respondents' views**

- 11.43 Most respondents agreed that section 329 should be amended in this way. One respondent preferred there to be a statutory duty for notification to the relevant exchange in addition to self-regulatory requirements. Another respondent suggested that the duty to inform the relevant exchange should be the responsibility of a designated officer of the company to perform within a set time limit. The Law Society took the view that either section 329 should require the submission of all information to the approved exchange in question or the issue of which information is to be submitted should be left entirely to the rules of that exchange. One suggestion was to leave this matter to be regulated by the Financial Services Authority assuming it would have the power to impose civil penalties for breach of such requirements. The Faculty of Advocates disagreed with the proposal to oblige the company to notify the exchange of transactions which the

<sup>11</sup> Paper, para 5.32.

<sup>12</sup> This is the approach taken in Listing Rule 16.13.

<sup>13</sup> See the "Financial Services and Markets Bill: A Consultation Document" (July 1998), para 13.4.

<sup>14</sup> See n 10 above.

director has not notified to the company as the company might inadvertently breach the criminal law.

### **Recommendation**

- 11.44 In our view, the risk of inadvertent breach of the criminal law is not materially increased by the proposal. The company is subject to a default fine under section 326 if it fails to maintain the register. **We recommend that section 329 be amended so that a company is bound to transmit to the relevant exchange details of information which the company is bound to enter into the register of directors' interests pursuant to section 325(3) and (4) without notification by the director.** The company is bound to have the necessary information and it can provide that notices of the exercise of options should be delivered to a particular officer of the company to prevent such notices being delivered to a person who is unaware of the company's obligations under section 329.

### **OTHER DEFICIENCIES IN SECTION 329 (QUESTION 68)**

- 11.45 We also asked consultees if section 329 raises any issue for reform not mentioned above.

### **Summary of respondents' views and recommendation**

- 11.46 The Institute of Chartered Secretaries & Administrators thought that while all changes in a director's interest should be notified to the company, there should be a *de minimis* threshold for individual notifications to be reported to the individual exchange. This point is covered by the response to the DTI's consultation document. The Association of British Insurers said that if section 323 was abolished, it would be essential that section 329 should require equivalent disclosures, as for share dealings, for all option dealings over the company's shares and not purely in respect of options to subscribe for shares. We agree but consider that Schedule 13 would have this effect in relation to call options. **We therefore recommend that, if section 323 is repealed, section 324(2)(b) should be extended to cover the taking of put options.**

**SUMMARY OF RECOMMENDATIONS UNDER THIS PART**

11.47 **To conclude, we recommend:**

- (1) **that sections 323 and 327 be repealed;<sup>15</sup>**
- (2) **that section 324 should not be amended to exempt non-beneficial shareholdings but that it be amended so as to give the Secretary of State the power by regulation to vary the rules in Part I of Schedule 13 for determining whether a person has an interest in shares or debentures for the purposes of sections 324-326 and 346;**
- (3) **that section 329 be amended so that a company is bound to transmit to the relevant exchange details of information which the company is bound to enter into the register of directors' interests without notification by the director pursuant to sections 325(3) and (4); and**
- (4) **that if section 323 is repealed, section 324(2)(b) be extended to cover the taking of put options.**

<sup>15</sup> We also make recommendations to amend ss 323 and 327 if they are not repealed. See para 11.17.



# **PART 12**

## **LOANS AND SIMILAR TRANSACTIONS**

### **INTRODUCTION**

- 12.1 In this Part we consider proposals to improve the statutory provisions which prevent companies from making loans to their directors or directors of their holding companies or from entering into transactions with such persons which are analogous to loans. We also consider the scope of and justification for the exemptions to those provisions. In the Paper, we also sought consultees' views on a rewrite of loan provisions which would make them easier to understand, but as explained in paragraph 1.35 above, we have agreed with the DTI to treat issues of legislative drafting as outside this report, and so we assume in this Part that in any new companies legislation the necessary steps will be taken to clarify these complex provisions.
- 12.2 These provisions contain a basic prohibition that prevents companies from making loans to their directors or directors of their holding companies. In 1980 further controls on loans and similar transactions were introduced after a number of scandals in the late 1970s. Unlike other provisions in Part X, such as sections 312 and 320, which allow a company to enter into certain transactions after obtaining shareholder approval, these sections prohibit loans and similar transactions. This means of regulation can be justified as a company that enters into loans and similar transactions with its directors may deplete its assets to the prejudice of creditors. The prohibitions are consistent with the "graduated regulation" principle, as we have explained it.<sup>1</sup> We set out below a brief description of the provisions.
- 12.3 There are two groups of prohibitions within these sections, being the prohibitions which apply to all companies and the prohibitions which apply to "relevant companies". Relevant companies are companies which are public companies or are members of a group of companies which include a public company. There are a number of exemptions from each group of prohibitions.
- 12.4 The provisions which apply to all companies prohibit companies from making loans to their directors or directors of their holding companies or from providing guarantees or security in connection with loans by a third party to such a director. There are three exemptions from these prohibitions. They are:
- (1) exemptions for loans of small amounts (currently £5,000 when aggregated) (section 334);
  - (2) exemptions for transactions (including loans, guarantees and securities) at the behest of the holding company, enabling a subsidiary, for example, to lend money to its parent company (section 336); and

<sup>1</sup> Part 3 above.

- (3) exemptions to allow a company to fund expenditure incurred by a director for company purposes, where specified details of the transaction have been disclosed to, and the actions in question approved by, the company in general meeting (section 337).
- 12.5 Relevant companies are subjected to further restrictions which apply to transactions which are analogous to loans. The restrictions extend not only to directors of the company and its holding company but also to persons who are connected with any such director. “Connected persons” are defined in section 346, and in paragraph 8.2 of the Paper we set out the principal persons who are for the purposes of Part X connected with a director.<sup>2</sup> In addition to the prohibitions on loans referred to in paragraph 12.3 above, a relevant company is prohibited from making loans to persons who are connected persons of its directors or directors of its holding company, from carrying out in favour of such directors or connected persons transactions which are quasi-loans (defined by section 331(3)) and credit transactions (defined by section 331(7)) and from giving guarantees or securities in connection with any of these transactions. The concept of a quasi-loan includes a transaction where a director commits the company to an item of personal expenditure for which he ought to reimburse the company. The concept of a credit transaction (the supply of goods or land on credit or on deferred purchase terms) includes a transaction where a company supplies goods on credit to a company which is controlled by or otherwise connected with a director.
- 12.6 In addition to the exemptions listed in paragraph 12.4 above, there are four exemptions from the prohibitions which apply to relevant companies. These are:
- (1) short-term quasi-loans (section 332);
  - (2) inter-company loans and quasi-loans within the same group (section 333);
  - (3) small credit transactions (section 335(1)); and
  - (4) credit transactions in the ordinary course of business (section 335(2)).
- 12.7 Short-term quasi-loans are transactions which impose an obligation on the director to reimburse his creditor within two months and the exemption applies only to the extent that the aggregate of the amounts due by a director under quasi-loans does not exceed a financial limit which is currently £5,000. The exemption for intra-group loans or quasi-loans is necessary because a company within a group of companies may be a person connected with a director of another member of that group. The exemption for small credit transactions applies where the aggregate of the relevant amounts does not exceed a financial limit which is currently £10,000. As we said in the Paper<sup>3</sup> the exemption for transactions in the ordinary course of business is available only if two hurdles are crossed: first, the transaction must be in the ordinary course of the company’s business and,

<sup>2</sup> See para 14.1 below.

<sup>3</sup> Paper, para 6.19.

secondly, the terms of the transaction do not discriminate in favour of directors or persons connected with them.

- 12.8 Further exemptions from the section 330 prohibition are provided for loans or quasi-loans made by a money-lending company to any person and for guarantees by such a company in connection with any other loan or quasi-loan. The exemptions apply where two hurdles are crossed, namely (a) the company enters the transaction in the ordinary course of its business and (b) the amount involved in the transaction is not greater and the terms of the transaction are not more favourable than the amount or terms which it was reasonable to expect the company to have offered to a person unconnected with it. This latter hurdle does not apply to prevent such a company from providing a loan to one of its directors or a director of its holding company to facilitate the purchase of an only or main residence, and similar purposes, but loans of that description must ordinarily be made by the company to its employees on terms no less favourable and are subject to an overall limit of amounts made available to any one director and his connected persons of £100,000. In the Paper we asked consultees whether these exemptions should be retained, whether they were being used in practice and whether they were satisfactory.
- 12.9 Two further restrictions apply to all companies. A company is prohibited from acquiring the obligation of a third party under an agreement into which it could not enter without contravening the section 330 prohibitions (section 330(6)). A company is also prohibited from taking part in an arrangement whereby another person enters into a transaction which is prohibited to the company and whereby that other person obtains a benefit from that company or its holding company (section 330(7)).

#### **Consultation issue**

- 12.10 In the Paper<sup>4</sup> we discussed a possible additional exemption for loans made with the consent of shareholders. We suggested that the prohibitions might serve no purpose where the directors of a company are also its shareholders and there are no creditors or the company is fully able to meet its liabilities. We sought consultees' views on the need in practice to create such an exemption for all or any of the transactions prohibited by section 330. We suggested that if there were to be such an exemption, the safeguard for shareholders should be to require either a special resolution or unanimous consent. We also set out two options to provide safeguards for creditors:
- (1) that the company must provide for the whole of the value of the transaction out of its distributable profits; or
  - (2) that the company's directors must make a statutory declaration as required by section 173 of the Act.
- 12.11 The principal questions on which we invited the views of consultees were:

<sup>4</sup> Paper, paras 6.33 to 6.43.

- (1) Is it necessary to have restrictions other than the prohibition against a company making loans to directors (Question 69);
- (2) To which companies should the prohibitions extend (Question 70);
- (3) Whether the various exemptions from prohibitions were used in practice and were satisfactory (Questions 71-77);
- (4) Whether the exemptions for loans or quasi-loans by a money-lending company were used in practice and were satisfactory (Question 78);
- (5) Whether consultees had any comments on the civil remedies provided by section 341 (Question 80);
- (6) Whether criminal penalties in section 342 should extend to cover offences by all companies (and their officers) (Question 81); and
- (7) Whether there is a need for and, if so, what should be the scope of a possible additional exemption to all companies for transactions made with the consent of shareholders (Question 82).

We set out below the questions put to consultees and the responses received to those questions.

**IS IT NECESSARY TO HAVE RESTRICTIONS OTHER THAN THE PROHIBITION AGAINST A COMPANY MAKING LOANS TO DIRECTORS? (QUESTION 69)**

**Summaries of respondents' views**

***(1) in relation to quasi-loans and related transactions***

- 12.12 Respondents considered that the present restrictions on quasi-loans and related transactions were necessary. It was the general view that these restrictions should extend to directors, holding company directors and their connected persons. There remained a concern amongst professionals that complex schemes are often used in order to evade the basic prohibitions against loans. There was recognition that the provisions are difficult and some respondents wished the language to be reviewed. Entire repeal of these sections was favoured only by a small number of respondents. The Institute of Chartered Secretaries & Administrators advocated reliance on the general law of fiduciary duties with the safeguard that all loans transactions should be on a strictly commercial basis. It was also suggested that this could be accompanied by a duty to disclose in the accounts any transaction over a set amount together with a declaration of solvency supported by an auditor's certificate. Another respondent suggested that quasi-loans which are made within the normal course of trading at full value within normal credit terms should be allowed.

***(2) in relation to credit transactions and related transactions***

- 12.13 The vast majority of respondents considered these restrictions to be necessary. Some respondents reiterated the concern that if these additional restrictions were removed, improper but indirect financial benefits could be conferred on directors without breaching the basic loans prohibitions.

### ***(3) in relation to indirect arrangements***

- 12.14 Again the retention of these restrictions was supported on consultation on the basis of the same concerns as those relating to credit transactions and quasi-loans. Some individual respondents questioned whether these sections were of much practical use and others thought that they were unnecessary.

#### **Recommendation**

- 12.15 Having considered the comments of respondents, we accept that the restrictions on quasi-loans, credit transactions and indirect arrangements are required in practice, not least to avoid the creation of complex schemes to avoid the more basic loans prohibition. **We recommend, therefore, that the restrictions on quasi-loans, credit transactions, indirect arrangements and all related transactions be retained and that they continue to apply to directors, holding company directors and connected persons.**

### **TO WHICH COMPANIES SHOULD THE PROHIBITIONS EXTEND?(QUESTION 70)**

#### **Summary of respondents' views**

- 12.16 The majority of respondents were of the view that these restrictions should apply to all companies. The Institute of Chartered Secretaries & Administrators suggested that the principle that a director should not borrow from the company was a sound one. A number of respondents, including the CBI and the Law Society (Company Law Committee), considered the distinction between "relevant" and "non-relevant" companies to be illogical and confusing while others thought that the rules would be much clearer and more simple to apply if there were no distinction. One respondent said that while it may seem odd to impose extra restrictions on more financially secure companies, it was preferable to retain the restrictions so as to give a clear message that creditors should be protected. There was very little support for removing the additional restrictions on relevant companies. One respondent thought that while the restrictions should apply to all companies, criminal sanctions should only apply to relevant companies. Most respondents preferred to extend these restrictions to all companies rather than defining companies on the basis of their size which respondents regarded as arbitrary, potentially confusing and an additional complication.

#### **Recommendation**

- 12.17 We agree with the view of most respondents that the restrictions should apply to all companies and not just relevant companies. There is merit in the argument that this extension would make these rules more clear and simple to apply. **We recommend therefore that the restrictions contained in sections 330(3), (4), (6) and (7)<sup>5</sup> be applied to all companies and not only relevant companies.** As explained above, we have not given consideration to the application of Part X to small companies. The Company Law Review is considering the application of the Companies Acts generally to small companies,

<sup>5</sup> And, consequently, the exemptions from these restrictions contained in ss 333, 337(3) and 338(4).

and we refer to that review the question whether there is merit in reviewing the application of these complex provisions to such companies.

**WHETHER THE EXEMPTIONS FROM PROHIBITIONS WERE USED IN PRACTICE AND WERE SATISFACTORY? (QUESTIONS 71-77)**

**Summaries of respondents' views and recommendations**

***(i) short term quasi-loans***

- 12.18 Respondents' views differed on this matter. Some professionals considered that these types of loans were used in practice while others had no experience of them. The practical use of this exemption was questioned by a number of respondents, one of whom thought that the short period specified and the small amount available probably meant that it was rarely used. It was emphasised that whilst some exemptions may be theoretically necessary, too long a list of exemptions may be cumbersome. An alternative approach suggested was to amend the definition of what was prohibited so as to exclude transactions which should not be regulated. Of the respondents who supported this exemption, most thought it was satisfactory in its present form. One respondent noted their preference for the layout adopted in the redraft of the relevant provisions in section 15 of Appendix B to the Paper whilst another questioned whether a director should ever use a company credit card for personal spending.
- 12.19 We agree with those respondents who favoured retaining this exemption on the basis that it still appears to be used in practice. We also agree that it seems to be satisfactory in its present form. **We recommend that this exemption be retained in its current form.**

***(ii) intra-group loans***

- 12.20 This exemption appears to be used in practice and its retention was supported by virtually all respondents who expressed a view. No detailed reasons were given by respondents.
- 12.21 **On the basis of the support received for this exemption on consultation, we recommend its retention in the current form.**

***(iii) loans of small amounts***

- 12.22 Most respondents favoured retaining this exemption although one or two respondents thought that it was probably rarely used in practice. However, it was thought that the exemption might be of more use if the relevant financial limits were increased. There was some support for the present limits to be at least doubled. It was also suggested that an alternative might be to apply the exemptions up to the greater of a fixed sum and a percentage of net assets.
- 12.23 **As the responses indicate, this exemption is used in practice and we recommend that the exemption for loans not exceeding the fixed sum set out in section 334 be retained.** However, we also recommend that the Company Law Review should consider increasing the financial limits under this exception.

***(iv) minor transactions***

- 12.24 Similarly, most respondents favoured the retention of this exemption although a number doubted the extent to which it is used in practice. Some respondents favoured an increase in the financial limits.
- 12.25 **Again, we were persuaded by the weight of respondents' views in favour of this exception for minor transactions and we recommend that it be retained.** We also suggest that the Company Law Review consider increasing the financial limits under this section.

***(v) transactions in the ordinary course of the company's business***

- 12.26 Most respondents also supported retaining this exemption. One respondent noted their experience of a company being unable to implement a transaction because of doubts over the "ordinary course" test and the inapplicability of the "no more favourable" test.<sup>6</sup> However, he considered that these difficulties would be better addressed not by amending this section, but by permitting such transactions with shareholder approval. Another point raised was that these transactions must occur frequently in companies buying and selling services to the public. We note the concern raised by some respondents of the "ordinary course" test. In the Paper<sup>7</sup> we explained that under section 335(2), the court has regard to the ordinary course of that particular company's business. Accordingly, there is a subtle difference between this test and the phrase "the ordinary course of business", which looks first and foremost at business practice in general and then to the specific practices of the company in question.<sup>8</sup> The section 335(2) approach therefore is company-specific while the other phrase looks to the ordinary operational activities of businesses as going concerns. Under section 335(2) it is clear that the court is only to have regard to the business of that particular company. This distinction should not cause confusion in practice.<sup>9</sup>
- 12.27 **In light of the consultation response, we recommend that the exception for transactions in the ordinary course of business be retained.**

***(vi) transactions at the behest of the holding company<sup>10</sup>***

- 12.28 Most respondents favoured retention of this exemption. As one respondent pointed out, this exemption allows companies in the same group to give loans when otherwise they would come under the "connected persons" restriction. It was also suggested that the layout of Clause 19 of the redraft of the relevant provision in Appendix B to the Paper was preferable to this provision.

<sup>6</sup> The Company Law Committee of the Law Society also thought that there was doubt over these two areas in practice.

<sup>7</sup> Paper, para 6.20.

<sup>8</sup> See for example the case of *Countrywide Banking Corporation Ltd v Dean* [1998] AC 338 and s 243(2)(a) of the Insolvency Act 1986.

<sup>9</sup> The ordinary course of the company's business test is also used in s 338 in relation to the exemption for a money-lending company. See para 12.32 below.

<sup>10</sup> It is to be noted that in effect it only applies to relevant companies as the recipient of the loan or the person benefiting from the guarantee/credit transaction is the holding company, not the director.

12.29 **We agree with the majority of respondents and recommend that transactions at the behest of the holding company be retained as an exemption under this section.**

*(vii) funding of director's expenditure on duty to the company*

12.30 Respondents again thought that this exemption, though little used in practice, should be retained. One respondent did not think it was used much by small to medium companies and preferred a monetary limit for the director to be set by the board, with expenditure above this limit being approved by the shareholders.

12.31 The majority of respondents supported this exemption. We see no reason to differ from their view. **We therefore recommend that exemption for a director's expenditure on duty to the company be retained.**

*(viii) loan or quasi-loan by a money-lending company (Question 78)*

12.32 Almost all respondents preferred this exemption to be retained although one respondent did not. Another respondent asked whether a director should benefit from this wide exemption. There was some disagreement over the £100,000 monetary limit in this section with one respondent favouring an increase while another argued that the limit was unnecessary given the requirement in section 338(3) that the amount of the loan or quasi loan should not be greater than that which would be given to an outside party of similar financial standing. It was also suggested that the meaning of the phrase "in the ordinary course of the company's business" needed to be clarified.<sup>11</sup>

12.33 We recognise the concern expressed by one respondent that it is difficult to justify a continuing exemption for loans or quasi-loans by money-lending companies. However, we also recognise the benefit of this exemption in that money-lending companies are not required to keep extensive records on customers who might be directors or connected persons of a director. There was also almost unanimous support for its retention amongst every category of respondent. **In the absence of any strong contrary view we recommend that money-lending companies should continue to benefit from this exemption.**

**SECTIONS 339-340: "RELEVANT AMOUNTS" (QUESTION 79)**

**Consultation issue**

12.34 In the Paper we also asked for comments on the terms of section 339 which defines "relevant amounts" for the purposes of specific provisions and section 340 which has effect to determine the value of a transaction or arrangement.

**Summary of respondents' views and recommendation**

12.35 Respondents had little to say on these sections. **We therefore recommend that sections 339-340 be retained in their current form.**

<sup>11</sup> See discussion at para 12.26 on "ordinary course of business" test.



**CIVIL AND CRIMINAL REMEDIES PROVIDED BY SECTIONS 341-342  
(QUESTIONS 80 AND 81)**

- 12.36 The existing civil remedies in section 341 were considered to be sufficient by respondents who saw no reason to amend them. The majority of respondents who addressed the issue of the criminal sanctions in section 342 were in favour of extending them to all companies. It was suggested that this would be more fair, logical and consistent.

**Recommendation**

- 12.37 Respondents did not indicate that the existing civil remedies in section 341 required amendment and we therefore recommend that they are retained in their current form. However, we suggest below<sup>12</sup> that the Company Law Review may wish to consider the introduction of a single code of civil remedies in Part X. Any recommendation made in relation to section 341 at present would therefore require to be reviewed at that stage. We note that there was support for the extension of criminal sanctions to all companies. However, the issue of criminal sanctions under Part X will be dealt with in the Company Law Review and **therefore we make no recommendation in this instance.**

**A NEW ADDITIONAL EXEMPTION FOR LOANS MADE WITH THE CONSENT OF  
SHAREHOLDERS? (QUESTION 82)**

- 12.38 Respondents were divided over the introduction of a new exemption. Almost half of the respondents did not support the exemption. The Faculty of Advocates pointed out that there have been no calls for such a change. However, the Company Law Committee of the Law Society, which supported the new exemption, considered that it should be applicable to all companies and to all transactions covered by these provisions, where shareholders have approved the transaction by special resolution and the directors have made a statutory declaration based on the auditors' report. Many of those respondents in favour of such an exemption qualified their support. Some thought that there was a case for a new exemption only in relation to management buyouts. Other respondents questioned whether there was sufficient demand in practice to introduce an additional exemption which might increase the complexity of the provisions.
- 12.39 Most respondents indicated that of the two options put forward as safeguards for shareholders, a special resolution was preferable, although some expressed the view that the director concerned should be excluded from voting. In relation to the safeguards put forward in the Paper for creditors, respondents were split in their support for Option 1 (the company providing for the whole value of the transaction out of its distributable profits) and Option 2 (the directors being required to make a statutory declaration under section 173). Some respondents were in favour of a combination of Options 1 and 2, with one suggestion being to include arrangements similar to those under the financial assistance procedure.

<sup>12</sup> Part 15.

## **Recommendation**

- 12.40 We proposed this option as a deregulatory measure and with a view to loosening some of the complex restrictions in the loans regime. However, we are aware that the introduction of a new exemption for loans with shareholder consent would involve adding further complexities to existing legislation which would be contrary to our remit to simplify and modernise the provisions of Part X. Therefore, and in the absence of clear-cut demand for such a new exemption, **we recommend against the introduction of a new exemption for shareholder approval.** However, the Steering Group of the Company Law Review have indicated in their Strategic Framework Document that they plan to review the capital maintenance structure of companies. If this structure is made more flexible in future, then the proposal to introduce an exemption for loans with shareholder consent could be reviewed at that stage.

## **SUMMARY OF RECOMMENDATIONS UNDER THIS PART**

- 12.41 **To summarise, we recommend that the prohibition in sections 330(3), (4), (6) and (7) on companies making loans to (or entering into analogous transactions with) their directors or the directors of their holding companies or connected persons should apply to all companies and not just relevant companies. This, however, is subject to the outcome of the Company Law Review which may favour the introduction of special provisions for small companies. We recommend the retention of the existing exemptions to the prohibitions in section 330 and that sections 339-340 be retained in their current form. We do not recommend the introduction of an additional exemption for loans made with the consent of shareholders.**

# **PART 13**

## **DISCLOSURE OF TRANSACTIONS IN WHICH DIRECTORS AND THEIR CONNECTED PERSONS ARE INTERESTED IN THE ANNUAL ACCOUNTS (SCHEDULE 6, PART II) AND THE SPECIAL PROVISIONS FOR BANKS**

### **INTRODUCTION**

- 13.1 In this Part we consider the requirement that a company disclose in its annual accounts details of self-dealing transactions by its directors and their connected persons. We also consider the corresponding requirements for banks. The purpose of disclosure is to enable shareholders to monitor those activities of the board where there may be a conflict of interests. The two main questions we asked were on the limitation on disclosures of directors' interests in contracts with the company<sup>1</sup> and whether Schedule 6 should be repealed and reliance placed instead on FRS 8.<sup>2</sup> We also consider a number of minor amendments to Part II of Schedule 6. Finally, we consider whether the separate regime for banks provides sufficient disclosure to shareholders.<sup>3</sup> The requirement of disclosure to shareholders is consistent with the "efficient disclosure" principle as we have explained it.<sup>4</sup>

### **AMENDMENTS TO SCHEDULE 6, PART II OF THE ACT**

#### **DEFINING MATERIALITY FOR THE PURPOSES OF PARAGRAPHS 15(C) AND 16(C) (QUESTION 83)**

##### **Consultation issue**

- 13.2 In the Paper<sup>5</sup> we explained that paragraphs 15(c) and 16(c) of Part II of Schedule 6 to the Act require disclosure in company accounts of the particulars of transactions or arrangements in which directors or their connected persons have a direct or indirect material interest. Paragraph 17 of Schedule 6 enables directors to determine whether a particular interest is material. "Material interest" is not defined in the Schedule and we expressed the view that it may bear one of two meanings: (1) an interest which is likely to be of relevance to shareholders or creditors if it could influence decisions taken by them on the basis of the financial statements; or (2) a transaction in which the director's interest was substantial. The former is a qualitative assessment and the latter quantitative. We drew attention to the DTI's suggestion in its consultative document in 1991 that an

<sup>1</sup> Para 13.2ff below.

<sup>2</sup> Para 13.12ff below.

<sup>3</sup> Paras 13.40 to 13.49.

<sup>4</sup> Part 3 above.

<sup>5</sup> Paper, paras 7.6-7.9.

interest in a transaction should be treated as material unless disclosure of the interest would be of no significance to the company's members or creditors.<sup>6</sup> We also noted that for the purpose of FRS 8,<sup>7</sup> materiality of a transaction is to be determined by reference to the significance of the transaction to both the company and the director. Finally, we referred to a technical release of the ICAEW<sup>8</sup> which expressed the view that materiality depends not just on a quantitative judgment as to the transaction's size, but also on a qualitative judgment and that ultimate materiality depends on how information could influence the economic decisions of users of the accounts. We asked consultees whether Schedule 6 should contain a definition of materiality for the purposes of paragraphs 15(c) and 16(c).

### **Summary of respondents' views**

- 13.3 The majority of responses indicated that Schedule 6 should contain a definition of materiality for the purposes of paragraphs 15(c) and 16(c). The responses varied as to what that definition should be. Some suggested that materiality should be defined by reference to materiality to the board and the director. Several suggested defining materiality in Schedule 6 in the same way as it is set out in FRS 8.
- 13.4 As Allan Cook, Technical Director of the Accounting Standards Board pointed out, materiality in the context of accounting standards is judgmental and contextual. It depends on the size and nature of the items in question in the particular circumstances of the case. In FRS 8, the materiality of related party transactions is judged not only in terms of their significance to the reporting entity, but also in relation to the other related party. Since the consultation period closed, the Accounting Standards Board has published a revised Exposure Draft on its Statement of Principles for Financial Reporting. The Exposure Draft emphasises the role of materiality as a criterion of what might reasonably be expected to influence the economic decisions of users of financial statements. Whether information is material depends on the size and nature of the item in question judged in the particular circumstances of the case.
- 13.5 Mr Cook also expressed the view that although directors are well placed to know the relevant facts, materiality should not be settled by directors as paragraph 17(2) of Schedule 6 permits.
- 13.6 Other suggestions included that materiality should be defined by reference to stakeholders in a company and that it should be based on either of the tests we had proposed in the Paper (i.e. by reference to (1) the significance for shareholders or creditors; or (2) the extent of a director's interest).

### **Comment**

- 13.7 Under Part II of Schedule 6 the directors must disclose in notes to the company's accounts any transactions or arrangements with the company in which a director had a material interest. The purpose of accounts is to give the shareholders a true

<sup>6</sup> See DTI, "Amendments to Schedule 6 to the Companies Act 1985: Disclosure by Companies of Dealings in Favour of Directors, A Consultative Document" (1991).

<sup>7</sup> Issued by The Accounting Standards Board in October 1995. See Appendix N of the Paper.

<sup>8</sup> TECH 32/96 on The Interpretation of Materiality in Financial Reporting (May 1996).

and fair view of the state of affairs of the company as at the end of the financial year.<sup>9</sup> The disclosure of directors' interests in the accounts is therefore a record for the shareholders of the information that was available to the directors when making the decision regarding the proposed contract. On the basis of the disclosure the shareholders can determine whether the directors have acted in a way which conferred an unacceptable benefit on them or persons who are close to them.

- 13.8 At present Schedule 6 requires disclosure of any transaction etc. in which a director has a "material interest". This wording seems to suggest that materiality is measured by reference to the extent of a director's interest in the transaction. Thus minor transactions which are of little relevance to the financial position of a company may require to be disclosed to shareholders simply because a director has a significant interest in them. In our view it is important to avoid cluttering financial statements with unnecessary and unhelpful disclosures. To achieve the appropriate level of disclosure, it is necessary to consider materiality more generally. We recommend that transactions should be disclosed under paragraphs 15(c) or 16(c) if the requisite degree of materiality exists either in relation to the director or in relation to the company. We gave the example above<sup>10</sup> of a transaction whereby a director sold an asset to the company which was of small value so far as the company was concerned but significant in relation to the director who has an interest in it. The director's interest in this transaction should not be excluded from disclosure simply because it is not material in financial terms to the company. Likewise the director may have a minor interest in a transaction which nonetheless may be appropriate for disclosure because of the significance of the transaction to the company. However, we do not recommend that materiality should be further defined. Much will depend on the judgment to be made in the light of the circumstances.
- 13.9 We note that this recommendation adopts a different approach to "materiality" in Schedule 6 from our recommendation for the purposes of section 317.<sup>11</sup> We consider that the difference in approach is justified. Disclosure to the board is a mechanism to enable the board to be aware of the possibility of conflict of interest when a transaction is being considered. Disclosure in the annual accounts is intended primarily to present a picture of a company's financial position and to allow an assessment of management's stewardship.
- 13.10 There is a corollary to our recommendation. If materiality is defined in these terms it is a matter to be determined objectively. This leads to the question whether paragraph 17(2) of Schedule 6 should remain. This enables the board to form a view as to whether an interest is material or not. While materiality is a judgmental matter, and paragraph 17(2) is no doubt convenient, we doubt whether it is appropriate. It enables a board to escape the disclosure obligation provided that their decision is reached in good faith and is not such that no reasonable board could have made it. However, this is a low standard of review. If paragraph 17(2)

<sup>9</sup> Section 226 Companies Act 1985.

<sup>10</sup> Para 8.20.

<sup>11</sup> Paras 8.20-8.34.

were not there, the board would err on the side of caution. As these situations involve conflicts of interest we would regard that a desirable situation.

### **Recommendation**

- 13.11 **To summarise, we recommend that the obligation under paragraphs 15 and 16 of Schedule 6 to disclose interests in transactions should apply to interests that are material to the director in question or the company. We also recommend the repeal of paragraph 17(2) of that Schedule.**

### **WHETHER SCHEDULE 6, PART II SHOULD BE RETAINED NOTWITHSTANDING THE INTRODUCTION OF FRS 8? (QUESTION 84(i))**

#### **Consultation issue**

- 13.12 The next issue on which we invited comment was whether it would be possible for Schedule 6, Part II to be repealed and reliance placed on FRS 8.<sup>12</sup> We said it would obviously be easier for preparers of accounts if they did not have to look at both accounting standards and the Act. However, we suggested that there were a number of difficulties with this course. The Schedule is drafted in more precise terms than FRS 8<sup>13</sup> and carries criminal sanctions.<sup>14</sup> The Schedule and FRS are administered by different bodies (being the DTI and Financial Reporting Review Panel respectively) and there are also differences between the two regimes.<sup>15</sup> Further, Schedule 6, Part II could not be repealed in its entirety because the Fourth EC Directive on company accounts<sup>16</sup> requires the notes to the accounts to give certain particulars of “advances and credits” granted to directors.<sup>17</sup> We said that there is accordingly likely to be a separate role for Schedule 6, Part II.

#### **Summary of respondents’ views**

- 13.13 Most respondents to the Paper thought that Schedule 6, Part II should be retained. Respondents pointed to the different purposes of the regimes and the different sanctions, and the view was expressed that the offence under section 233(5) provides an incentive to disclosure. There was also reference to the need for a simplified statutory underpinning, with one respondent commenting that the disclosures relate to directors’ statutory and common law duties of stewardship and there should therefore be minimum statutory disclosures as set out in Schedule 6. It would be unsatisfactory to leave it to an accounting standard which might be amended or withdrawn at any time. On the other hand it was suggested that most of Schedule 6, Part II could be repealed on the basis that reliance could

<sup>12</sup> Paper, paras 7.10-11.

<sup>13</sup> See the discussion on “connected persons” at paras 8.15 - 8.18 in the Paper.

<sup>14</sup> Section 233(5), but only if the director knows that the accounts do not comply with the Act or is reckless as to whether they comply.

<sup>15</sup> Paper, para 7.10.

<sup>16</sup> 1987 OJ L 222/11.

<sup>17</sup> Art 43.1 (13).

be placed on FRS 8, a section 317 register of directors' interests and the Financial Reporting Review Panel's powers of enforcement.<sup>18</sup>

### **Recommendation**

- 13.14 To replace Schedule 6 Part II by FRS 8 would reduce the overlap between statutory and non-statutory requirements and thus the burden on issuers of accounts. However the two regimes are different in character and carry different consequences.
- 13.15 Section 232(1) imposes a legal obligation on a company to disclose the information specified in Schedule 6 Part II in the notes to the annual accounts. If the legal requirement were removed there would be no obligation on the face of the Act to report to the owners of a company on transactions in which directors have a material interest.
- 13.16 This is because the Companies Acts do not in terms require companies to comply with accounting standards. They merely require a company to state whether its annual accounts have been prepared in accordance with applicable accounting standards and to give particulars of and reasons for any material departure from those standards.<sup>19</sup> On the other hand the annual accounts are required to show a true and fair view. Annual accounts must in general comply with accounting standards to satisfy this requirement.<sup>20</sup> Accordingly most companies subject to FRS 8<sup>21</sup> could be expected to comply with it even if it was not a requirement of the Act. Likewise the Act could in theory provide that companies should comply with FRS 8, but this would be problematic as it is not written in statutory language.
- 13.17 There are differences between FRS 8 and section 232(1) in the way in which they are enforced. Directors who approve the annual accounts which do not give the information which is required by Schedule 6, knowing that they do not comply with that Schedule or reckless to whether they do or not, commit an offence. The position is not as straightforward where what is alleged is that there has been a failure to comply with FRS 8. Failure to comply with FRS 8 is not on the face of it a breach of the Act but, as we have explained, it is likely that non-compliance with FRS 8 will mean that the accounts do not show a true and fair view, which would amount to a criminal offence in some circumstances. A criminal offence will if prosecuted be dealt with by the courts. If however the non-compliance with either Schedule 6 or FRS 8 is of sufficient significance the Financial Reporting Review Panel may also take steps to see that the accounts are revised. In the nature of things this will not happen in many cases.

<sup>18</sup> However, we recommend that the register of directors' interests is not open for inspection by shareholders. See paras 8.71-8.75 above.

<sup>19</sup> Schedule 4, para 36A of the Act.

<sup>20</sup> See Paper para 1.45 for 1985 Act Schedule 4 para 36A.

<sup>21</sup> Small companies and groups are not subject to FRS 8 but to the modified requirements of the Financial Reporting Standard for Smaller Entities.

- 13.18 We attach considerable importance to the disclosure of the material interests of directors in transactions with their company.<sup>22</sup> We consider that the Act should require disclosure of these interests, and furthermore that the disclosure of these interests needs to be supported by criminal sanctions to ensure the highest practicable degree of compliance. While we are anxious to eliminate unnecessary duplication of regulation, we do not consider that FRS 8 can safely be substituted for Schedule 6, Part II. **Accordingly, we recommend that Schedule 6, Part II is retained and not replaced by FRS 8.**

**IMPOSING A DUTY ON DIRECTORS TO GIVE NOTICE OF HIS AND HIS CONNECTED PERSONS' INTERESTS? (QUESTION 84(ii))**

**Consultation issue**

- 13.19 We drew consultees' attention to the fact that although a director (and certain past directors) must notify the company of such matters relating to himself as may be necessary for the purposes of Part I of Schedule 6,<sup>23</sup> there is no corresponding duty in relation to the matters covered in Part II of Schedule 6. Consultees were asked whether a duty of this kind should be introduced. Part I deals with emoluments, compensation for loss of office and pension payments.

**Summary of respondents' views**

- 13.20 The predominant view was that a director should be placed under a duty to give notice to the company of matters relating to himself and (so far as known to him) his connected persons as may be necessary for the purposes of Part II of Schedule 6. Respondents considered that it was a logical extension of section 232(3) and also noted that it was necessary as companies cannot know whether they are dealing with connected persons. It was thought important that the duty should only extend "so far as known to [the director]". One respondent expressed concern that the amendment may give rise to difficulties of compliance because it would be difficult to prove what a director knew of the affairs of a connected person. Dissenting opinions indicated that it should not be for directors to judge what is within Part II and an alternative proposal was made that the duty should be perhaps to respond to the company's enquiries.

**Recommendation**

- 13.21 A company may be expected to know of the director's interest in a transaction, such as loan, which it enters into directly with him. Where the director in question is director of the holding company there may be greater risk of ignorance. In either circumstance we see an advantage in imposing a duty of notification on a director to ensure that the relevant persons within the company have the requisite information. Greater problems may arise in relation to the interest of a connected person. A company may often not know of the connection between the director and his connected person. Equally, the director may not know about the affairs of a person connected with him, and for this reason, any duty must be expressed to be "so far as known to the director".

<sup>22</sup> Para 3.21 above.

<sup>23</sup> See s 232(3).



- 13.22 **Our recommendation, therefore, is that a director should be placed under a duty to give notice to the company of such matters relating to himself and (so far as known to him) his connected persons as may be necessary for the purposes of Schedule 6, Part II.**

**WHETHER THE EXCEPTION FOR TRANSACTIONS IN THE ORDINARY COURSE OF BUSINESS IN PARAGRAPH 20 SHOULD BE RETAINED AND IF SO WHETHER IT SHOULD BE EXTENDED TO APPLY TO TRANSACTIONS WHICH ARE NOT INTRA-GROUP? (QUESTION 84(iii))**

**Consultation issue**

- 13.23 We referred consultees to that paragraph of Schedule 6, Part II which exempts from the general disclosure requirements of paragraphs 15(c) and 16(c) arms' length transactions in the ordinary course of business.<sup>24</sup> This exemption extends to intra-group transactions only. We indicated that one reason for disclosure is that the terms of a transaction might have been affected by the director's interest in it. We asked whether it should be retained. We also asked whether it should be extended to apply to all transactions, and not solely those which are intra-group. This had been proposed by the DTI in 1991.<sup>25</sup>

**Summary of respondents' views**

- 13.24 The predominant view was that the exception for transactions with group members in the ordinary course of business should be retained and extended to transactions that are not intra-group. A reason put forward by respondents for not retaining the exception was that it was not allowed by FRS 8.

**Recommendation**

- 13.25 We appreciate that the factors involved in determining whether the requirements of paragraph 20(b) are satisfied involve questions of judgment on which views may differ and of which advantage might be taken by the unscrupulous. On the other hand, to extend paragraph 20 to non-group companies would serve the valuable purpose of eliminating disclosure of information which is unlikely to be helpful to the parties. **We therefore recommend that the exception for transactions in the ordinary course of business in paragraph 20 of Schedule 6 should be retained and that it should be extended to apply to transactions which are not intra-group.**

**CONFORMING TREATMENT OF SIMILAR TRANSACTIONS**

**Consultation issues**

- 13.26 The next three questions we asked addressed what appeared to us to be inconsistencies in the treatment of similar transactions. They were as follows.

<sup>24</sup> See para 20 of Schedule 6 Part II, and not para 21, as stated in one place in the Paper.

<sup>25</sup> See DTI, "Amendments to Schedule 6 to the Companies Act 1985: Disclosure by Companies of Dealings in Favour of Directors, A Consultative Document" (1991).

**WHETHER THE DETAILS OF THE VALUE REQUIRED TO BE GIVEN IN RELATION TO LOANS (AND RELATED GUARANTEES AND SECURITY) UNDER PARAGRAPH 22(2)(D) AND (E) SHOULD BE THE SAME IN RELATION TO QUASI-LOANS AND CREDIT TRANSACTIONS (INCLUDING RELATED GUARANTEES AND SECURITY) OR VICE-VERSA? (QUESTION 84(iv))**

**Summary of respondents' views**

- 13.27 A majority of respondents were in favour of conforming the requirements. Of those who addressed the question as to how to conform the requirements, more were in favour of setting the paragraph 22(2)(d) and (e) level of disclosure to quasi-loans and credit transactions than vice-versa. The main reason for introducing the higher level of disclosure was that to do so would mean that the maximum amount outstanding during the year and the opening and year-end balances would be required for quasi-loans and credit transactions. An argument made in favour of adopting the paragraph 22(2)(f) level of disclosure was that the details required by that paragraph sufficed. A view was also expressed that the details needed to be distinct in view of the disparate incidents of the three types of transaction.

**Recommendation**

- 13.28 **We recommend that the level of detail of disclosure of the incidents of quasi-loans and credit transactions and related guarantees and security should in principle be the same as that required under sub-paragraphs (d) and (e) of paragraph 22 of Schedule 6 for loans.**

**WHETHER THE EXEMPTION IN PARAGRAPH 23 SHOULD EXTEND TO CREDIT TRANSACTIONS? (QUESTION 84(v))**

**Summary of respondents' views**

- 13.29 The majority of respondents either considered that the exemption in paragraph 23 should extend to credit transactions, or could not see any immediately obvious reason for excluding credit transactions from the exemption. One respondent, however, suggested that the exemption should not be extended because the definition of a credit transaction could cover such a wide range of transactions.

**Recommendation**

- 13.30 The exemption in paragraph 23 of Schedule 6 serves the valuable purpose of eliminating the requirement to disclose details of intra-group transactions in which a director is interested only because of his association with the holding company. The members of the group must be wholly-owned so no minority shareholder of a subsidiary will be involved. **We recommend that this exemption should be extended to credit transactions.**

**WHETHER THERE SHOULD BE EXEMPTIONS SUCH AS THOSE IN PARAGRAPH 24 FOR LOANS AND QUASI-LOANS? (QUESTION 84(vi))**

**Summary of respondents' views**

- 13.31 Respondents to this question were virtually unanimous in their view that exemptions on the lines of the de minimis exemptions in paragraph 24 (for credit transactions and related guarantees, arrangements and agreements made for a

director) should apply to loans and quasi-loans. One additional suggestion was that it would be appropriate to grant an aggregate de minimis disclosure exemption for loans, quasi-loans and credit transactions taken together.

### **Recommendation**

- 13.32 **We recommend that there should be a de minimis exception for loans and quasi-loans on similar lines to paragraph 24 of Schedule 6.**

### **MISCELLANEOUS QUESTIONS ON PART II OF SCHEDULE 6**

- 13.33 We asked consultees two further questions on Part II of Schedule 6, which are set out below.

### **WHETHER, WHERE THE DEEMED VALUE PROVISION IN SECTION 340(7) APPLIES, THE DIRECTORS SHOULD BE REQUIRED IF POSSIBLE TO GIVE SOME ESTIMATE OF THE VALUE? (QUESTION 84(vii))**

#### **Consultation issue**

- 13.34 The next issue we raised for consultation was on paragraph 27 of Schedule 6. Paragraph 27(1)(c) provides that section 340 of the Act applies for the purposes of the Schedule in assigning values to transactions and arrangements. Section 340(7) provides that the value of a transaction or arrangement which is not capable of being expressed as a specific sum of money is deemed to exceed £100,000. It may be of little assistance to the user of accounts simply to be told that the value of a transaction is over £100,000, when clearly it may be much greater than that amount. We therefore raised for consideration whether, where the deemed value provision in section 340(7) applies, the directors should be required to give an estimate of the value of the transaction.

#### **Summary of respondents' views**

- 13.35 A large majority of respondents supported a requirement that directors should give some estimate of the value of a transaction or arrangement that it unascertainable. One respondent commented that it should be clear that it is a bona fide estimate and not a valuation.
- 13.36 Dissenters said that an estimate would not be of much help and it may not be feasible, as section 340(7) applies only where the value is not capable of being expressed. One of them said that it may be appropriate for the accounts to disclose the fact that the deeming provision applies. It was suggested that in any event the giving of an estimate should not result in section 340(7) being overridden. Two respondents observed that prior to the consolidation of the Companies Act 1980 into the Act, the deeming provision applied also for the purpose of what is now section 320, and that this link should be restored.

### **Recommendation**

- 13.37 **We recommend that, where the deeming provision applies, a director should, wherever possible, be required to give an estimate of the value of the transaction.** However, we consider that section 340(7) should not be extended to section 320 since it may otherwise bring within that section transactions which are not of the requisite value.

**WHETHER A TRANSACTION SHOULD BE OUTSIDE PARAGRAPHS 15(C) AND 16(C) SIMPLY BECAUSE THE DIRECTOR IS A COMMON DIRECTOR OF BOTH PARTIES TO THE TRANSACTION? (QUESTION 84(viii))**

**Summary of respondents' views**

- 13.38 A slight majority of respondents were against excluding a transaction from paragraphs 15(c) and 16(c) because the director is a common director of both parties to the transaction. One respondent drew attention to the fact that this point appears already to be covered by the exemption in paragraph 18(a).

**Recommendation**

- 13.39 **We do not consider that a company should be exempted from an obligation to disclose such transactions in which a director has a material interest merely because that interest is as a director of the other company. He has a conflict of duties and therefore shareholders should receive this information. Accordingly, we recommend that paragraph 18(a) of Schedule 6 should not apply to transactions disclosable under paragraphs 15(c) and 16(c).**

**SECTIONS 343-344: SPECIAL PROVISIONS FOR BANKS (QUESTION 85)**

**Consultation issue (1)**

- 13.40 A bank must disclose in its annual accounts certain transactions in which a director is interested as must any other company.<sup>26</sup> However, it need only disclose abbreviated particulars of the following transactions with directors or their connected persons: loans, quasi-loans, credit transactions, related guarantees and security and agreements to enter into any of those transactions.<sup>27</sup> For example, it need state only the aggregate amounts outstanding under the transactions at the end of the financial year (as against full particulars of individual transactions). A bank is, however, required to keep a register of copies of these transactions and make particulars of the transactions available to shareholders in the form of a statement.<sup>28</sup> In the Paper we observed that in practice the requirement to keep a register instead of making full disclosure in the accounts may not provide a sufficiently stringent form of disclosure.
- 13.41 Accordingly, we asked consultees whether they considered that sections 343 and 344 (i.e. the requirement to keep a register and make a statement available to shareholders) are necessary or desirable.

**Summary of respondents' views**

- 13.42 Relatively few respondents replied to this question, but, of those that did, the majority considered that a separate regime for banks was necessary and desirable. The main reason given was that the business of banks includes the provision of

<sup>26</sup> Paras 15(c) and 16(c) of Schedule 6, Part II.

<sup>27</sup> Para 3 of Part IV of Schedule 9.

<sup>28</sup> Sections 343 and 344 of the Act. The statement must be examined and reported on by the company's auditors.

loans whereas loans by companies should, in the main, be the exception rather than the rule. The full disclosure by companies in their accounts was, at the time of introduction of the legislation, thought likely to deter abuse. The reasons for differential treatment which we had quoted in the Paper<sup>29</sup> were said still to hold true. These included the need to avoid the disruption of perfectly proper commercial business between companies associated with a director and the bank. It was also thought that sections 343 and 344 did provide sufficient protection to shareholders, given the level of disclosure, the auditors' review of the statement and the regulation of financial institutions.

- 13.43 Respondents also commented that the volume of transactions between a bank and its directors or persons connected with its directors would be likely to be great, and certainly larger than that of ordinary companies, and that disclosure of full details of transactions in a bank's annual accounts would produce a very long list. It was thought that it would not make sense now to require details to be published in the annual accounts when it has in the past been sufficient to make a statement of that detail available for those who wish to review it. Furthermore, experience has shown that shareholders do not raise questions regarding loans by banks to directors and do not seek the additional information despite clear statements that it is available.
- 13.44 One respondent said that the point we raised in the Paper that supermarkets and building societies now offer banking facilities was not significant as, if they are to trade as banks they will be regulated as banks and should be treated as banks. The same respondent commented that the regulation of banks is outside the scope of the Act.
- 13.45 Amongst those in favour of removing the special regime, one respondent commented that if the loans are on proper commercial terms, there should be no difficulty for the directors in raising them from another source.

#### **Recommendation**

- 13.46 **In view of the low response to this question, we prefer not to make a recommendation but suggest that the Company Law Review may wish to consider the matter.**

#### **Consultation issue (2)**

- 13.47 We also asked consultees whether, on the basis that sections 343 and 344 are retained, they were aware of any deficiency in these sections which required to be addressed.

#### **Summary of respondents' views**

- 13.48 Several respondents suggested extending the period during which the section 343 statement can be inspected as there seems little reason for it being limited to the 15 days before the company's annual general meeting. Respondents suggested that the statement should be available for inspection until the next year's statement is

<sup>29</sup> Paper, para 7.14.

available. They also commented that section 343(5) should refer to the company's general meeting and not its annual general meeting, as the statutory requirement in section 241 is for accounts to be laid in general meeting. A number of respondents commented that the disclosure regime for banks in Schedule 9 and sections 343 and 344 is complex, repetitious and could benefit from being written in simple English.

**Recommendation**

13.49 **Our recommendation is that these suggestions are taken into account if the sections are rewritten.**

# **PART 14**

## **CONNECTED PERSONS (SECTION 346)**

### **AND THE EXTRA-TERRITORIAL APPLICATION OF PART X**

#### **Introduction**

- 14.1 In this Part we consider proposals to improve the current statutory definition of “connected persons” and discuss whether the Secretary of State should be given power to alter the list of connected persons by subordinate legislation. Section 346 sets out the definition of “connected person” which is used in many of the sections in Part X. The principal persons who are “connected” with a director are:
- (1) his spouse and infant children;
  - (2) a body corporate with which the director is associated;
  - (3) trustees of a trust under which the director or his family or his associated companies are beneficiaries; and
  - (4) partners (and any Scottish firm of which, or with which, the director is a partner).
- 14.2 In this Part we also consider the extra-territorial application of Part X and whether to extend the application of section 347, which does not allow a company to contract out of certain sections of Part X by choosing a foreign governing law.

#### **THE MEANING OF CONNECTED PERSON (QUESTIONS 86 AND 87)**

##### **Consultation issue**

- 14.3 In the Paper we discussed the possibility of assimilating the definition of “connected person” with that of an “associate” in section 435 of the Insolvency Act 1986 and the definition of “related party” in the Listing Rules and FRS 8. To have a number of similar yet disparate lists governing the same area seemed to us to be inefficient and inconvenient. We suggested tentatively that the latter definitions involved a high degree of judgment and that it was important that the company, the director and others should be able to know who was a connected person. The case for modernising this section by extending it to include other persons such as cohabitants was also considered and we asked consultees whether the list should be extended to any other categories. We were also aware that the provisions for determining whether a director is associated with a body corporate are complex.<sup>1</sup>
- 14.4 In making our recommendations, we are aware that any rewrite of these provisions is outside the scope of the project. However, we believe that these provisions can be modernised and simplified by a number of improvements. These include

<sup>1</sup> Paper, para 8.3.

extending the connected persons definition to encompass cohabitants, including same-sex cohabitants, and their infant children (if they live with the cohabitant and the director), adult children, parents and siblings. We do not support changes to the definition by subordinate legislation at the instance of the Secretary of State.<sup>2</sup> Such changes in our view may increase the risk of piecemeal legislation leading to further complexity and uncertainty. We also suggest that the Company Law Review consider simplifying the provisions which detail the circumstances in which a director is associated with a body corporate. These recommendations in our view, help to modernise the connected persons definition as a whole while retaining a prescriptive approach so that the scope of the definition is clear. We think that this is an example of the application of the certainty principle as described in Part 3 above.

### **Summary of respondents' views**

- 14.5 The majority of respondents considered that the current definition of “connected persons” caused difficulties in practice and favoured its amendment. A number of respondents remarked that the definition was very complex and difficult to apply, while one significant respondent did not think that directors should be subject to serious sanctions where they have failed to appreciate the implications of such a technical definition. The Law Society (Company Law Committee) suggested that the list of connected persons (which they considered arbitrary) could be reduced, if not abolished, and instead a general formulation could be applied. Another respondent pointed out that the court’s relieving power under section 727 was not applicable to matters involving connected persons.
- 14.6 Most respondents including the Institute of Chartered Secretaries & Administrators, the CPS and the Faculty of Advocates rejected the option of making the test for “connected persons” more akin to the present definitions for “associates” or “related parties”.<sup>3</sup> There was some support for retaining the current definition of “connected persons” and simply making specific additions to this. Most respondents were in favour of including cohabitants as “connected persons” although the view was expressed by the IoD that there may be some difficulty in agreeing on those persons deemed to be “cohabitants” thereby complicating the provisions further. The Faculty of Advocates, however, thought that as a matter of certainty the definition should remain the same. In relation to cohabitants, respondents were split over whether the minimum period of cohabitation should be one year or some other period. A number of respondents such as the Institute of Chartered Secretaries & Administrators and the Institute of Chartered Accountants of Scotland agreed that one year was appropriate although approximately the same number thought that there should be no minimum period. Most respondents thought that infant children of the cohabitant should be treated as connected persons if living with the director and the cohabitant. Some respondents thought that there was an argument for extending the definition to include adult children also while there was support for the inclusion of same sex cohabitants and even parents and siblings.

<sup>2</sup> We have above recommended that the Secretary of State should have power to amend the rules in Part I of Schedule 13 for determining when a person is interested in shares.

<sup>3</sup> The Law Society on the other hand preferred a more general approach.



14.7 Some respondents expressed concern about the complexity of the definition of connected persons.<sup>4</sup> We think that this is particularly true in relation to the circumstances in which a body corporate is treated as a connected person. To understand the scope of this category of connected person, this section must be read in conjunction with sections 346(4), (5), (8) and paragraphs (4) and (5) of Schedule 13.

### **Comment**

- 14.8 We think that respondents are justified in their concern about the complexity of the provisions which define the circumstances in which a body corporate is treated as a connected person. The basic rule set out in section 346(2) is that a body corporate is connected with the director where that director is *associated* with the company. The circumstances in which this association is deemed to occur are set out in section 346(4): (a) where the director and persons connected with him are interested in shares amounting to at least 20% of the equity share capital of the company or (b) where they are entitled to exercise or control the exercise of more than 20% of the voting power at any general meeting of the company.
- 14.9 Section 346(8) provides that a director is to be taken as controlling the exercise of voting power where a company, which is controlled by him, controls the exercise of that voting power. This provision is relevant to criterion (b) in section 346(2) above and also to the second criterion in section 346(5) (below).
- 14.10 The next consideration is section 346(5) which defines the circumstances in which a director is deemed to control a body corporate. These circumstances involve two cumulative hurdles. First, the director or any connected person must be interested in the equity share capital of the company or be entitled to exercise or control the exercise of some part of the voting power at any general meeting of the company (section 346(5)(a)). Secondly, the director, connected persons and other directors of the company together must be interested in more than 50% of the equity share capital of the company or be entitled to exercise or control the exercise of more than 50% of the voting power in a general meeting of that company (section 346(5)(b)).
- 14.11 Thus a director will be treated as having the necessary control over the voting power in company X (so as to make company X a connected person under section 346(2)) where company Y (in which he is also a shareholder and in which he, connected persons and other directors control 50% of the voting power) is entitled to exercise or to control the exercise of 20% of the voting power in company X.
- 14.12 Schedule 13 is applied by section 346(7) for the purposes of determining the circumstances in which a person is interested in shares. Paragraphs 4 and 5 of Schedule 13 determine the circumstances in which a director is taken to be interested in shares through his control of a body corporate which is interested in those shares.

<sup>4</sup> It should be noted that any change to the definition of connected person would impact upon s 343, 344 and Schedule 6, Part II.

14.13 We see scope to simplify the provisions by rationalising the separate mechanisms by which a director is associated with a company through his control of another company. At present indirect control of voting power is governed by section 346(4)(b), (5) and (8). Indirect interests in shares are governed by section 346(4)(a) and Schedule 13, paragraphs 4 and 5.

14.14 We think that one of the principal difficulties in operating these provisions is the overlap between section 346(4), (5) and (8) on the one hand and paragraphs 4 and 5 of Schedule 13 on the other. It would be much simpler to have these provisions within one section and to avoid the overlap which presently exists. For example, section 346(8) could be extended to cover the circumstances in which a director is interested in shares if a body corporate which is controlled by the director is interested in them. But section 346(5) would also require to be extended so that the circumstances in which a director is deemed to control a body corporate would include control exercised by a shadow director (as in paragraph 4(a) of Schedule 13). There may also be scope to clarify the operation of these provisions by use of examples in the explanatory notes which accompany any new legislation. These issues can be taken forward in the wider Company Law Review.

#### **Recommendation**

14.15 We think it is important to draw a distinction here between individual natural persons and those connections which arise through a body corporate or partnership. There does not appear to be a difficulty in respect of the first category. Respondents supported, as do we, extension of the definition of connected persons so as to include co-habitants, parents, siblings and adult children. Respondents made few comments on the provisions relating to bodies corporate as connected persons but some respondents stated that they found the provisions particularly difficult in practice. **We recommend that the provisions relating to a “body corporate” with which a director is associated be simplified.**

14.16 **We therefore recommend that:**

- (1) **the current definition for “connected persons” is extended so as to include cohabitants. We see no reason to stipulate a time limit for such cohabitation;**
- (2) **the current definition should be extended to include infant children of the cohabitant if they live with the director and the cohabitant and the cohabitant is a connected person;**
- (3) **the current definition should be extended to same-sex cohabitants, adult children, parents and siblings; and**
- (4) **the Company Law Review should consider simplifying the circumstances in which a director is associated with a company through his control of another company.**

14.17 We consider below in Part 15 the question whether the power of the court to grant relief in section 727 of the Act should extend to connected persons.

**GIVE THE SECRETARY OF STATE POWER TO VARY THE LIST BY REGULATION?  
(QUESTION 88)**

- 14.18 We stated in the Paper that circumstances may arise which require a further category of person to be included or excluded from the list of connected persons in section 346. We asked consultees to consider whether the Secretary of State should be given the power to vary the list of connected persons in section 346 by regulation.

**Summary of respondents' views**

- 14.19 Respondents' views were divided over whether this power should be given to the Secretary of State with a slight majority including the Law Society of Scotland, the Institute of Chartered Secretaries & Administrators and the Law Reform Advisory Committee for Northern Ireland favouring this. The Law Society disagreed with this option on the basis that it would be likely to lead to complex and piecemeal legislation. The IoD were also against this proposal on the basis that there is already much uncertainty as to who constitutes a connected person. They thought that giving the Secretary of State a power of variation would merely add to further confusion.

**Recommendation**

- 14.20 **On balance, we prefer the arguments of those respondents who were not in favour of this proposal. Our recommendation is therefore not to amend section 346 so as to give the Secretary of State the power to vary by regulation the list of connected persons.**<sup>5</sup>

**THE EXTRA-TERRITORIAL APPLICATION OF PART X AND WHETHER SECTION 347 SHOULD BE AMENDED TO INCLUDE REFERENCES TO SECTIONS 322A AND 322B? (QUESTIONS 89 AND 90)**

- 14.21 Finally, we considered the extra-territorial application of Part X.<sup>6</sup> We explained that while Part X of the Act<sup>7</sup> applies only to UK registered companies, the provisions are not limited to acts done by the company in the jurisdiction.<sup>8</sup> This

<sup>5</sup> This differs from our recommendation about Schedule 13 in para 11.36 above because Schedule 13 deals with matters of comparative detail and secondary legislation is needed principally to fine-tune rules that have already been in use for some time and to keep them up to date as commerce develops. To give a power to amend the definition of "connected person" by statutory instrument would go beyond this and enable the Secretary of State to bring people within the definition whom Parliament had not regarded as such when s 346 was enacted.

<sup>6</sup> Paper, paras 8.21-8.24.

<sup>7</sup> With the exception of s 323.

<sup>8</sup> This is because the provisions affect the capacity of such companies or impose duties or restrictions on them and their directors. In both cases, the law of the company's place of incorporation applies. (We are not here referring to provisions imposing criminal offences, as criminal jurisdiction is territorial.)

point is emphasised by section 347 which prevents parties from contracting out of particular sections by choosing a foreign law.<sup>9</sup>

- 14.22 We recognised in the Paper<sup>10</sup> the argument that where a company does not carry on business here, holds no assets here and has no creditors or members domiciled or resident here then there is no need for UK regulation. However, we thought such a situation would be rare and it would be very difficult to create a statutory exception for it. In our view, the aim of Part X is to ensure fair dealing by directors so as to protect the interests of persons based in the UK. To do this effectively, Part X has to apply to a transaction whether or not it is entered into or executed abroad. We asked consultees if they agreed with our provisional view that Part X should apply to acts done outside the jurisdiction.
- 14.23 We also asked whether section 347 should apply to sections 322A and 322B on the basis that section 347 applies to those sections in Part X which are transaction-based.<sup>11</sup> We asked consultees whether they agreed with our provisional view that section 347 should be amended to include references to sections 322A and 322B.

#### **Summary of respondents' views**

- 14.24 There was unanimous support for our provisional view that Part X<sup>12</sup> should apply to acts done outside the jurisdiction. The Institute of Chartered Secretaries & Administrators thought there might be a negative effect on the UK being a respectable place of incorporation if UK registered companies are not required to conform to the same standards of behaviour outside the jurisdiction. One respondent pointed out that this would reflect the fact that 12% of directors in the UK are non-resident while another respondent agreed in principle with our view although thought that there may be practical difficulties in enforcing these provisions abroad. All respondents, with one exception, agreed with our provisional view that section 347 should be amended to include references to section 322A and 322B.

<sup>9</sup> Section 347 states that for the purposes of ss 319-322 and 330-343, it is immaterial whether the proper law is English or Scottish or another law.

<sup>10</sup> Paper, para 8.23.

<sup>11</sup> Paper, para 8.24.

<sup>12</sup> Except in so far as it creates criminal offences.

### **Recommendation**

- 14.25 **In line with respondents' views, we recommend that Part X continues to apply to acts done outside the jurisdiction.<sup>13</sup> We also recommend that section 347 be amended so as to include references to sections 322A and 322B.**

<sup>13</sup> We note the view of Lawrence Collins QC that express provision to this effect should be made in the provisions of Part X imposing a liability to account for gains or indemnify the company against loss.

# PART 15

## A SINGLE CODE OF REMEDIES AND EFFECTS

### Introduction

- 15.1 In general, we consider that where Part X sets out a prohibition or restriction, the consequences of breach should also be set out. We also consider that Part X would benefit from the introduction of a single code of civil remedies and effects which could set out these sanctions in one place. They could then be compared for consistency and any anomalies removed.
- 15.2 Part X offers a bewildering variety of civil sanctions. Remedies by way of liability to account or indemnify are provided in relation to sections 320, 322A and 330.<sup>1</sup> Breach of those sections may also result in a transaction being “voidable”.<sup>2</sup> Under another section, the consequence of breach is that the contravening term is “void”.<sup>3</sup> In another case, the payment is “unlawful”, but without an express statutory statement that the arrangement is void.<sup>4</sup> In other cases, an unlawful payment is “deemed to be received in trust” for the company,<sup>5</sup> or relevant shareholders.<sup>6</sup>
- 15.3 Even where the sections are apparently designed to achieve the same purpose, there are unexplained discrepancies. For example, sections 322, 322A and 341 contain similar remedies, but there are curious differences. Affirmation must take place within a reasonable time under section 322,<sup>7</sup> but there is no such limit in section 322A.<sup>8</sup> Laches or delay is not a bar to avoidance under section 322,<sup>9</sup> but it may be a bar to avoidance under section 322A.<sup>10</sup> The court has a statutory jurisdiction to sever a voidable transaction as between the parties to it under section 322A,<sup>11</sup> but there is no corresponding power under sections 322 or 341.<sup>12</sup>

<sup>1</sup> Sections 322(3), 322A(3) and 341(2). We have discussed under s 317 the problems to which the indemnity gives rise.

<sup>2</sup> Sections 322(1), 322A(2) and 341(1).

<sup>3</sup> Section 319(6).

<sup>4</sup> Section 312.

<sup>5</sup> Section 313(2).

<sup>6</sup> Section 315(1).

<sup>7</sup> Section 322(2)(c).

<sup>8</sup> Section 322A(5)(d).

<sup>9</sup> *Demite Ltd v Protec Health Ltd* [1998] BCC 638.

<sup>10</sup> See *Palmer's Company Law*, 25th ed (1992-1998) § 3.305.

<sup>11</sup> Section 322A(7).

<sup>12</sup> Another peculiar discrepancy (probably of no practical significance) is in the references to indemnification, which in ss 322(2)(a) and 341(2)(a) has to be in pursuance of the section in question; there is no such limitation under s 322A(5)(b).

- 15.4 A new, unified remedies section, setting out the civil law consequences of breaching the various rules in Part X would provide an opportunity to improve clarity and accessibility. It could eliminate repetition, overlap and inconsistencies. There is considerable scope to make these provisions simpler and more coherent. Furthermore, it would assist the process of interpretation by the courts, since questions of construction need only be litigated once in the context of a single remedies section.
- 15.5 Some differences between the civil remedies and effects resulting from a breach of the provisions of Part X may remain. For instance in relation to section 322 we recommend against any limitation on the right to an account of profits or an indemnity against loss if the company has not been prejudiced by the transaction. In relation to section 317, however, we recommend that liability for an account of profits and indemnity should be subject to a limitation, namely that it should extend only so far as the court thinks fit. The fact that the company is not prejudiced by the breach may be one of the factors which the court takes into account under this section.
- 15.6 There are two further points that occur to us that should be considered in the course of this review:
- (1) As we point out above,<sup>13</sup> unlike directors, connected persons cannot claim relief from the court under section 727 of the Act. It is for consideration whether there should be some general provision which enables them to be relieved by the court from the consequences of liability under Part X.
  - (2) Consideration should be given to whether the remedies conferred by sections 317, 322 and 341 for an account of profits or an indemnity against loss should exhaust remedies arising out of a breach against any director or other person mentioned in the sections.<sup>14</sup> Any other remedy against them arising out of a breach under the general law would then be excluded.

### **Recommendation**

- 15.7 We did not consult specifically on this issue. **However, we consider that Part X would benefit from a single code of civil remedies and accordingly we recommend that the Company Law Review should consider this as part of its wider review.**

<sup>13</sup> Para 14.5.

<sup>14</sup> Although we would have dealt with this point if the report had included a bill for a new Part X, we have decided not to investigate it in this report as we do not have views from respondents and are not producing a bill.

## **PART 16**

# **SUMMARY OF RECOMMENDATIONS**

- 16.1 We recommend that:
- (1) there should be a statutory statement of a director's main fiduciary duties and his duty of care and skill, being those duties which are set out in Appendix A;<sup>1</sup>
  - (2) the statement should so far as possible be drafted in broad and general language as in Appendix A; and
  - (3) it should not be exhaustive i.e. it should state that a director is subject to other duties which have not been codified.
- 16.2 We recommend that Forms 10(2) and 288a should contain the statutory statement of duties and that when a director signs the Forms he should acknowledge that he has read this statement.
- 16.3 We recommend that the DTI should consider the most effective way of producing and distributing a pamphlet explaining a director's duties.
- 16.4 We recommend that (1) a director's duty of care, skill and diligence to his company should be set out in statute; (2) the standard should be judged by a twofold objective/subjective test; and (3) regard should be had to the functions of the particular director and the circumstances of the company.
- 16.5 We do not recommend a statutory business judgment rule.
- 16.6 We recommend that there should not be a statutory provision setting out the circumstances in which a director may delegate his powers to others and rely on information provided by others without incurring liability.
- 16.7 We recommend that sections 312-316, 319, 320-322 and 330-344 of the Act should not be repealed.
- 16.8 We recommend that sections 312 to 316 should not apply to covenanted payments. Since the point has not been conclusively established by English case law, we also recommend that the section be amended to make the position clear.

<sup>1</sup> We recommend, however, that the *content* of the duty of care and skill is that described in para 16.4 below and not that set out in Appendix A.



- 16.9 We recommend that the compensation for loss of office which by virtue of paragraph 8(2) of Schedule 6 to the Act must be shown in the notes to the annual accounts should be shown for each director separately. We recommend that the components of the compensation package set out in paragraph 7.26 above should be shown in the notes to those accounts.
- 16.10 We recommend that no amendment be made to sections 312 to 316 to make express reference to former directors.
- 16.11 We do not recommend that sections 312 to 316 be extended so that they apply to payments to connected persons.
- 16.12 We recommend that where a director receives a payment for the loss of some office with the company in the context of the loss of office as a director, sections 312 to 316 should apply to that payment. However, in line with our earlier recommendations, sections 312 to 315 should not apply to any such payment which is a covenanted payment.
- 16.13 We consider that section 314 should not be amended to cover takeovers by scheme of arrangement and we therefore recommend against it.
- 16.14 We recommend that section 314 be amended so as expressly to cover unconditional offers.
- 16.15 We recommend that the offeror or an associate of his should not be entitled to vote at a meeting convened pursuant to section 315.
- 16.16 We recommend that the directors to whom sections 312 to 316 apply should include directors of holding companies.
- 16.17 We recommend, in line with our provisional views, as follows:
- (1) there should be no change to the majorities required for approvals under sections 312 to 315; and
  - (2) sections 312 to 316 should not be amended to require disclosure of details of other payments being made to the director.
- 16.18 We do not recommend introduction of a mechanism for deemed shareholder approval into sections 312 to 315.
- 16.19 We recommend that there should be statutory remedies as suggested in paragraphs 7.81 and 7.82 above, where a payment is received in breach of sections 312-6, and section 315 does not apply. We also recommend that a provision similar to section 313(2) should for consistency be inserted into section 312. In addition, we recommend that there should be a separate section or group of sections setting out in one place the statutory civil remedies for breach of the provisions of Part X.
- 16.20 We recommend that, if the offeree shareholders seek to enforce their claims under section 315, their claim should prevail over any claim to which the company may be entitled arising out of the same facts, unless the court otherwise orders.

- 16.21 Our provisional view that section 311 may safely be repealed has not changed through consultation and accordingly we recommend its repeal.
- 16.22 We recommend that we exclude from the disclosure obligation in section 317 immaterial interests by providing that the section should not apply where:
- (1) the director satisfies the court that the interest did not give rise to a real risk of an actual conflict of interest between his position as the holder of that interest and his position as a director of the company; or
  - (2) the director satisfies the court that the rest of the board were aware of the nature and extent of his interest before the directors approved the transaction.
- 16.23 We recommend that section 317 should continue to require disclosure of interests, whether or not the transaction comes before, or requires the approval of, the board or a committee of the board.
- 16.24 We consider that section 317 should be subject to an exception for the interests of directors in their own service agreements.
- 16.25 We do not recommend exemption from disclosure of interests in arrangements for the benefit of all employees.
- 16.26 We do not recommend that there should be exempted from disclosure under section 317 interests which a director has by reason only that he is a director of another company in the same group or has a non-beneficial shareholding in it.
- 16.27 We recommend an exemption from disclosure under section 317 of interests of which the director has no knowledge.
- 16.28 We confirm our provisional recommendation that section 317 should provide that a director should disclose the interests of connected persons if they would have to be disclosed if they were interests of his.
- 16.29 We recommend the introduction of a requirement to keep a register of directors' interests but do not recommend that the proposed register should be open to inspection by shareholders. We also recommend against any further requirement for disclosure in the annual accounts.
- 16.30 Our recommendation is that a sole director should be exempt from the requirements of section 317, but that the director's interest should be recorded in the register of directors' interests which we recommend above, or, if that recommendation is not accepted, in a written memorandum or minutes of the next director's meeting. We do not recommend that a sole director should disclose his interests to the company in a general meeting.

- 16.31 We do not recommend disqualifying directors of public companies (or companies generally) from voting on matters in which they are interested.
- 16.32 We recommend that section 317 should be amended so as to require a director to disclose the nature and extent of his interest.
- 16.33 We recommend that
- (1) the criminal penalty for breach of section 317 should be replaced by a civil remedy, by which the contract or transaction would be voidable at the instance of the company unless the court otherwise directs;
  - (2) the contract or transaction would cease to be voidable in circumstances analogous to those set out in section 322(2), save that the protection of third parties (under section 322(2)(b)) would extend to parties to the contract or transaction including connected persons;
  - (3) whether the transaction is voidable or not the liability of a director and/or a connected person would be:
    - (a) to account for any profits from the transaction; and
    - (b) to indemnify the company for loss resulting from the transactionin either case to the extent that the court thinks just and equitable;  
and
  - (4) the connected person would incur no liability under either head unless he knew of the failure to disclose.
- 16.34 We recommend that:
- (1) the Secretary of State should not be able to disapply section 318 where the company is already bound, in his opinion, by sufficient disclosure under the Listing Rules;
  - (2) disclosure under section 318 be extended to contracts for services and non-executive directors' letters of appointment;
  - (3) section 318(5) and (11) be repealed as they are no longer appropriate;
  - (4) section 318 should not be amended to require the disclosure of particulars of terms collateral to service contracts;
  - (5) the statutory limit on the duration of directors' service contracts without shareholder approval should be reduced from five years to three years although we suggest that further consideration should be given to the position of small companies in the course of the Company Law Review. We also recommend that the three year limit should be applied to rolling contracts; and
  - (6) no mechanism for deemed shareholder approval should be introduced into section 319.

- 16.35 We make no recommendation on whether to allow public inspection of directors' service contracts.
- 16.36 We recommend that section 320 be amended so as to allow a company to enter into a contract which is conditional on the company first obtaining shareholder approval.
- 16.37 We recommend that section 320 be amended in order to clarify that it does not apply to covenanted payments under service agreements or to other payments to which section 316(3) applies.
- 16.38 We recommend that section 321 be amended to introduce a new exemption for transactions with administrators. We also recommend that where there is reason to believe that the company's assets are insufficient to make a payment to shareholders, or for some other good reason, administrative receivers should have the option of applying to the court for approval of a transaction as an alternative to shareholder approval.
- 16.39 We recommend that section 320 should not be amended so as to give the Secretary of State power to exempt listed companies.
- 16.40 We recommend that section 320 should not be amended so as to displace the requirement of shareholder approval where:
- (1) independent non-executive directors approve the transaction;
  - (2) shareholders do not object within a specified period; or
  - (3) an expert reports that in his opinion the transaction was fair and reasonable.
- 16.41 We recommend that, subject to our recommendation that consideration be given to the introduction of a single code of remedies, section 322 should not be amended to the effect that the company would have no remedy where the defendant/defender shows that it was not prejudiced by the transaction.
- 16.42 Subject to our recommendation that consideration be given to the introduction of a single code of remedies, we recommend that sections 322A and 322B be retained as they stand.
- 16.43 We recommend:
- (1) that sections 323 and 327 be repealed;<sup>2</sup>
  - (2) that section 324 should not be amended to exempt non-beneficial shareholdings but that it be amended so as to give the Secretary of State the power by regulation to vary the rules in Part I of Schedule 13 for determining whether a person has an interest in shares or debentures for the purposes of sections 324-326 and 346; and

<sup>2</sup> We also make recommendations to amend ss 323 and 327 if they are not repealed.

- (3) that section 329 be amended so that a company is bound to transmit to the relevant exchange details of information which the company is bound to enter into the register of directors' interests without notification by the director pursuant to sections 325(3) and (4);
  - (4) that if section 323 is repealed, section 324(2)(b) be extended to cover the taking of put options.
- 16.44 We recommend that the prohibition in sections 330(3), (4), (6) and (7) on companies making loans to (or entering into analogous transactions with) their directors or the directors of their holding companies or connected persons should apply to all companies and not just relevant companies. This, however, is subject to the outcome of the Company Law Review which may favour the introduction of special provisions for small companies. We recommend the retention of the existing exemptions to the prohibitions in section 330 and that sections 339-340 be retained in their current form. We do not recommend the introduction of an additional exemption for loans made with the consent of shareholders.
- 16.45 We recommend that the obligation under paragraphs 15 and 16 of Schedule 6 to disclose interests in transactions should apply to interests that are material to the director in question or the company. We also recommend the repeal of paragraph 17(2) of that Schedule.
- 16.46 We recommend that Schedule 6, Part II is retained and not replaced by FRS 8.
- 16.47 We recommend that a director should be placed under a duty to give notice to the company of such matters relating to himself and (so far as known to him) his connected persons as may be necessary for the purposes of Schedule 6, Part II.
- 16.48 We recommend that the exception for transactions in the ordinary course of business in paragraph 20 of Schedule 6 should be retained and that it should be extended to apply to transactions which are not intra-group.
- 16.49 We recommend that the level of detail of disclosure of the incidents of quasi-loans and credit transactions and related guarantees and security should in principle be the same as that required under sub-paragraphs (d) and (e) of paragraph 22 of Schedule 6 for loans.
- 16.50 We recommend that the exemption in paragraph 23 of Schedule 6 should be extended to credit transactions.
- 16.51 We recommend that there should be a de minimis exception for loans and quasi-loans on similar lines to paragraph 24 of Schedule 6.
- 16.52 We recommend that, where the deeming provision in section 340(7) applies for the purpose of Schedule 6, a director should, wherever possible, be required to give an estimate of the value of the transaction.

- 16.53 We do not consider that a company should be exempted from an obligation to disclose transactions in which a director has a material interest merely because that interest is as a director of the other company. Accordingly, we recommend that paragraph 18(a) of Schedule 6 should not apply to transactions disclosable under paragraphs 15(c) and 16(c).
- 16.54 We make no recommendation as to whether sections 343 and 344 are necessary or desirable.
- 16.55 We recommend that:
- (1) the current definition for “connected persons” is extended so as to include cohabitants;
  - (2) the current definition should be extended to include infant children of the cohabitant if they live with the director and the cohabitant and the cohabitant is a connected person;
  - (3) the current definition should be extended to same-sex cohabitants, adult children, parents and siblings; and
  - (4) the Company Law Review should consider simplifying the circumstances in which a director is associated with a company through his control of another company.
- 16.56 Our recommendation is not to amend section 346 so as to give the Secretary of State the power to vary by regulation the list of connected persons.
- 16.57 We recommend that Part X continues to apply to acts done outside the jurisdiction. We also recommend that section 347 be amended so as to include references to sections 322A and 322B.
- 16.58 We consider that Part X would benefit from a single code of civil remedies and accordingly we recommend that the Company Law Review should consider this as part of its wider review.

*(Signed)* ROBERT CARNWATH, *Chairman, Law Commission*  
ANDREW BURROWS  
DIANA FABER  
CHARLES HARPUM  
STEPHEN SILBER

MICHAEL SAYERS, *Secretary*

BRIAN GILL, *Chairman, Scottish Law Commission*  
E M CLIVE  
P S HODGE  
KENNETH G C REID  
N R WHITTY

N RAVEN, *Secretary*

14 July 1999

# **APPENDIX A**

## **DRAFT STATEMENT OF DIRECTORS' DUTIES<sup>1</sup>**

### **General**

- (1) The law imposes duties on directors. If a person does not comply with his duties as a director he may be liable to civil or criminal proceedings and he may be disqualified from acting as a director.
- (2) Set out below there is a summary of the main duties of a director to his company. It is not a complete statement of a director's duties, and the law may change anyway. If a person is not clear about his duties as a director in any situation he should seek advice.

### **Loyalty**

- (3) A director must act in good faith in what he considers to be the interests of the company.

### **Obedience**

- (4) A director must act in accordance with the company's constitution (such as the articles of association) and must exercise his powers only for the purposes allowed by law.

### **No secret profits**

- (5) A director must not use the company's property, information or opportunities for his own or anyone else's benefit unless he is allowed to by the company's constitution or the use has been disclosed to the company in general meeting and the company has consented to it.

### **Independence**

- (6) A director must not agree to restrict his power to exercise an independent judgment. But if he considers in good faith that it is in the interests of the company for a transaction to be entered into and carried into effect, he may restrict his power to exercise an independent judgment by agreeing to act in a particular way to achieve this.

### **Conflict of interest**

- (7) If there is a conflict between an interest or duty of a director and an interest of the company in any transaction, he must account to the company for any benefit he receives from the transaction. This applies whether or not the company sets aside the transaction. But he does not have to account for the benefit if he is allowed to

<sup>1</sup> As referred to in paras 4.13, 4.25, 4.34, 4.35 and 4.48 below.

have the interest or duty by the company's constitution or the interest or duty has been disclosed to and approved by the company in general meeting.

**Care, skill and diligence**

- (8) A director owes the company a duty to exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having both
  - (a) the knowledge and experience that may reasonably be expected of a person in the same position as the director, and
  - (b) the knowledge and experience which the director has.

**Interests of employees etc.**

- (9) A director must have regard to the interests of the company's employees in general and its members.

**Fairness**

- (10) A director must act fairly as between different members.

**Effect of this statement**

- (11) The law stating the duties of directors is not affected by this statement or by the fact that, by signing this document, a director acknowledges that he has read the statement.



## **APPENDIX B**

# **EMPIRICAL RESEARCH REPORT**

This Appendix sets out the report to the Law Commissions by the ESRC Centre for Business Research at the University of Cambridge on empirical research carried out by the Centre during the consultation period.

A summary of the report can be found in Part 2 above.

# **Directors' Duties: Empirical Findings**

Report to the Law Commissions

Simon Deakin and Alan Hughes

ESRC Centre for Business Research,  
University of Cambridge

August 1999

## 1. Introduction

This is a report of the findings of empirical research on the law and practice relating to directors' duties, carried out by the ESRC Centre for Business Research on behalf of the Law Commissions.<sup>1</sup> Section 2 below outlines the aims and objectives of the research and section 3 describes the methods used. Section 4 reports on how far corporate governance processes vary across companies of different types. Section 5 examines the empirical findings with regard to conflicts of interest, self-dealing and the exploitation of corporate opportunities, and section 6 analyses data concerning directors' service contracts. Section 7 outlines findings with regard to the duty of care and section 8 is concerned with responses to the Law Commissions' proposals for a written statement of directors' duties. Section 9 concludes. Appendix 1 provides background information on the nature of the survey and the sample from which the results are drawn. Appendix 2 reproduces the questionnaire and provides a concordance mapping text, tables and charts to the questions in the survey instrument.

## 2. Aims and objectives of the empirical research

The economic analysis contained in Part 3 of the Law Commissions' Joint Consultation Paper on *Directors' Duties* indicated a number of issues which were appropriate for empirical research. An overarching objective was to bring empirical evidence to bear on theoretical claims relating to the efficiency of the legal rules operating in this area. Theoretical economic analysis suggests that company law may enhance efficiency by (amongst other things) reducing agency costs, facilitating bargaining between corporate actors, and mitigating the effects of externalities (that is to say, the negative, unbargained-for effects of corporate transactions on third parties, such as creditors). Statutory regulation may, in principle, play a useful role in supplementing the general principles of fiduciary law, particularly by providing incentives for the disclosure of certain categories of information by senior managers to other board members and to shareholders. However, it was also accepted that many of the claims made for the efficiency of legal intervention in this area could not be properly assessed without a better understanding of how relations between the different corporate actors currently operate in practice.

A central aim of empirical research was therefore to clarify the nature of the relationship between shareholders and directors, focusing in particular on the role played in this process by representatives of institutional shareholders and non-executive directors. It was also intended that the work should uncover evidence on the various types of procedures and practices which exist in companies of different types (in particular, listed and unlisted companies) and size. In this report we use the term 'internal corporate governance processes' to refer to mechanisms of this kind. This is not a term of art, but

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<sup>1</sup> The research was supported by a grant from the Centre for Business Performance at the Institute of Chartered Accountants in England and Wales and, as explained in the text, was facilitated by the Institute of Directors which provided access to its database of members. We are very grateful to both organisations. We would also like to thank our CBR colleagues Anna Bullock, who provided expert help in designing the questionnaire used in the survey, managed the survey process, and carried out the bulk of the statistical analysis on which we report; Diana Day, who prepared the database; and Linda Brosnan, who prepared the charts and text in their final form. In addition we are grateful to John Armour, of the University of Nottingham and the CBR, and to two anonymous referees of the ICAEW for their comments on an earlier draft. All remaining errors are of course our own.

may be used to convey the distinction between norms and procedures which operate within companies and those which are imposed from outside by regulatory intervention. The empirical stage of the research was also designed to ascertain the extent to which bargaining over the form and content of directors' duties in fact takes place. A central contention of the economic theory of the corporation is that legal rules can be used to induce the parties to arrive at efficient allocations of resources through contractual arrangements. So-called 'penalty default rules' provide incentives for the sharing of information through bargaining which avoids the imposition of a legal liability which would otherwise arise. However if, in practice, bargaining is seen as excessively costly or impractical, it may not be feasible to expect the law to play this role. Again, whether this is the case is not a question which can be answered *a priori*, but only through empirical investigation.

Part 3 of the Consultation Paper also considered the issue of whether raising the standard of care for directors' duties of care and skill would deter directors from taking office or from taking normal business risks. A possible tightening in the standard of care might also have effects upon internal systems of communication within companies. In order to address these questions, the empirical stage of the work sought to find out more about the way directors perceive their current legal responsibilities under the duty of care, and how they would regard a possible restatement of the law. The views of commercial creditors, banks, and the insurance industry were also sought.

The following more specific objectives of the empirical research were laid out in the Consultation Paper:

whether an authoritative statement of directors' duties would assist directors in practice;

whether such a statement could most usefully be set out in legislation, or in some other form (such as an annexe in the articles of association);

whether it would be helpful for such a statement to refer to release, ratification and approval, and to include reference to a business judgement rule;

the usefulness to directors of non-statutory guidelines specifying what they should do in certain specific situations;

the role of non-executive directors, and the extent to which they are independent of management;

whether directors' service contracts which are 'rolling contracts' are common;

the length of directors' service contracts in private companies;

how section 316(3) (concerning payments to directors for breach of contract) is interpreted and applied in practice;

the behavioural effect of criminal penalties, and in particular whether they serve a useful purpose in backing up legal advice and making it more likely that rules will be obeyed, even if, in practice, there are no prosecutions;

whether section 317 (concerning disclosure to the board of a contract in which the director has an interest) serves a useful purpose in a sole director company;  
whether further disclosure requirements are likely to produce benefits to shareholders;

the costs of calling shareholder meetings; and

the cost and practicability of shareholder-led litigation against directors.

### **3. Methods**

In order to examine these issues, a dual approach was undertaken.

#### **3.1 Qualitative analysis: ‘scoping’ interviews with corporate governance practitioners**

Firstly, a number of face to face interviews were conducted with directors, institutional shareholders, commercial lenders, and legal advisers. The aim of these interviews was to obtain qualitative evidence of the nature of current practices with regard to director-shareholder relations, and the effects of possible changes to the law. In all 21 interviews were conducted. The interviews lasted on average 1.5 hours.

The interviews were not designed to constitute a sample from which statistical inferences could be drawn. Their purpose was rather to provide qualitative insights which could inform the design of the survey and help to define the scope of the project more clearly.

#### **3.2 Quantitative analysis: the postal survey, the characteristics of the respondents, and the method of analysis**

Secondly, information concerning corporate practices was obtained through the administration of a questionnaire, which was circulated to a large sample of directors in companies of different types and sizes. The design of the questionnaire and the interpretation of responses to it were informed by the qualitative insights gained from the interviews.

A sample of approximately 5,500 directors was drawn from the membership of the Institute of Directors (IoD). This sample was stratified by the turnover size of the companies in which each director held office, with higher sampling proportions drawn from the larger turnover size bands. This ensured that the very large number of very small companies in the IoD database would not overwhelm the sample. The target achieved sample was 1000 director responses. In the event a response rate of over 20% was achieved, with 1259 directors responding in respect of the full size range of companies. This response rate was consistent with that achieved in good practice surveys of this kind. Appendix 1 contains further details on the sample, and the survey method, whilst the questionnaire itself is reproduced in Appendix 2.

Chart 1 shows that 65% of the respondents answered in respect of private companies, 16% unlisted plcs, and 19% listed plcs. Chart 2 reveals that 31% of the respondents held their positions in independent companies without subsidiary or associated companies; 35% in independent companies with subsidiary or associated companies;

and 4% in associated companies. A further 30% held their positions in subsidiaries. Our sample therefore covers the full range of company types and forms.

In analysing the survey data we focus on responses from the directors of independent and associated companies and exclude the responses from subsidiaries. The boards and governance structures of the latter are clearly different in kind from those of the rest, with many of the monitoring issues with which we are concerned dealt with by the parent company. The analysis of the responses of directors of subsidiaries is left for another occasion. Our analysis here therefore relates to a sample of 879 directors of independent and associated companies

Chart 3 breaks this sample down by the position held by the respondents. It shows that around two thirds of the respondents were either managing directors or other executive directors. A further 16% were chairmen, 7% were non-executive directors and 13% were company secretaries. The vast majority of our sample therefore consists of senior executive directors or individuals who were otherwise well qualified to answer the questions we posed.

Chart 4 provides data on company size in the sample. It shows that 37% of the companies on whose boards our respondents sat had a turnover of less than £5m, 18% had a turnover between £5m and £20m, 23% between £20m and £200m and 22% had a turnover in excess of £200m. A separate analysis revealed that the median sized company in the sample employed 65 people. Our sample therefore covers the full range of independent company sizes and types, although because of our sample design it contains proportionately more larger listed companies and plcs than the company population as a whole.

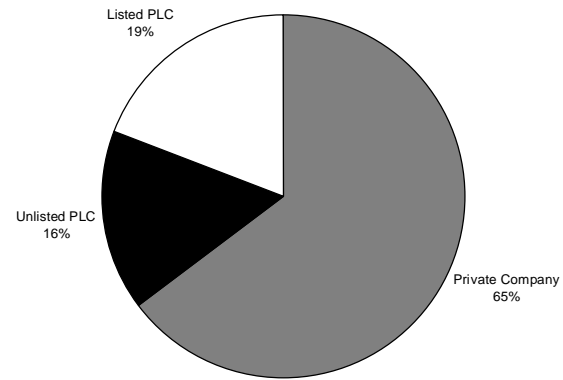
The responses cover companies in the whole of Great Britain and Northern Ireland. However the Institute of Directors' sample contained relatively few directors of companies in Scotland and Northern Ireland. It was not therefore possible to present separate analyses for those sub categories.

The range of sizes and types of companies represented in the sample and the large sample size did however make it possible to break down the responses to our questionnaire into a number of other sub categories.<sup>2</sup> These have been chosen to reflect potential differences in governance structures and processes. By splitting our sample into different categories in this way we are able to see if the responses to our survey questions vary across them. Our categories are based on size (where we consider 4 size groups based on turnover); on company type (listed and unlisted); on board size (5 or more directors, and less than 5); the number of board meetings per year (9 or fewer and more than 9); the proportion of non-executive directors (no non-executive directors, less than 50% non-executives on the board, and boards with a majority of non-executives); and board shareholding (where we distinguish between majority controlling boards and the rest).

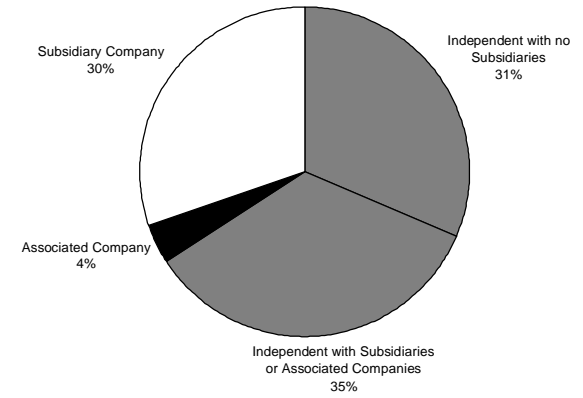
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<sup>2</sup> It was also possible to group answers to questions by whether the respondent was an executive or non-executive director. We analysed our data using this cross classification in relation to our questions about the Standard of Duties of Care and to the Law Commissions' proposals in relation to the Statement of Directors' Duties. In general there were no significant differences. To save space in presenting data we report the results of this analysis in Appendix 1 Table A3-A9. Where a significant result did emerge we refer to it in the main body of the report.

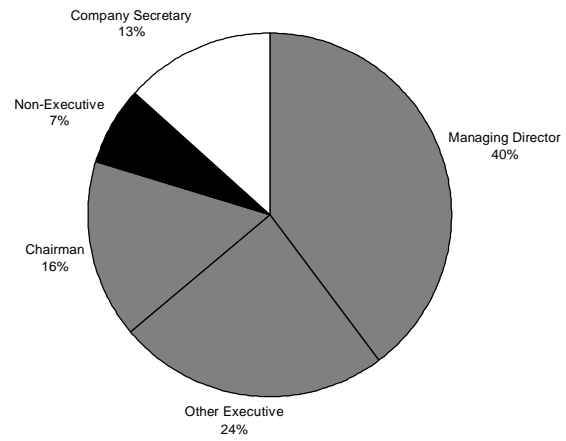
**Chart 1 - The Sample Classified by Company Form**



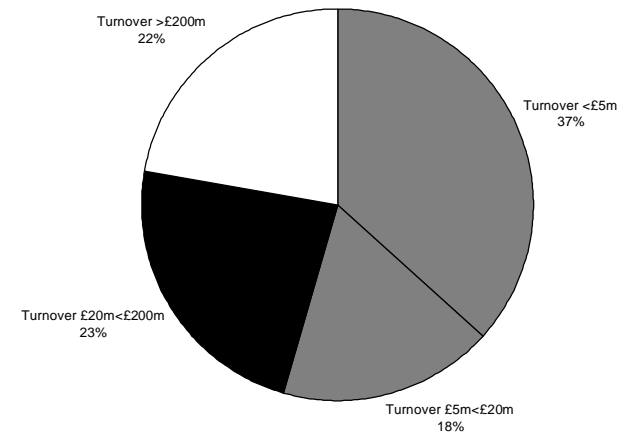
**Chart 2 - The Sample Classified by Company Type**



**Chart 3 - The Respondents by Type of Position held**



**Chart 4 - The Size of Independent Companies in the Sample**



When we analyse differences in responses between these sub categories we use standard statistical techniques to test for their statistical significance.<sup>3</sup> In general we report results as being significantly different at the 5% level (if there is a less than one in twenty probability that the difference could have occurred by chance), or at the 10% level (if there is a less than one in ten probability that the difference could have occurred by chance). These significance levels are indicated by a system of asterisks set out in each table we present, and described in full under Table 1<sup>4</sup>. When presenting averages in the tables we use the median value, which is the value above and below which 50% of the sample values lie. This is because the median is less sensitive than the mean to the pressures of small numbers of extreme outlying values in the data.

In our analysis we concentrate on univariate comparisons. That is to say, we make comparisons between each set of subcategories taken separately, so as to provide a straightforward account of how responses vary across them. Thus we compare responses across our four size categories, or across listed and unlisted companies. This is useful in its own right since our sub categories are based on commonly used criteria for distinguishing different types of company behaviour.

It is however the case that company size is closely related, for instance, to both board size *and* shareholder dispersion. If our main purpose was to separate out the effects of one sub category taking account of these inter-relationships, we would need to carry out a multivariate analysis. This would mean considering combinations of the sub categories taken together (e.g. boards of companies with less than £5m turnover, who also have a particular board size and a controlling shareholding, compared to other companies). This type of analysis is beyond the scope and purpose of the present report and is left for a separate occasion.

Finally, in interpreting the analysis which follows, it should be remembered that the sample is size stratified. No simple inferences can therefore be made about the population of company directors as a whole without appropriately weighting and grossing up the responses. The results are however randomly drawn *within* the turnover size categories so that comparisons between these categories can readily be made.

It is of course the case that the distribution of companies by turnover size is tremendously skewed. Around 80% of companies registered for VAT are small with a turnover of less than £1 million, whilst a handful of the very largest plcs account for a significant proportion of total economic activity. It follows that any data we report for our smallest size category (less than £5 million turnover) would dominate the results of any grossing up procedure designed to estimate values for the whole company population of the United Kingdom. In these circumstances it is of more

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<sup>3</sup> We use the Chi-Square test, supplemented by the non-parametric Mann-Whitney test (for comparisons of two categories) and its extension (for comparisons across three or more categories) the Kruskal-Wallis test. These non-parametric tests are less sensitive to extreme values in the data and require less stringent assumptions about the underlying shape of the distributions of the responses than do parametric tests (see, for example, W.J.Conover, *Practical Non-Parametric Statistics*, 2<sup>nd</sup> Edition (New York: John Wiley & Sons, 1980)).

<sup>4</sup> Appendix 2, which reproduces the questionnaire used in our study, also contains a concordance which relates the questions asked to the Tables in which the results appear.



interest to produce comparisons between size classes which we present in some detail. Where an interpretation of a result is likely to be misleading unless grossing up is taken into account we draw attention to this fact in the text.

#### **4. Agency costs and corporate governance processes: some general considerations**

##### **4.1 Agency costs as determinants of internal corporate governance processes**

Economic theory predicts that corporate governance processes will be a function of agency costs, that is, the costs which arise from the separation of ownership and control within companies. Agency costs, in turn, are determined by factors which include the size of companies and the degree of concentration of shareholdings. Although, in principle, it is in the interests of shareholders to engage in monitoring of the conduct and performance of directors, direct monitoring is costly where shareholdings are widely dispersed. Individual shareholders may not see it as in their interests to intervene when any resulting benefits, in terms of improved performance, would have to be shared with the other shareholders. Coalitions of shareholder groups may also be costly to construct and maintain. The quality and nature of information flows may also be unreliable in the case of companies with large-scale and complex business operations and with shareholders who are unable to judge the quality of the information which they receive. By contrast, in small firms which are 'quasi partnerships' with few shareholders, where the board of directors have a controlling and/or majority stake in the company, the opportunity for direct observation and control may be greater. To that extent, there would not be the same need for formal internal procedures.

This contrast between large, 'open' companies and smaller 'closed' ones can only be taken so far.<sup>5</sup> Thus it is sometimes suggested that in the case of listed companies, institutional investors *are* in a position to engage in direct monitoring of the board, and that the notion of a clear separation between ownership and control is no longer appropriate for such companies. Although this point is well made, it does not necessarily follow that the growing role of institutional investors in corporate governance removes the need for internal governance processes. It is possible that institutional investors may rely on processes of this kind to generate information for them and to enhance managerial accountability.

The role of market-based monitoring must also be borne in mind here. By this we mean evaluation of corporate performance through the operation of the stock market. Movements in the share price of a listed company reflect the market's assessment of that company's future prospects, which is, in part, a function of how well its managers are expected to perform. Share prices are influenced by the evaluations of market analysts who have access to expertise which shareholders may lack. The existence of a market for the shares of listed companies can therefore be seen as overcoming some

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<sup>5</sup> We are here using the terms 'open' and 'closed' and 'large' and 'small' in a relative analytical sense rather than in terms of any particular administrative or legal definition. When we present our empirical research we provide particular definitions in terms of size where we distinguish 4 groups based on level of turnover, and 'openness' where we distinguish between companies where the board holds less than 50% of the equity ('open') and those where the board holds 50% or more ('closed').

of the problems of monitoring which are faced by shareholders in companies of this kind.<sup>6</sup>

For present purposes, it is not necessary to enter into the debate about whether the market for shares processes the information which is made available to it in a completely efficient way. It is sufficient to acknowledge that in the case of listed companies, external monitoring, through movements in share prices, provides shareholders with an important source of information concerning managerial performance. However, it is not possible to judge *a priori* how effective this form of external monitoring is likely to be by comparison with internal monitoring.

Subject to the qualifications just made, we would expect to see internal mechanisms of corporate governance develop within companies where (1) agency costs are high but (2) *direct* monitoring by shareholders is also costly. These internal procedures may range from the appointment to the board of one or more non-executive directors; the setting up of remuneration and audit committees within the board; the generation of internal codes of practice relating to the conduct of directors; and the use of internal reporting procedures aimed at ensuring that the board as a whole is kept properly informed of corporate activities.

#### **4.2 Internal processes in practice**

Table 1 throws some light on the above suggestion. It contains information on the number of executive and non-executive directors in companies and the numbers of hours worked by non-executives, broken down according to the categories outlined above. The Table shows that the median number of executive and non-executive directors increases with company size, as does the median number of board meetings per year. 31% of the smallest size category of companies had non-executives on the board, compared to 83% of the largest size category. Boards of companies with a turnover less than £5 million met on average 4 times per year compared to 10 times per year for each of the other three categories; boards of unlisted companies met on average 6 times a year and boards of listed companies 10 times per year. A similar difference was found between companies in which the board owned more than 50% of the share capital of the company and companies in which the board owned 50% or less.

Table 2 shows that concentration of shares in the hands of the managing director/CEO or the board as a whole is much greater in small companies, unlisted companies, companies in which there are fewer than 5 directors, companies which meet less than 10 times per year, and companies in which the board owns more than 50% of the shares. The Table also shows that where there is a significant shareholding by the managing director/CEO or by the board as a whole, the company tends not to have any non-executive directors. These findings on share concentration and board structure are entirely consistent with other recent evidence for both small and 'giant'

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<sup>6</sup> See F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991).

firms in the United Kingdom.<sup>7</sup>

In short, the presence of non-executives, larger boards and more frequent board meeting is correlated both with size and with the concentration of shareholdings. This suggests that as shareholdings are dispersed, the benefits from putting in place internal governance systems increase. At the same time, the larger the company is, the lower the costs of internal procedures tend to be in relation to turnover; large companies are in a position to benefit from economies of scale which are not available to smaller organisations.

Tables 1 and 2 also indicate that a vital indicator of the type of internal governance procedures adopted by a company is whether the company has a stock exchange listing. 98% of listed companies in the sample had non-executive directors, compared to 46% of non-listed companies. The median number of directors on boards of listed companies was twice that of non-listed companies (8 as against 4) and there were also significant differences between listed and non-listed companies in the number of hours spent on company business by non-executives, and in the number of board meetings held per year.

The incidence of internal governance systems may, then, be a function of the regulatory system to which companies are subject. There appears to be a high level of observance by UK-listed companies of most aspects of the Combined Code on Corporate Governance. Although compliance with the Code is not a condition of listing, it is a condition that listed companies should disclose the extent to which they are complying with the Code and give reasons for their failure to comply with any part of it. It is not surprising, therefore, to find that listed companies make greater use of non-executive directors and, as we shall see in further detail below, of remuneration committees within the board, as recommended by the Code.

The analysis presented here does not allow us to make a clearer judgement on how far diversity in corporate governance practices is the result of the listing rules and the impact of the Combined Code, and how far it is the consequence of agency costs. This is a matter for future research. However, this point does not necessarily invalidate the finding that the use of internal governance procedures is driven, at least in part, by size and concentration of shareholdings. It suggests, rather, that there is a high degree of correspondence between companies which have a stock exchange listing, on the one hand, and companies with large turnover and a high degree of dispersion of shareholdings, on the other. This conforms with what is more generally known about publicly-listed companies in the UK.

As we have seen, in smaller, closed and unlisted companies there is less of a monitoring role for non-executives. This suggests that in companies of this kind, shareholders engage directly in monitoring without making use of an intermediary level of non-executives. If the major shareholders (or their representatives) are also directors, monitoring will take place within the board.

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<sup>7</sup> See A. Cosh and A. Hughes (eds.) *Enterprise Britain. Growth, Innovation and Public Policy in the Small and Medium Sized Enterprise Sector 1994-1997* (Cambridge: ESRC Centre for Business Research, 1998), ch. 1; A. Cosh and A. Hughes, 'The Changing Anatomy of Corporate Control and the Market for Executives in the United Kingdom' (1997) 24 *Journal of Law and Society* 104.

**Table 1 Median No. of Directors, Proportion of Companies with Non-Executives, Median Hours per Month Spent by Non-Executives and the Number of Board Meetings**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	Unlisted co	Listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
Executive Directors	3	2 **	3	4	4	3 **	4	2 **	4	3 **	4	3 **	4	3	4 **	3
Non-Executive Directors	1	0 **	1	2	3.5	0 **	4	0 **	3	0 **	2	0 **	2	4	3 **	0
Total Directors	5	3 **	5	6	8	4 **	8	3 **	7	4 **	6	3 **	6	7	7 **	3
Proportion of Board with Non-Executives†	57	31 **	58	71	83	46 **	98	24 **	86	48 **	66		100	100	83 **	39
Number of Hours Spent by Non-Executives	10	8	10	10	10	9.5 *	10	8	10	8 **	10		10	10	10	10
Number of Board Meetings per year	9	4 **	10.5	10.5	10	6 **	10	5 **	10	4 **	12	6 **	11	10	10 **	7
Number of respondents	856	309	152	200	193	669	182	398	452	421	417	360	268	215	343	347

† only for companies with Non-Executive Directors

In this and all the following tables asterisks in the first column of a set of categories indicate statistically significant differences between the types of businesses grouped by size, company type, number of directors etc. (\* significant at the 10% level, \*\* significant at the 5% level or better)

**Table 2 Shareholding Structure and Meetings**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executive			Board Shareholding	
		<5	5<20	20<200	≥200	Unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
Median % shares held by																
Managing Director/Chief Executive Officer	25	50 **	24.5	7	1	40 **	1	50 **	2	43.5 **	11.85	50 **	10	1	1 **	50
Whole Board	51	100 **	60	29	1	80 **	2	100 **	12	70 **	35	100 **	34.3	2.5	4 **	100
Largest Shareholder	50	50 **	50	40	17	50 **	13	51 **	28	50 **	39	51 **	37.5	20	22 **	50
% firms where largest shareholder not on the board																
Non Board Shareholder	44	22 **	40	54	75	33 **	83	25 **	62	37 **	51	26 **	50	70	74 **	18
Median No of shareholders meetings	1	1 **	1	1	1	1 **	1	1	1	1	1	1 *	1	1	1 **	1

\*significant at 10% level

\*\*significant at 5% level

However, we cannot assume that, in such companies, board-level monitoring is always effective in protecting the rights of minority shareholders. It is noteworthy that in a sizeable proportion of smaller or closed companies, the largest shareholder was not on the board. This was the case with 22% of companies in the smallest turnover band, 33% of non-listed companies, 25% of companies with 5 or fewer directors, 26% of companies with no non-executives (and 50% of companies with a minority of non-executives), and 18% of companies in which the board held the majority of share capital.

### **4.3 Implications for the reform of Part X**

The finding that internal corporate governance procedures differ according to company size and type has some general implications for the reform of Part X. In Part 3 of the Consultation Paper, it was suggested that from an economic point of view, the purpose of many of the rules contained in Part X, and of the fiduciary principle more generally, was to induce flows of information between corporate actors – between directors and the board (as in the case of the disclosure rules relating to self-dealing) and between the board and the shareholders (as in the case of rules requiring disclosure of the terms of service contracts). However, we also suggested that the present provisions of Part X did not constitute a consistent approach to the issues of disclosure and ratification or approval by shareholders of directors' conduct. In particular, it was not clear why, in some cases, disclosure only to the board was required, whereas in others it was necessary for information concerning certain transactions to be disclosed to the shareholders or for them to ratify or approve the transactions in question.

The following general principle was therefore suggested: the law should require *disclosure* to shareholders of information concerning self-dealing, conflicts of interests and the terms of service contracts, subject only to those constraints which could be shown to be necessary on the grounds of protecting confidential information. Such disclosure should be meaningful, that is to say, it should take a form which was cost-effective and useful to the recipients of the information. However, *approval* or *ratification* by the shareholders should be required only in two sets of circumstances: firstly, where there was a particularly high danger of shareholder losses because of a lack of information or transparency concerning directors' conduct (as in the rules concerning substantial property transactions); and, secondly, where the agreed division of power between shareholders and the board was otherwise in danger of being circumvented (as in the rules requiring shareholder approval for decisions of the board taken in contravention of the articles).

The empirical evidence provides a clearer picture of the background against which this approach would operate. The essential point to note is that the forms taken by internal corporate governance processes are highly diverse. The diversity of approaches indicates that, in practice, there is no single model of corporate self-regulation, and that companies adapt to the particular conditions under which they operate. This strongly reinforces the view that the law should be essentially facilitative rather than prescriptive – in other words, the law should be seen as providing incentives for the corporate actors themselves to arrive at effective and workable corporate governance arrangements. This is consistent with establishing a general principle of disclosure of the kind outlined above.

The diversity of approaches taken by companies also implies that the way in which the law operates in practice will vary considerably according to the context in which it is applied. On the one hand, it should not be assumed that smaller companies have the resources to engage in the kind of ‘bargaining in the shadow of the law’ which we find in larger companies. On the other hand, it may be that there are substantial costs associated with bargaining around legal rules in the context of larger companies, for whom the costs of obtaining the *approval* of a large body of dispersed shareholders may in practice be very considerable. This issue poses some problems for the concept of a unitary system of rules which covers all types of corporate organisations. However, it does not imply that a unitary system is either unfeasible or undesirable. It means, rather, that the existence of diversity is a consideration which must be taken into account when analysing the possible effects of particular legal reforms. We return to this theme at relevant points in the discussion below.

## **5. Conflicts of interests, self-dealing, and the use of corporate opportunities**

### **5.1 Internal processes relating to conflicts of interests**

Tables 3-6 report on the degree to which companies in the sample dealt with the rules governing conflicts of interest, self-dealing and the use of corporate opportunities by internal corporate governance mechanisms. These included company procedures, disclosure requirements, and contracts regulating the use by directors of information and opportunities.

Table 3 reports on whether companies allowed their directors to hold outside directorships. This provides some indication of how far contracts or other constraints were used to impose on directors obligations of exclusive service. The Table shows that it is very rare for non-executive directors to be barred from being directors of other firms, confirming their advisory role. By contrast, in a fifth of all companies in the sample, executive directors were subject to constraints of this kind. Bars on outside directorships were significantly more likely in unlisted companies than in listed companies, and they were significantly more frequent outside the top 25% of companies by turnover.

Table 4 provides further evidence to the effect that the use of internal procedures to deal with conflicts of interest varies according to the size and status of the company and the extent of board ownership of the share capital. Hence procedures were significantly more likely to be found in the larger companies according to size of turnover (23% in the smallest band, 73% in the largest). The difference was also significant in the case of unlisted versus listed companies (32% and 82% respectively) and companies where the board held more or less than half the share capital (25% and 63% respectively). The presence of internal procedures was also correlated to the number of board meetings per year and the presence and proportion of non-executives on the board.

Table 4 shows that 22% of all companies reported that there had been disclosure to the board of a transaction in which a director had a personal interest in the past three years. Such disclosure was more likely in larger companies, listed companies, companies with larger boards, boards which met more often and boards with non-executives, and in companies where the board had 50% or less of the share capital.

**Table 3 Outside Directorships**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	unlisted co	Listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
% permitting Non Executives to hold outside directorships†																
All Non-Executives	91	84 **	91	91	96	90	94	88	92	92	91	-	91	92	93	90
Some Non-Executives	7	13 **	7	6	3	8	5	7	7	5	8	-	7	7	6	8
No Non-Executives	2	3	2	3	1	3	1	4	2	3	2	-	2	2	1	2
Firms with Non-Executives (Numbers)	487	97	88	142	160	306	176	96	387	203	274	0	268	215	283	136
% permitting Executives to hold outside directorships																
All Executives	57	65 **	45	50	63	59	52	67 **	49	63 **	51	68 **	41	61	50 **	63
Some Executives	22	15 **	23	29	26	19 **	34	14 **	29	18 **	27	15 **	32	22	29 **	17
No Executives	21	20 **	32	22	11	23 **	13	19	22	19	23	17 **	27	17	21	20
Firms with Executives (Numbers)	835	299	150	196	188	651	179	390	444	407	411	360	268	206	338	341
All firms	856	309	152	200	193	669	182	398	452	421	417	360	268	215	343	347

† only for firms with Non Executives

\*\*significant at 5% level

**Table 4 Directors' Fiduciary Duties: Procedures, Litigation, Disclosure and Lost Investment Opportunities**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	Unlisted co	Listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
% with Procedures for Dealing with Conflicts of Interest	43	23 **	35	53	73	32 **	82	22 **	63	37 **	49	23 **	54	65	63 **	27
% with Litigation over Directors Duties	2	1	0	3	2	1	2	1	2	2	1	1	3	1	2	1
% with Lost Investment Opportunities	7	5 **	3	7	14	6 **	12	5 **	9	7	7	5	9	9	8	7
% with Disclosure of Personal Interest Transactions	22	12 **	21	25	38	16 **	47	12 **	32	17 **	28	8 **	30	36	30 **	17

\*significant at 10% level \*\*significant at 5% level

Table 5 is based on open-ended answers given by the respondents who stated that they had corporate governance procedures in place for dealing with conflicts of interest. 326 respondents from independent companies answered in this way, approximately 20% of all such companies in the sample. Those with procedures were not typical of the sample as a whole: as a sub-sample they were heavily weighted towards larger companies in terms of turnover, listed companies, companies with larger and more frequently meeting boards, companies with non-executives, and companies with dispersed ownership.

The answers given by these respondents were reclassified into six categories as indicated in the first column of Table 5. Here, the category of 'constitutional control' includes responses which referred to rules laid down in the articles of association and shareholders' agreements. 'Directors' contracts' consists of answers which made reference to service contracts and/or handbooks of good practice issued to directors by their companies. 'Control by board' refers to responses which emphasised disclosure and approval at board level, which, in some cases, would include a specific role for the chairman, managing director or company secretary, or for the non-executives as a group. 'Control by shareholders' indicates requirements that conflicts of interest be disclosed and conduct ratified or approved by the shareholders in general meeting or through the use of a register, and 'external control' refers to control by outside regulatory bodies or external trustees or accountants. 'Other procedures' is a residual category of answers which did not specify the precise source of control.

The grouping of answers by reference to these six categories should not be taken to imply that, in every case, they would have been mutually exclusive. In a few cases, respondents mentioned more than one source of control; in other cases, where only one was cited, it is entirely possible that there were others in place (for example, it is highly likely that terms in directors' service contracts would operate in conjunction with board-level monitoring for listed companies). However, what is important here is the emphasis placed upon these procedures by the respondents themselves. The answers tell us something about the importance which respondents attached in practice to particular procedures.

Table 5 suggests that constitutional control is significantly more likely to occur in smaller, unlisted and 'closed' companies with a concentrated share ownership. A similar pattern emerges for control by shareholders, but the number of cases is too small to place much reliance on this result. The findings relating to the relative balance between service contracts and control by the board indicate that respondents in 'open' companies (that is, those with a more dispersed share structure) were less likely to cite service contracts as a source of control and more likely to refer to intra-board monitoring as a source of procedures. A possible reason for this is indicated in the analysis of responses by reference to the presence of non-executive directors. In this set of columns, references to board monitoring *increase*, and references to contracts *decrease*, according to the presence of non-executives on the board.

These findings show that of those companies which operate internal procedures, there is a tendency in smaller and medium-sized companies to rely on a mixture of constitutional control and direct shareholder intervention. In addition, such companies place greater reliance on constraints on directors taking outside employment, either in the form of provisions in directors' service contracts, articles of association, or shareholders' agreements. In open companies, by contrast, monitoring



tends to take the form of review by the board, and in particular by the non-executive directors.

This finding is reinforced by the material collected during the interview stage of the project. Interviews with company directors and officials indicated that it was becoming common for open companies to place increased reliance on non-executive directors to perform a number of monitoring roles. Particular features of this process were the splitting of the functions of the chairman and chief executive/managing director, the expansion of the role of remuneration and audit committees, and the adoption of formal corporate governance codes outlining the division of powers between the chief executive and the wider board of directors.

This qualitative evidence raises a number of questions which merit further investigation. The role of non-executive directors in open companies, and in particular the nature of their relationships with executive directors on the one hand and shareholders (in particular institutional shareholders) on the other, is currently in the process of evolving in the light of the corporate governance reforms initiated by many companies since the early 1990s. In the course of the present research it was not possible to gain evidence of these practices in more than a small number of organisations; a larger number of case studies would be needed before more specific conclusions could be drawn. Nevertheless, the qualitative stage of the research confirms the evidence which we have presented from the survey of a tendency for open companies to rely increasingly on processes of intra-board monitoring.

## **5.2 Litigation and contracting over directors' duties**

Litigation over the performance of directors' duties is unusual. Thus only 2% of all directors in the sample reported that their company had entered into litigation with a director over the performance of their directors' duties within the past three years, with the smallest companies being least likely to report this experience. It should be noted however that we have less than 1,000 companies in the sample and that there are over half a million companies registered for VAT. Grossing up these numbers to the company population as a whole would therefore reveal a very large absolute number of cases. Loss of investment opportunities because of conflicts of interest is similarly small in proportionate terms. Thus 7% of respondents reported that a director had given up an investment opportunity because of a potential conflict of interest. Giving up an investment opportunity for this reason was significantly more likely in larger firms by turnover size, listed companies, and companies with larger boards.

Table 6 is concerned with the extent of disclosures relating to corporate opportunities, and with the incidence of contracting over their use. 6% of all companies in the sample reported that in the past three years there had been disclosure to and approval by the company in general meeting of the use by a director of a corporate opportunity. Companies with a dispersed shareholding (that is, whose boards had 50% or less of the share capital) were reported to be significantly *less* likely to have experienced this type of disclosure to the shareholders; otherwise, there were no significant differences within the various categories. 5% of all firms reported that they had entered into a contract with a director over the use of a corporate opportunity; here, no significant differences by responses according to the type or size of company were found.

These data show that some contracting ‘in the shadow of the law’ relating to the fiduciary principle does take place, by directors seeking shareholder approval for their action. This tends to take place in smaller, ‘closed’ companies. It is in larger, ‘open’ companies, conversely, that directors are more likely to give up the opportunity to make use of a corporate opportunity. This would seem to indicate that the costs of seeking and obtaining shareholder approval are very high in ‘open’ companies. For the director concerned, these costs may include not simply the resources required to arrange a vote of shareholders, but also adverse reputational effects which may be associated with the widespread disclosure of a potential conflict of interest.

In short, the rules relating to the use of corporate opportunities, although they allow for some adjustment through implicit bargaining between the shareholders and the director concerned, are rarely varied in this way in larger companies with dispersed shareholdings. In smaller companies, by contrast, where there are fewer affected parties, bargaining around the rules prohibiting a conflict of interests is more likely to take place.

### **5.3 Implications for the reform of Part X**

#### **5.3.1 Disclosure to the board**

The evidence just presented suggests that in larger companies, board-level monitoring is the most important mechanism through which conflicts of interest are dealt with. For companies in this position, compliance with those existing provisions of Part X which require certain disclosures to be made to the board – such as section 317 – should not be unduly costly, since it is highly likely that internal procedures already embody, and may go beyond, the requirements of the section.

Conversely, for larger companies, rules imposing a requirement of shareholder approval may pose a significant constraint on the types of transactions which directors of larger companies are prepared to enter into. In smaller, closed companies, the evidence suggests that direct shareholder oversight of conflicts of interests is more feasible. In practice, the result may well be to discourage nearly all larger or ‘open’ companies from entering into these transactions, while, in the case of smaller, ‘closed’ companies, some will contract round the legal rules where it is in their interests to do so.<sup>8</sup>

The issue for policy makers can therefore be clarified in the following way: rules which focus on intra-board monitoring are likely to function most effectively within larger companies. For smaller companies, without extensive internal procedures of their own, such rules may well give rise to significant compliance costs since they will need to develop new procedures. Companies of this kind tend to rely to a greater extent on provisions in the articles of association and in shareholders’ agreement.

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<sup>8</sup> In economic analysis, these two situations are referred to, respectively, as a ‘pooling equilibrium’ and a ‘separating equilibrium’: see Part 3 of the Consultation Paper, at para. 3.38.

**Table 5 Procedures for Dealing with Conflict**

Procedure	All		Turnover Size Group (£m)				Type of company		Number of directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
	Nos	%	<5	5<20	20<200	≥200	unlisted co	Listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	Non-execs ≥50%	≤50%	>50%
Constitutional control	26	8.0	16.9 **	8.3	3.4	6.5	11.9 **	2.3	12.8 *	6.5	5.7	9.9	9.5	10.1	4.9	5.2 **	14.4
Directors' Contracts	52	16.0	23.1	12.5	12.4	16.1	18.0	13.3	23.1 **	13.7	17.7	14.8	27.0 **	14.0	11.5	13.0 **	23.3
Control by Board	170	52.1	36.9 **	62.5	59.6	50.8	45.4 **	63.3	38.5 **	56.5	51.1	52.7	33.8 **	52.7	63.1	58.9 **	42.2
Control by Shareholders	7	2.1	4.6 **	0.0	4.5	0.0	3.6 **	0.0	2.6	2.0	2.8	1.6	2.7	2.3	1.6	1.6	3.3
External Control	9	2.8	3.1	4.2		4.0	2.6	2.3	3.8	2.4	3.5	2.2	4.1	1.6	2.5	2.1	2.2
Other Procedures	62	19.0	15.4	12.5	20.2	22.6	18.6	18.8	19.2	19.0	19.1	18.7	23.0	19.4	16.4	19.3	14.4
Total	326	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note. 314 companies had procedures for dealing with conflict, 10 companies had 2 procedures and 1 company had 3 procedures making a total of 326

\*significant at 10% level \*\*significant at 5% level

**Table 6 Disclosure of Benefits From the Use of Company Property, Information or Opportunities**

	All		Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
			<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
No. of firms with disclosures of benefits	50	21	4	12	13	41	8	23	27	23	27	17	17	14	16	30	
% of firms with disclosures of benefits	6	7	3	6	7	6	5	6	6	6	7	5	7	7	5 **	9	
Median no. of disclosures of benefits	2	1	1	2.5	2	2	2	2	1	2	1	2	1	2	2	2	
No. of occasions entered into contract over benefits	41	11	9	9	12	34	6	17	24	21	20	13	17	11	15	21	
% occasions entered into contract over benefits	5	4	6	5	6	5	3	4	5	5	5	4	7	5	5	6	
Median no. of occasions	1	1	1	1	2	1	1	1	1	1	1	1	1	1	1	2	

\*\*significant at 5% level

This does not mean, however, that the present operation of section 317 (for example) is excessively costly for smaller companies. Even in this context, the fundamental economic rationale for rules of this kind - their role in promoting information flows - justifies the wide range of matters over which disclosure is required by section 317 (although this principle would still permit a loosening of section 317 to absolve directors of the rather otiose obligation formally to notify the board that they have an interest in their *own* service contract).

### **5.3.2 Shareholder approval**

The empirical evidence suggests that larger companies are less likely to seek shareholder approval where this is necessary to validate a particular transaction, preferring instead to forego the opportunity in question. In practice this means that rules of this kind tend to lock these companies into a particular outcome. We would expect it to be rare for such companies, therefore, to enter into substantial property transactions under sections 320-322 or loans to directors under sections 330-344. These rules, then, operate as 'strong defaults' - the costs of contracting around them are so high that the benefits to be gained by doing so rarely justify entering into such transactions. This result may well accord with the aims of policy-makers; however, it should be clearly recognised that this is, in practice, the most likely outcome.

### **5.3.3 Approval by non-executive directors**

Another possible solution would be to allow certain transactions to go through if the non-executive directors (as an alternative to the shareholders) gave their approval. This proposal to increase the monitoring role of non-executives must be seen against the background of the findings outlined above, namely that many smaller firms do not have non-executive directors. In their case, this may not matter much, since, on balance, it would be easier to obtain direct shareholder approval.

In the case of larger firms, giving the non-executives the power to approve particular transactions would involve an extension of a role which, in many companies, they are already assuming, in relation to questions of conflicts of interest. On that basis, a reform of this kind would be likely to see an increase in transactions of this kind in larger companies. Whether the shareholders, under such circumstances, would be adequately protected against the possibility of a depletion of assets, is a matter of fine judgement. Given the particularly high risk of loss to shareholders which is inherent in permitting such transactions, there is a clearly a case for maintaining the rule in the form which it currently takes.

### **5.3.4 Disclosure to shareholders**

A more problematic issue is whether there should be an extension of the role played by rules requiring disclosure to shareholders. The key finding of this part of the empirical research was that imposing a requirement of shareholder *approval* for particular transactions most likely involves heavy costs for larger, 'open' companies. There is some evidence to suggest that for larger companies, it is not just shareholder approval which is costly, but also the costs of disclosing information which would normally be confidential or would entail reputational costs for the individual directors concerned. The issue is whether the gain to shareholders of increased disclosure

outweighs the loss to the company (and hence, ultimately, to the shareholders themselves) of being unable to pursue certain transactions, which is the likely consequence at least for larger companies.

The law currently operates on the assumption that the gain to shareholders is *not* sufficient to justify disclosure to them of self-dealing under section 317, since that section only requires disclosure to the board. This is in contrast to the position with regard to corporate opportunities and other clear cases of conflicts of interests under the general law, where the assumption is that disclosure to shareholders is required, although there may be exceptions to this.

We are not able, on the evidence we have, to make a definitive assessment of the efficiency implications of widening the scope of disclosure under section 317. However, we are able to say, on the basis of the empirical study, that any extension of section 317 to require general disclosure of self-dealing to shareholders would have substantial implications for the type of transactions which larger companies enter into, since they may then give up opportunities for certain types of transactions to avoid incurring the extra costs of wider disclosure.

### **5.3.5 Criminal and civil sanctions**

The general rationale for the application of the fiduciary principle in relation to conflicts of interests provides an economic basis for the use of restitutionary remedies for breach of the provisions of Part X. As explained in Part 3 of the Consultation Paper, this can be seen as providing an efficient level of incentives for disclosure (see paras. 3.73-3.78). It was also argued there that, for similar reasons relating to the difficulty of observing breaches by directors of the duty of loyalty and the costs to shareholders of mounting civil litigation, criminal sanctions could play a role in this area (paras. 3.79-3.84). In relation to the use of criminal sanctions, background interviews with legal practitioners which we carried out as part of the empirical stage of the research suggest that there is a widespread view to the effect that the possibility of criminal sanctions can concentrate the minds of directors. Advisers feel that without the threat of such sanctions, it would be more difficult for them to persuade certain directors to avoid certain transactions of dubious legality. We do not have any direct evidence of this use of the law, but frequent references by practitioners suggest that the threat of criminal liability may, through the medium of legal advice, have a significant influence on behaviour in practice.

Where to strike the right balance between criminal and civil sanctions in this area is fundamentally an issue of policy and judgement. Civil sanctions, because they contain a restitutionary element which sharpens the incentive for compliance, may fulfil much the same function as criminal sanctions. However, for this to be the case, it is likely existing remedies for breach of duty by directors would have to be sharpened, as envisaged by the Law Commission Report on *Shareholder Remedies* (No. 246).

### **5.3.6 Disclosure in the context of a sole director company**

One of the issues addressed by the empirical research was whether disclosure by a director of an interest in a transaction involving the company (under section 317)

serves any purpose in a company which has a sole director. We were not able to obtain information on this issue through the survey. In interviews with legal advisers, it was suggested that the principal purpose served by this provision was to provide some protection for creditors of companies of this kind, in the event of corporate failure.

## **6. Directors' service contracts**

### **6.1 Incidence, form and duration of service contracts**

Table 7 indicates, as economic theory would predict, that the use of formal service contracts tends to be higher in larger companies, listed companies, companies with non-executives on the board, and companies where the board holds a minority of the share capital. The extent of non-usage is perhaps more surprising: fully 58% of companies in the smallest size band, 43% of non-listed companies, 62% of companies with no non-executives, and 47% of companies whose boards held the majority of shares, had no service contracts for their directors. Where service contracts are agreed, they tend nearly always to be in writing.

Table 8 indicates the normal length of directors' service contracts. The median normal length for the whole sample is 1 year. Longer-term contracts were rare among listed companies in the sample – only 1.8% ran for 3 years or above and 9.4% had no specified length, compared to 22.4% and 22.1% respectively for non-listed companies, although differences in median contract lengths between these groups were not statistically significant. Longer-term contracts were also more common where there are no non-executives on the board, in smaller boards and where the board meets more frequently. In these cases the median contract lengths were also significantly higher.

Table 9 shows that contracts are significantly more likely to be terminable on notice where the company is listed, the board has 5 or more directors, there are non-executives on the board, and where the board as a whole does not have a majority shareholding. Rolling contracts are also more likely in these companies (and in companies with greater turnover) and notice periods are likely to be longer. The median length of notice for the sample as a whole is 12 months (but only 6 months in unlisted companies, companies without non-executives, and companies where the board has a majority shareholding).

One interpretation of these data would be that formal mechanisms of accountability for executive directors – larger and more frequently meeting boards, a stock exchange listing, the presence of non-executives, and contracts terminable on notice – go together with *longer* notice periods, thereby providing some 'cushion' for directors who are in this position.

Tables 10 and 11 carry the analysis further by providing evidence on the disclosure and approval of the contracts of executive directors. Nearly all listed companies reported disclosure of contracts to and approval by the remuneration committee in all or some cases; fewer report disclosure to the board as a whole. This suggests that in listed and larger companies, the key monitoring role with respect to service contracts

**Table 7 Proportions of Companies where Directors have Service Contracts and Proportion of Such Contracts in Writing**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
For Companies with Executive Directors																
% All Service Contracts	54	31 **	59	63	77	43 **	92	29 **	75	45 **	63	27 **	72	77	72 **	40
% Some Service Contracts	12	11 *	18	11	10	14 **	5	12	13	12	13	11	15	10	12	13
For Companies with Executive Directors and Written Contracts																
% Always written	96	95	93	96	98	94 **	99	94	96	94	97	93	96	97	97 **	93
% Sometimes written	3	4	6	2	2	5 **	0	5	3	4	2	6	3	2	2 **	6
% Never written	0	1	1	0	0	0	1	1	0	0	0	1	0	0	0	0
% Don't Know	1	0	1	2	0	1	0	1	1	1	1	1	1	1	1	1
All firms	856	309	152	200	193	669	182	398	452	421	417	360	268	215	343	347

\*significant at 10% level \*\*significant at 5% level

**Table 8 Normal Length of Service Contracts (% distribution)**

Length of Contract	All Nos	All %	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
			<5	5<20	20<200	≥200	unlisted co	Listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
Less than 1 year	30	5.7	9.1	6.6	5.0	3.2	7.8	1.8	8.7	4.6	5.0	6.1	4.9	8.0	3.5	4.0	8.2
1 year	211	40.3	30.6	47.2	40.7	42.7	36.2	49.1	30.2	44.1	32.7	46.3	28.5	45.8	40.9	47.1	28.0
2 years	105	20.0	8.3	9.4	23.6	33.1	11.5	38.0	12.8	23.0	18.6	20.3	13.0	19.1	26.3	25.5	12.9
3 years and above	84	16.0	29.8	17.0	12.1	8.3	22.4	1.8	26.2	12.2	25.0	9.5	29.3	11.1	13.5	8.8	21.6
No specified length†	94	17.9	22.3	19.8	18.6	12.7	22.1	9.4	22.1	16.2	18.6	17.9	24.4	16.0	15.8	14.6	19.3
Median length		1.0	1.0	1.0	1.0	1.0	2.0	1.0	1.5 **	2.0	2.0 **	1.0	2.0	1.0	2.0	1.0	1.0
All	524	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

† Includes variable and no fixed lengths of contract

\*significant at 10% level \*\*significant at 5% level

**Table 9 Rolling Service Contracts and Terms of Termination for Executive Directors**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
% Always terminable on Notice	77	74	73	78	83	73 **	85	67 **	81	76	79	64 **	77	87	81 **	70
% Always Rolling	55	43 **	53	51	70	47 **	73	45 **	60	53	56	39 **	60	62	62 **	49
% Always or Sometimes Terminable	89	85 **	85	89	95	86 **	95	81 **	92	88	90	82 **	89	94	93 **	84
% Always or Sometimes Rolling	77	67 **	81	74	84	72 **	87	72 *	79	75	78	67 **	82	77	81 **	72
Median length of Notice	12	6 **	9	12	12	6 **	12	6 **	12	6 **	12	6 **	12	12	12 **	6
All firms	856	309	152	200	193	669	182	398	452	421	417	360	268	215	343	347

\*significant at 10% level \*\*significant at 5% level



**Table 10 Disclosure of Executive Directors' Contract Terms to the Board and to Shareholders (% Distribution)**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executive			Board Shareholding	
		<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
<b>Always Disclosed to (%)</b>																
The Board	67	72	72	65	62	64 **	73	72	65	70	66	70 **	61	74	66	73
Executives	65	77 **	68.0	63	55	65	64	74 **	62	71 **	61	71	61	67	60 **	78
Non-Executives	73	69	76	71	75	64 **	85	72	74	68	75		72	76	76	71
Remuneration Committee	72	42 **	61	78	90	56 **	96	38 **	81	65 **	77	43 **	71	86	87 **	44
Shareholders in General Meeting	42	39	42	38	46	33 **	58	41	42	43	41	44 *	36	49	45	38
Shareholders by Inspection	46	25 **	41	43	63	25 **	79	23 **	53	40 *	49	33 **	42	57	57 **	29
Others (N=33)	6	3	6	7	9	6	8	4	7	5	7	6	6	7	7	6
<b>Always or sometimes disclosed to (%)</b>																
The Board	83	84	89	80	82	80 **	90	82	84	83	84	80 *	81	89	83	88
Executives	85	89	88	80	83	82 **	90	87	84	87	83	80	86	88	85	90
Non Executives	91	84 *	94	89	94	85 **	99	87	92	89	92	*	89	94	92	90
Remuneration Committee	77	49 **	68	82	94	64 **	99	43 **	87	70 **	82	49 **	78	89	91 **	54
Shareholders in General Meeting	53	48	55	49	57	45 **	67	51	53	53	53	52	50	57	58 **	47
Shareholders by Inspection	55	38 **	52	51	69	36 **	85	37 **	60	47 **	59	43 **	54	63	64 **	41
Others (N=48)	9	5	8	11	11	8	10	5 **	11	9	10	6	10	10	10	9
All firms	856	309	152	200	193	669	182	398	452	421	417	360	268	215	343	347

\*\*significant at 5% level

\*significant at 10% level

**Table 11 Shareholder and Board Approval of Executive Directors' Service Contracts (% Distribution)**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
<b>Always approved by (%)</b>																
The Board	47	59 **	53	41	38	49	41	62 **	40	52 *	44	60 **	42	43	40 **	60
Executives	42	65 **	49	36	24	50 **	24	68 **	32	51 **	36	58 **	43	28	30 **	65
Non-Executives	48	41	45	52	50	38 **	62	53	47	42	51	49	47	52	45	
Remuneration Committee	67	32 **	55	69	89	48 **	95	28 **	77	56 **	73	32 **	66	82	83 **	36
Shareholders in General Meeting	14	22 **	17	13	9	18 **	6	26 **	10	19 **	11	31 **	9	11	9 **	20
Others (N=34)	6	6	6	9	5	9 **	1	6	7	7	6	7	8	4	5	6
<b>Always or sometimes approved by (%)</b>																
The Board	67	77 **	77	64	53	67	66	79 **	61	72 **	63	77 **	60	68	60 **	79
Executives	57	79 **	70	51	37	64 **	42	80 **	48	64 **	52	71 **	60	42	47 **	78
Non Executives	69	65	72	71	67	63 **	77	71	68	70	68	67	71	68	73	
Remuneration Committee	74	40 **	62	77	94	56 **	99	33 **	84	63 **	79	36 **	74	88	89 **	46
Shareholders in General Meeting	23	35 **	27	18	15	28 **	12	39 **	16	28 **	19	39 **	18	18	18 **	30
Others (N=38)	7	7	6	11	5	10 **	1	7	7	8	7	8	9	4	5	8
All firms	856	309	152	200	193	669	182	398	452	421	417	360	268	215	343	347

\*\*significant at 5% level

\*significant at 10% level

is performed by remuneration committees. In such companies, shareholders very rarely approve the terms of service contracts.

Fewer than half of all respondents in the sample report that contracts are always disclosed to shareholders for inspection, despite the legal obligation to this effect in section 318. It is not clear how far this reflects non-compliance with the law. It is likely to reflect ignorance of the law on the part of certain respondents whose companies do nevertheless comply with the legislation, but it is not possible to judge the extent of this. At any rate, the finding suggests that many directors are unaware of section 318.

Table 11 indicates the degree to which, in unlisted companies, shareholders in general meeting are invited to approve the terms of directors' service contracts. This occurs in less than 10% of listed companies, and its incidence also decreases with size of company. However, approval was reported in the case of 35% of companies in the smallest size band, 28% of non-listed companies, 39% of companies with less than 5 directors, 39% of companies without non-executives, and 30% of companies with majority board shareholdings.

What of the approximately two thirds of smaller, closed or non-listed companies in which shareholder approval is not generally sought? It is not clear from the survey whether these are companies where contracts are approved by the board, or possibly by a single director. It should also be borne in mind that most of these companies did not even have service contracts for their directors.

Table 12 indicates that around a third of companies always or sometimes seek shareholder approval for special payments to directors (compensation for loss of office, compensation for reduction in the term of office or notice period, and increased pension payments to directors). Approval is significantly more likely to occur in companies reliant on direct shareholder monitoring, that is to say, unlisted companies, companies with smaller boards, no non-executives and majority board shareholdings. However, even in these cases, only around half the companies in each case seek such approval.

Table 13 provides information on the costs of holding board meetings and shareholders' meetings. It reveals that these costs rise with company size, the number of directors, the number of board meetings, the presence and number of non-executives, companies with dispersed ownership, and with listed companies. The relationship between costs and company type is basically driven by company size. What is also noticeable, however, is that the costs of shareholders' meetings increase much less than in proportion to turnover size, so that these costs are disproportionately heavy for smaller companies.

## **6.2 Implications for the reform of Part X: Approval or disclosure of directors' service contracts?**

We referred earlier to the guiding principle for reform of the law in this area, namely that the law should seek to operate on the basis of disclosure of relevant information rather than, in general, requiring shareholder approval for particular transactions. On this basis, section 319 looks anomalous. By requiring shareholder approval for

contracts beyond five years, it potentially entails significant compliance costs for larger, open companies which, as we have seen, are reluctant to seek approval of this kind. The rule operates as a 'strong default rule' which is close to being mandatory for larger companies, since they will very rarely bargain around it by obtaining shareholder approval.

This is reflected in the very small number of larger and listed companies in which the median length of directors' service contract is longer than three years (Table 8). Longer notice periods, however, operate in the case of larger and listed firms, suggesting that directors may receive some other contractual benefit in return for de facto limits being placed on their length of service. If it is the case that companies can take steps to ensure that directors are no worse off than they would have been as a result of a reduction in the duration of their service contract, shareholders may be placed in no better position than they were before as a consequence of this provision.

Viewed as a mechanism for limiting large pay-offs to directors who end their service early, then, section 319 is probably ineffective. Since the law sets no limit to the overall remuneration which directors can receive (and there are no plans to set an upper limit of this kind to directors' pay), there is only a limited amount which rules aimed at limiting pay-offs through restrictions on notice periods can achieve.<sup>9</sup>

Section 319 makes more sense as a measure designed to ensure that the agreed balance of powers between shareholders and the board is not undermined, and, on this basis, comes under the second of the two exceptions justifying the imposition of a requirement of shareholder approval (see above). It thereby complements the power of the shareholders, under section 303 of the Companies Act 1985, to remove a director from office by vote at a general meeting. In effect, this is a power to submit the director to the threat of removal at least once a year. It could be argued that shareholders would be reluctant to exercise this power in the case of a director with a long-term service contract. How far this rationale operates in practice is difficult to judge. It was pointed out to us at the qualitative stage of the research that the removal of a director by resolution of the shareholders was, in any event, an extreme step. It is not clear whether shareholders prepared to go this far would be deterred by the duration of the director's service contract. Nor would such a rationale have much application in the case of a listed company where, it was suggested, institutional shareholders were likely to be able to bring influence to bear without the need for a formal vote on a resolution.

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<sup>9</sup> One of the questions which the empirical research addressed concerned the manner in which damages for breach of contract were calculated for the purposes of compensating directors whose contracts were terminated prematurely. We were not able to get evidence from a wide range of sources on this question; however, some legal advisers suggested to us that companies making such payments frequently took into account the possibility that the director in question would find alternative work, and reduced the size of the payment accordingly.

**Table 12 Shareholders' Approval of Payments (% Distribution)**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
<b>Always Seeking Shareholder Approval for</b>																
Payment loss of office	27	40 **	41	19	15	37 **	7	39 **	23	29	26	43 **	24	19	20 **	40
Payment reduction terms of office	25	41 **	41	15	11	36 **	3	41 **	19	28	23	46 **	20	16	16 **	37
Increased Pension Payment	26	47 **	36	13	12	36 **	4	44 **	19	28	25	50 **	21	15	16 **	40
<b>Always or Sometimes Seeking Shareholder Approval for</b>																
Payment loss of office	38	46 **	54	34	26	48 **	18	52 **	33	41	37	51 **	38	29	30 **	49
Payment reduction terms of office	36	47 **	52	32	22	47 **	13	53 **	30	41	34	55 **	34	26	26 **	46
Increased Pension Payment	37	51 **	51	27	25	49 **	12	52 **	32	38	37	57 **	37	23	27 **	48
All firms	856	309	152	200	193	669	182	398	452	421	417	360	268	215	343	347

\*significant at 10% level    \*\*significant at 5% level

**Table 13 Costs of Board and Shareholders' Meetings (£s)**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
Median Cost of one Additional Board Meeting	500	450 **	500	1000	1300	500 **	2750	250 **	1000	500 **	850	200 **	1000	1000	1000 **	500
Median Cost of two Additional Board Meetings	1800	1200 **	1900	3000	6000	1500 **	9000	725 **	4500	1500 **	3000	600 **	3825	3000	4000 **	1275
Median Cost of one Additional Shareholders Meeting	600	300 **	500	1000	5000	475 **	10000	250 **	2000	500 **	1000	200 **	1500	2500	2900 **	300
All firms	856	309	152	200	193	669	182	398	452	421	417	360	268	215	343	347

\*significant at 10% level    \*\*significant at 5% level

It is unclear, then, what the precise rationale of section 319 is. If, however, its purpose is to buttress section 303 as just suggested, then reform of the law to neutralise the use of 'rolling contracts' would clearly be needed since, as the law currently stands, contracts can be drawn up in such a way as to ensure that a director is entitled to a further five years of employment if he or she is dismissed at any given point in time. However, we should not lose sight of the point that, as long as companies remain free under the law to raise directors' pay, regulation of the other non pay terms of directors' contracts may have only limited effects in practice.

If section 319 were to be retained but with a shorter period of, for example, three years substituted for the current five, Table 11 shows that the impact on listed and larger companies would be limited. Only 1.8% of listed companies and less than 10% of the largest group of companies by turnover reported having directors' contracts for 3 years' or more duration. This reflects the impact of the Combined Code on Corporate Governance, which recommends a maximum duration of two years for directors' service contracts. The main effect of any change would therefore fall on smaller and unlisted companies. Nearly 30% of companies in the smallest size band and 17% of companies in the next band reported having contracts for 3 years or more. The impact of a change in the law would therefore be considerable, although it is possible to argue that since, in practice, it is easier for smaller companies than it is for larger ones to seek shareholder approval (see above), any such negative impact would be limited. However, the wider question is whether such a change would make shareholders in smaller companies significantly better off. The empirical evidence suggests that shareholders in around a third of smaller firms already approve the terms of directors' service contracts (including, presumably, their duration).

A possible avenue for reform would be to move to a generalised system of disclosure. At present, many aspects of directors' remuneration do not have to be disclosed to shareholders. This is the case, for example, with regard to the way in which payments of compensation for breach of contract are calculated in the context of section 316(3), which permits such payments to be made without disclosure to and approval by shareholders.

It would be consistent with the general principle referred to above to make provision for disclosure to shareholders of all aspects of directors' remuneration including the basis of all payments to directors following the termination of their service contracts. Thus if sections 312-216 are revised so as to make it clear that shareholders do not have the right to withhold approval from covenanted payments, there should nevertheless still be an obligation upon companies to disclose such payments, and the basis upon which they were calculated, to the shareholders.

However, it should be noted, at the same time, that the *existing* law on disclosure may not be well understood by directors. Fewer than half of all respondents to the survey reported that the terms of directors' service contracts were disclosed to shareholders. This implies either widespread ignorance of the law, or failure to implement its requirements. If it is the former, consideration could be given to clarifying the law and communicating its requirements to directors through leaflets or official guides to the law's operation.

## 7. The duty of care

As part of the survey, respondents were asked for their views on the appropriateness of proposed changes to the general standard of care required of directors. This information is valuable since it not only provides some indication of directors' views, but also enables us to say something about how directors in different sizes and types of companies might respond to a change in the law. At the same time, it is unclear, then, what the precise rationale of section 319 is. If, however, its purpose is to buttress section 303 as just suggested, then reform of the law to neutralise the use of 'rolling contracts' would clearly be needed since, as the law currently stands, contracts can be drawn up in such a way as to ensure that a director is entitled to a further five years of employment if he or she is dismissed at any given point in time. However, we should not lose sight of the point that, as long as companies remain free under the general law to raise directors' pay, regulation of the other, non-pay terms of directors' service contracts may have only limited effects in practice. This point applies to rolling notice periods just as much as it does to other non-pay terms.

Methodological limitations of this technique should be recognised. It represents the views of only one constituency among those who might be affected by legal reform. Moreover, it is not possible to say how far directors responding to the survey were in a position properly to evaluate the legal implications of the different options. Nevertheless, subject to these qualifications, the information offers what we believe to be some useful insights, in particular in the way responses differed according to the degree of concentration of ownership of the company's shares.

Thus Table 14 shows that option C – the combined objective/subjective test – was favoured by around half of respondents, while option A – the 'traditional' subjective test of *re City Equitable*<sup>10</sup> – was favoured by little less than a third. Significantly more directors favouring the 'traditional' option, option A, were from companies where the board had a majority shareholding. This could be seen as reflecting the greater range of skills to be found among directors of such companies, and the difficulties which some directors in 'closed' companies might have in complying with a more objective standard.

Background interviews carried out with legal advisers, bankers, accountants and insolvency practitioners about the operation of the present law relating to the duty of care, wrongful trading and disqualification of directors revealed a number of views. It was widely felt that banks' lending decisions were assisted by legal controls over wrongful trading and the possibility of disqualification was of benefit to advisers in being able to point out to directors the consequences of their actions. There was also some concern that the law should not reach the point of allowing disqualification (or personal liability leading to bankruptcy for the individual concerned) in cases where the failure of a business was caused by a factor beyond the control of the board. The following comments sum up two points of view:

'you can be diligent as a director, but still be very unlucky and as a lending banker, you accept that you can do all the checks on the market, the financials, you have a group of competent managers and it can still go wrong. So I would

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<sup>10</sup> *Re City Equitable Fire Insurance Co.* [1925] Ch. 407; see the Consultation Paper, at para. 12.7.

not want to see anything which meant that if any company that got into serious difficulties, that necessarily reflected on the professional competence of managers. Sometimes it is just sheer bad luck. It happens. On the other hand, I do think that the standards which directors have to keep to have not been particularly onerous up to recently and I think it is absolutely right that there should be hurdles which directors, both executive and non-executive, should reach.’ (Banker)

‘I think what [the law] does do across quite a broad spectrum is to cause directors of companies in difficulty and their advisers to focus on the fact that a point comes where they have to think about their duty to creditors as well as or instead of their duty to shareholders... [it] causes decisions about when to pull the plug to be made and to be brought at the right time in a large number of cases.’ (Insolvency practitioner).

Within the context of business failure, the objective elements which are contained in section 214 of the Insolvency Act 1986 and the wrongful trading legislation appear to have support among those involved in insolvency and rescue procedures.

It is more difficult to predict the wider effects of introducing a combined objective/subjective standard for directors. In larger and listed companies, there are already moves to formalise the process of reporting to the board by senior management, in particular on matters of legal and ethical responsibility. This trend would be confirmed by a change in the law but is in the process of occurring anyway.

For smaller and unlisted companies, much would depend on how precisely a new standard was to be interpreted to take into account the different degrees of knowledge and experience of directors.

It seems unlikely, on the basis of our own interviews and also by reference to responses to Law Commission Consultation Paper No. 142 on *Shareholder Remedies*, that a change in the standard of care would lead to intra-corporate litigation at the instigation of institutional shareholders. Institutional shareholders can exercise pressure on boards, where they deem it necessary, by other means. Whether litigation from other shareholder groups would become more likely as a consequence of any change in the law is more difficult to judge. It seems unlikely that the volume of such litigation would increase to US levels even if the law relating to the duty of care were to be made more stringent, since rules of procedure (even with the changes contemplated in Law Commission Report No. 246 on *Shareholder Remedies*) would be much less amenable to this type of action than is the case in most US jurisdictions.

## **8. Responses to the draft statement of directors’ duties**

Table 15 shows that an overwhelming number of respondents (over 80%) consider that the Law Commissions’ draft statement of directors’ duties is about right in terms of content.

Around a quarter of the whole sample consider that the Law Commissions’ statement is likely to be of either great assistance or very great assistance (Table 16). There are



**Table 14 Duty of Care Preference Between Options Proposed by Law Commission**

% Preferring	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
Option A	31	35	31	29	27	32	29	33	29	31	31	36	25	31	26 **	35
Option B	19	16	17	21	25	17	27	15	23	19	20	14	25	22	22 **	19
Option C	48	48	49	48	48	49	44	49	47	48	48	48	49	47	50 **	44
None	2	2	3	2	1	2	0	3	1	3	1	3	2	1	2 **	2
All respondents	804	288	141	181	189	627	174	372	427	400	387	338	252	203	328	325

Directors owe a duty of care to the company, and so may be personally liable for the consequences of negligence in the performance of their duties. The Law Commission have proposed a number of options for reforming the duty of care, as explained below.

Under Option A, a director would owe the company a duty to exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having the knowledge and experience which that director had.

Under Option B, a director would owe the company a duty of exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having the knowledge and experience that might reasonably be expected of a person in the same position as the director, regardless or the degree of knowledge and experience which that director had.

Under Option C, a director would owe the company to duty exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having both the knowledge and experience that might reasonably be expected of a person in the same position as a director, and the knowledge and experience which that director had.

**Table 15 Law Reform: Contents of the Statement of Directors' Duties**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
% Too Detailed	4	4	5	5	4	4	6	4	4	5	3	4	5	4	4	4
% Not Detailed Enough	13	11	17	13	12	13	13	11	14	13	13	10	16	13	13	11
% About Right	83	85	79	83	83	84	82	85	81	83	84	86	80.0	83	83	85
Total	841	308	150	194	187	661	175	395	441	417	406	357	265	207	337	342

no differences by type of firm except between listed and unlisted companies: directors in unlisted companies were significantly more likely to find the statement of great or very great assistance.

Of the options for the use of the statement, the most strongly supported was the proposal that directors should be required to sign to the effect that they have read the statement when confirming their appointment as a director (Table 17). 88% of all respondents gave this their support. The proposals to annex the statement to the company accounts, require a director to sign that he or she has read the statement when making the annual company return, and include the report in all statutory returns made by the company, were significantly more likely to be favoured by directors in non-listed companies. Executive directors were also more likely to favour compulsory annexure than were non-executives (Appendix 1 Table A9).

This suggests that the value of the statement is greater for directors in unlisted companies, possibly because they are less likely to have access to legal or expert advice through the company. Tables 18 and 19 likewise, shows that directors in smaller, non-listed, and closed companies, and companies without non-executives, placed greater importance on some of the duties listed in the Law Commissions' statement (in particular the duty of loyalty, the duty to take into account the interests of employees and the duty to act fairly as between shareholders) than did directors in larger, listed and open companies. There were very few differences in responses between non-executive directors and executive directors, although the former were significantly less likely to favour listing care skill and diligence than the latter (Appendix 1 Tables A6 & A7).

Table 20 reports that 61% of all respondents thought that it would be helpful for the statement to be set out in a Companies Act even though it would not be a complete statement of directors' duties. Respondents in non-listed companies, closed companies, companies with few non-executives and companies with greater than 5 directors were significantly more likely to approve of this suggestion.

In short, the evidence suggests that a statement of duties would assist directors in practice. Those most assisted would be directors in smaller firms who may not have regular access to legal advice in the same way that directors in larger and listed companies normally do. There was very strong approval for the level of detail in the statement (over 80%) and for its inclusion in a Companies Act. Around a quarter of the sample thought that the statement would be of great or very great assistance to them. Approval was higher among directors of smaller, non-listed and closed companies as well as companies without non-executives. This is consonant with the suggestion that in larger and listed companies, where use is made of non-executives, internal corporate governance procedures already deal effectively with many of the issues raised in the statement. However, in companies without such procedures, it would appear that the statement would play a valuable informational and guiding role.

**Table 16 Assistance to Directors of the Law Commissions' Statement Relating to Directors Duties: Mean Scores and Percentages Scoring the Statement as of Great or Very Great Assistance**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥20	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
Mean Score	3.1	3.1	3	3.1	3.1	3.1 **	2.9	3.1	3.1	3.1	3.0	3.1	3.1	3	3	3.1
% Scoring 4 or 5	24	25	18	27	21	26 **	15	24	23	26	21	24	23	23	23	23
All Respondents	844	308	148	197	189	661	178	394	445	417	409	356	265	211	338	343
Missing Values	12	1	4	3	4	8	4	4	7	4	8	4	3	4	5	4
<b>Total</b>	<b>856</b>	<b>309</b>	<b>152</b>	<b>200</b>	<b>193</b>	<b>669</b>	<b>182</b>	<b>398</b>	<b>452</b>	<b>421</b>	<b>417</b>	<b>360</b>	<b>268</b>	<b>215</b>	<b>343</b>	<b>347</b>

\*significant at 10% level \*\*significant at 5% level

Respondents were asked to score the variable on a scale of 1-5 with 1 meaning of no assistance and 5 meaning of very great assistance.

**Table 17 Options for Use of Statement Related to Duties**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
<b>% yes to</b>																
Compulsory Annex to Company Articles	53	61 **	51	53	39	58 **	35	59 **	47	53	52	60 **	51	43	48 **	55
Inclusion in Directors' Report	44	46	40	47	41	45	41	46	43	43	45	45	46	42	44	43
Signed Return by Director on Appointment	88	89	87	87	87	89	85	88	88	87	88	87	89	88	90	86
Signed Return by Director with Annual Return	41	46 **	42	35	37	43 **	33	47 **	35	43	39	47 **	36	36	37	41
Appear in all Statutory Returns	27	35 **	25	21	21	30 **	19	35 **	21	30 *	24	32 **	24	22	25	29

\*significant at 10% level \*\*significant at 5% level

**Table 18 Listing of Duties in a Companies Act (Mean Scores)**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
Duty of loyalty	3.9	4 **	4	3.7	3.7	4 **	3.5	4 **	3.7	3.9	3.8	4.0 **	3.9	3.6	3.8 *	4
Duty of obedience	3.6	3.7 *	3.6	3.5	3.5	3.6 **	3.4	3.6	3.5	3.6	3.6	3.7 **	3.6	3.4	3.5	3.6
No secret profits	4	4.1	3.9	4	4	4.1	3.9	4	4	4	4	4	4	3.9	4.1 *	4
Independence	3.7	3.7	3.7	3.6	3.7	3.7	3.5	3.7	3.6	3.7	3.6	3.7	4	3.5	3.6	3.6
Conflict of interest	4.1	4.1	4	4.1	4	4.1 *	3.9	4.1	4	4	4.1	4.1 **	4.2	3.9	4	4.1
Care, skill and diligence	4	4.1 *	4	3.9	3.9	4.1 **	3.7	4.1 **	3.9	4	4	4.1 **	4.1	3.7	4	4
Interests of employees etc	3.8	4 **	3.9	3.7	3.5	3.9 **	3.5	3.9 **	3.7	3.8	3.8	3.9 **	3.8	3.5	3.7	3.9
Fairness	3.8	3.9 **	3.7	3.7	3.6	3.8 **	3.5	3.9 **	3.7	3.8	3.7	3.9 **	3.8	3.5	3.7	3.8

\*\*significant at 5% level

**Table 19 Listing Duties in a Companies Act (% Scoring the Listing of a Duty as of great or very great importance)**

	All	Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
		<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%
Duty of loyalty	74 *	72	64	66	73 **	57	75 **	66	69	70	73 **	72	61	67	72	
Duty of obedience	58	58	52	54	57 *	50	56	56	55	56	58	58	50	55	58	
No secret profits	78	70	71	75	75	72	74	75	74	75	75	77	70	75	71	
Independence	60	61	56	60	60	56	61	58	59	59	60	61	55	58	57	
Conflict of interest	79	76	75	76	78	74	78	76	76	78	78	80	72	76	76	
Care, skill and diligence	79	75	72	71	78 *	65	78 *	73	75	75	79 **	79	63	74	75	
Interests of employees etc	73 **	66	64	56	68 **	57	70 **	63	66	65	69 *	67	60	62 *	68	
Fairness	71 **	62	59	60	66 *	58	68 **	61	65	63	68 **	65	57	62	63	

\*\*significant at 5% level

\*significant at 10% level

**Table 20 Include Law Commissions' Statement Relating to Directors' Duties in Companies Act**

	All		Turnover Size Group (£m)				Type of Company		Number of Directors		Number of Board Meetings		Proportion of Non-Executives			Board Shareholding	
	<5	5<20	20<200	≥200	unlisted co	listed co	<5 dir	≥5 dir	≤9/year	>9/year	no non-execs	non-execs <50%	non-execs ≥50%	≤50%	>50%		
% yes	61	63	64	62	55	64 **	51	64 *	58	59	63	64 **	64	52	55 **	66	
Total Respondents	836	306	148	196	184	656	175	390	440	414	406	351	263	209	332	342	
Missing Values	20	3	4	4	9	13	7	8	12	7	11	9	5	6	11	5	
Total	856	309	152	200	193	669	182	398	452	421	417	360	268	215	343	347	

\*\*significant at 5% level

\*significant at 10% level

## **9. Summary and conclusions**

### **Diversity of corporate governance practice**

The key finding of the empirical research relates to the diversity of corporate governance mechanisms which operate in practice. The scale and complexity of internal procedures are related to the nature of agency and monitoring costs within different types of companies. The research confirms the suggestion of economic theory to the effect that complex procedures – involving an expanded role for non-executive directors, intra-board monitoring, and the use of internal codes of practice – are most likely in larger companies with dispersed ownership. Whether a company is listed or not is also a good indicator of the type of procedures it adopts. This illustrates the influence of the listing rules, although agency cost considerations also appear to be highly relevant in the case of listed companies.

Given this degree of diversity, the general approach of the law should be one of encouraging corporate actors to adopt the types of measures which best suit them in practice. As suggested in the Consultation Paper, the law can do this by encouraging disclosure in various ways. A general principle of disclosure to shareholders of matters relating to conflicts of interests and the use of corporate opportunities should inform reform of Part X. This general principle should be qualified by the need to retain the confidentiality of information in certain instances. Where, however, confidentiality is an issue, there is a good case for retaining and if necessary strengthening rules relating to disclosure to the board (as in the case of section 317).

### **The balance between disclosure and approval**

The findings of the empirical research on the diversity of existing practices also have important repercussions for the extent of disclosure to shareholders which the law should require. We saw that in larger, open and listed companies, disclosure to shareholders is often seen as costly. In open companies, monitoring increasingly takes place within the board, where the role of non-executive directors is growing in importance. The growing role of non-executive directors in such companies need not imply, though, that shareholder disclosure is of no value. The accountability of non-executive directors is a matter requiring further research. Their position with regard to the executive directors can be strengthened by rules which require information to be made available beyond the board.

In smaller, closed companies, direct shareholder monitoring and control through directors' service contracts, shareholders' agreements and the articles of association are more common than in open companies. Here, non-executives play a less significant role. The empirical research shows that bargaining over the use of corporate opportunities does take place in closed companies where shareholder approval can be sought if necessary, although this is much less likely in listed and 'open' companies. In such cases, there is a strong case for rules maintaining a high level of disclosure of conflicts of interest to the shareholders so that such bargaining can take place.

For the above reasons, statutory rules requiring shareholder *approval* should be seen as the exception in this area. The empirical evidence shows that the scope for

bargaining around such rules is particularly limited for larger, 'open' companies, which tend to see the cost of obtaining shareholder approval as excessive. Hence such rules end up operating as de facto mandatory rules. While such rules will not necessarily be inefficient, they may have adverse effects in terms of efficiency if they lock the parties into transactions which they would not otherwise have chosen or if they give rise to costly attempts to evade the effect of the prohibition in question.

In general, then, both the economic analysis contained in Part 3 of the Consultation Paper and the empirical research suggest that rules which require shareholder approval should be confined to cases of exceptional risk to shareholders, such as those relating to certain substantial property transactions. Likewise, complete prohibitions (which cannot even be overcome by shareholder approval) should be confined to situations where third parties (that is, creditors) are clearly at risk.

However, the case for a systematic and effective disclosure regime is a strong one with regard both to open companies and to closed companies. In open companies, disclosure to shareholders performs important functions notwithstanding the existence of processes of intra-board monitoring. The growing role played by non-executive directors does not obviate the need for shareholders to be informed about issues relating to the loyalty and performance of directors as a whole. The nature of the relationship between non-executive directors and shareholders is currently changing, as a consequence of corporate governance reforms and all aspects of this process of change are not, as yet, clearly understood. Nevertheless, it is plausible to suggest that for non-executives to operate effectively it is important that the shareholders should have the necessary information to perform their role as the body to which the board as a whole is ultimately responsible.

In the case of closed companies, shareholder monitoring and control through the articles of association and shareholders' agreements is common. For these processes of direct monitoring to function effectively, the provision of reliable information from the directors to the shareholders is essential. Here, the law would appear to have a significant part to play in ensuring that meaningful disclosure takes place.

### **Criminal and civil sanctions**

The use of criminal sanctions as part of the enforcement of the obligations imposed on directors by Part X may in principle play an important role for reasons discussed initially in the Consultation Paper. Given the difficulties of observing a breach of the duty of loyalty by directors and the costs to shareholders of mounting litigation, an element of public enforcement is appropriate. This view was reinforced by the empirical research which found evidence to the effect that legal advisers regard the existence of criminal sanctions as an important means of ensuring that clients comply with their obligations in this area of the law.

Restitutory remedies can be seen as heightening the incentives for shareholders to bring civil claims and hence may reduce the need for criminal penalties. However, the procedural difficulties facing shareholders (in particular minority shareholders) are still considerable and are likely to remain so notwithstanding the reforms envisaged by the Law Commission's Report on *Shareholder Remedies* (No. 246). This reinforces further the case for retaining criminal sanctions.

## **Reform of the law relating to directors' service contracts**

The case for reform of the law relating to directors' service contracts is strong. The law here can go in two directions. One is to remove the current controls on the length of directors' service contracts, because they are not working as intended. As already explained, larger companies tend to regard obtaining shareholder approval for longer-term contracts as excessively costly. They therefore have an incentive to bargain around the law by, for example, increasing direct remuneration. Where this happens, shareholders are no better off as a consequence, and the law is failing in its ostensible purpose. An alternative route is to amend section 319 and put strict limits on rolling contracts, possibly in conjunction with a shortening of the permitted duration from five years to three. This could address the issue of ensuring that directors remain properly accountable to shareholders. For example, the threat of removal at the general meeting might not then be chilled by fear of a high pay out as it currently may be, given that, under present practice, directors will very often receive compensation based on long-term, rolling contracts. Even this reform would not completely remove the possibility of contracting around the law in the sense just referred to. If, moreover, this step is taken, care must be taken with smaller companies, in which contracts for more than three years are still common. In listed companies, it appears that contract duration has already been reduced for many directors, by way of compliance with the Combined Code on Corporate Governance.

## **The duty of care**

With regard to the duty of care setting a dual objective/subjective standard of care for directors would be in line with developments taking place already in listed companies, which are moving towards more systematic internal audit procedures. It would, however, have a bigger impact on smaller companies, among which there is still some support for the more traditional *re City Equitable* principle. Reform in this area must address the issue of avoiding a situation of excessive risk for directors who act in good faith in relation to business decisions.

## **The statement of directors' duties**

The empirical research revealed widespread support for the use of a statement of directors' duties. This was particularly the case among directors of smaller companies (who make up the vast majority of the total population of company directors). For such directors, who often have no regular access to legal advice, a statement of directors' duties would be an important source of information and clarification of the law.



## **Appendix 1**

### **The Sample and the Survey**

#### **1. The Pilot Survey and Selected Responses by Type of Director**

The survey process began with an extensive pilot survey in December 1998. A size stratified sample of approximately 1000 directors was drawn from the Dunn and Bradstreet business database. There were invited to take part in the pilot survey and 158 agreed and completed the pilot questionnaire. The questionnaire was extended and clarified in the light of the responses received.

#### **2. The Survey**

The final version of the questionnaire was mailed in February 1999 to a sample of 5,500 members of the Institute of Directors with a target achieved sample of 1,000 responses. The sample was drawn from the directors' database of the Institute of Directors (IoD). They generously provided a size stratified sample of directors drawn from 5 turnover size bands. (Turnover less than £1 million, £1 million and over but less than £5 million, £5 million and over but less than £20 million, £20 million and over but less than £200 million, and over £200 million.) The sample was stratified to draw higher proportions from the larger turnover size groups. Equal sampling would have led to insufficient numbers in the larger size classes for statistical analysis within the overall target achieved sample of 1,000. Table A1 shows that the overall response rate achieved was 23.5%. This represented 1,259 completed returns from a total of 5,353 eligible respondents (of the total of 5,550 directors in the original sample, 197 in total were excluded: 165 because they were partners or sole proprietors; 12 because they were no longer directors; 2 because they were directors of companies no longer trading, 10 because they had retired and 8 because they were not contactable at the given address.) The good response rate is a reflection of the interest shown in the subject by directors and by the use of a follow up letter and questionnaire to prompt non-respondents. This was sent out two weeks after the first mailing of the questionnaire. Table A2 provides a breakdown of response rate by IoD turnover size band, and geographical area of the address of the director. The table reveals that the IoD sample is dominated by directors of English companies. It also shows that the directors of the largest English companies were somewhat less likely to respond than the directors of smaller English companies.

The tendency of directors of smaller companies to be more likely to respond is also true for Scotland and Northern Ireland although the numbers involved are small compared to the English sample.

It should be noted that the sample is size stratified so that no simple inferences can be made about the population of company directors as a whole without approximately weighting and grossing up the responses. The results are however randomly drawn *within* the turnover size categories so that comparisons between them can be drawn.

### **3. Analysis of Selected Responses by Type of Director**

In addition to the analysis of our sample data by category of company we were also able to carry out an analysis by type of director responding to our questionnaire. This allowed a distinction to be made between executives and non-executives. We analysed the answers to our questions relating to the Standard of Duty of Care and the Uses and Contents of a Statement of Directors' Duties in this way. Very few statistically significant differences emerged. Those that are, are reported in the main body of the report. The full results are shown here for completeness as Tables A3-A9.

**Table A1 The Survey Response Rate**

Total Sample	5550
Excluded for being ineligible:	
Partnerships or sole traders	165
Left Company	12
Company no longer trading	2
Retired	10
Address unrecognised	8
Total ineligible	197
Final Sample (5550-197)	5353
Usable questionnaires returned	1259
Response rate	23.5%

**Table A2 Response Rates in the Total Sample by Area and Turnover Size Band**

Turnover Size Class	England			Scotland			Northern Ireland		
	Nos in IoD Sample	Nos Responding	% Response	Nos in IoD Sample	Nos Responding	% Response	Nos in IoD Sample	Nos Responding	% Response
To £5m	1233	336	27.3	47	19	40.4	19	7	36.8
£5m< to £20m	855	237	27.7	33	6	18.2	18	4	22.2
£20m< to £200m	1362	318	23.3	72	25	34.7	20	6	30.0
To > £20m	1612	289	17.9	67	8	11.9	10	0	0.0

There were 4 respondents with unknown turnover which are excluded from the table. There were 5 directors of foreign firms in the IoD sample, none of whom responded. These are also excluded from the table.

### A3 Duty of Care Preference between Options Proposed by Law Commission

<b>% Preferring</b>	<b>Executives</b>	<b>Non-executives</b>
Option A	32	31
Option B	18	26
Option C	49	42
None	2	1
All respondents	645	106

### A4 Law Reform: Contents of the Statement of Directors' Duties

	<b>Executives</b>	<b>Non-executives</b>
% Too detailed	4	8
% Not detailed enough	13	12
% About right	83	80
Total	673	115

### A5 Assistance to Directors of the Law Commissions' Statement Relating to Directors Duties: Mean Scores and Percentages Scoring the Statement as of great or Very Great Assistance

	<b>Executives</b>	<b>Non-executives</b>
Mean score	3.1	3.1
% Scoring 4 or 5	24	26
All respondents	675	116
Missing Values	8	0
Total	683	116

### A6 Lists of Duties in a Companies Act (Mean Scores)

	<b>Executives</b>	<b>Non-executives</b>
Duty of loyalty	3.9	3.7
Duty of obedience	3.6	3.5
No secret profits	4.1	4.0
Independence	3.7	3.7
Conflict of interest	4.1	4.0
Care, skill and diligence **	4.1	3.8
Interests of employees etc	3.9	3.7
Fairness	3.8	3.6

\*\* Difference significant at 5% level

**A7 Listing Duties in a Companies Act (% scoring the Listing of a Duty as a great or very great importance)**

	<b>Executives</b>	<b>Non-executives</b>
Duty of loyalty	71	68
Duty of obedience	56	54
No secret profits	75	75
Independence	60	63
Conflict of interest	78	76
Care, skill and diligence **	77	67
Interests of employees etc	67	66
Fairness	65	60

\*\* Difference significant at 5% level

**A8 Include Law Commissions' Statement Relating to Directors' Duties in Companies Act**

	<b>Executives</b>	<b>Non-executives</b>
% yes	62	58
Total respondents	669	114
Missing values	14	2
Total	683	116

**A9 Options for Use of Statement Related to Duties**

<b>% yes to</b>	<b>Executives</b>	<b>Non-executives</b>
Compulsory annex to company articles**	56	40
Inclusion in Directors' report	45	46
Signed return by Director or appointment	88	90
Signed return by Director with annual return	42	35
Appear in all statutory returns	28	24

\*\* Difference significant at 5% level

## Appendix 2: Question Concordance and Questionnaire

Table/Chart	Question
Chart 1	1
Chart 2	2
Chart 3	4
Chart 4	IoD Sampling frame data*
Table 1	5, 6, 7, 10
2	11, 12, 13
3	8, 9
4	14, 15, 16, 17
5	14
6	18,19
7	20, 21
8	22
9	23, 24, 25
10	26
11	27
12	28
13	29, 30
14	31
15	32
16	33
17	34
18	35
19	35
20	36

\* Note : Question 3 asked for data on employment size of the company. This was not used in the analysis of the data where we chose to group the companies into the turnover size bands used in the Institute of Directors' sampling frame.

## **The Law Relating to Directors' Duties**

This questionnaire is designed for a wide variety of firms. Please answer as many questions as you can.

All information will be kept confidential and anonymous, and will be used only for academic research.

**University of Cambridge**

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**SECTION A****GENERAL INFORMATION ABOUT YOU AND YOUR COMPANY**

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In this section we would like you to tell us something about the structure of your company and the board of directors. This will be helpful in interpreting the answers to questions on directors' duties asked later in the questionnaire.

1. Is your company one of the following? (Please tick one box)

A private company .....	<input type="checkbox"/>
A public limited company with a listing on the London Stock Exchange.....	<input type="checkbox"/>
A public limited company without a listing on the London Stock Exchange.....	<input type="checkbox"/>

2. Is your company one of the following? (Please tick one box)

An independent company with no subsidiaries or associated companies .....	<input type="checkbox"/>
A parent company.....	<input type="checkbox"/>
An associated company .....	<input type="checkbox"/>
A subsidiary company .....	<input type="checkbox"/>

3. How many individuals does your company employ (excluding directors)? .....

4. What is your own position in the company? (In each row, please circle yes or no in the box provided)

The managing director / chief executive officer .....	<input type="checkbox"/>	<input type="checkbox"/>
Other executive director .....	<input type="checkbox"/>	<input type="checkbox"/>
Chairman .....	<input type="checkbox"/>	<input type="checkbox"/>
Non-executive director .....	<input type="checkbox"/>	<input type="checkbox"/>
Company secretary.....	<input type="checkbox"/>	<input type="checkbox"/>

5. How many executive directors in total are there on your board? .....

6. How many non-executive directors are there on your board? .....

**If none, please go to question 9.**

7. How many hours a month, on average, does your company expect a non-executive director to devote to its business? .....



8. Does your company permit its non-executive directors to hold directorships in other companies (apart from those in the same group)? (Please tick one box)

All directors are permitted to .....

Some directors are permitted to .....

No directors are permitted to .....


9. Does your company permit its executive directors to hold directorships in other companies (apart from those in the same group)? (Please tick one box)

All directors are permitted to .....

Some directors are permitted to .....

No directors are permitted to .....


10. How many times does the board of your company normally meet each year? .....

--

11. Approximately what percentage of the share capital of your company is owned by:

The managing director / chief executive officer .....

The whole board of directors .....

The largest single shareholder .....

	%
	%
	%

12. What type of shareholder is the largest single shareholder? (Please tick one box)

The managing director / chief executive officer .....

Another director .....

A non-board individual .....

A non-financial business .....

A financial business .....

Other (please specify) .....

.....


13. How many shareholders' meetings does your company normally hold each year? .....

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**SECTION B    DIRECTORS' FIDUCIARY DUTIES**

Under the present law, directors owe a number of *fiduciary duties* to their companies. These fiduciary duties have the effect that a director must act in good faith in what he or she considers to be the interests of the company; a director must not use the company's property, information or opportunities for their own or another's benefit, unless they are allowed to by the company's constitution or the use has been disclosed to and approved by the company in general meeting; and a director must in general avoid a conflict between his or her own personal interest in or duty under a particular transaction and the interest of the company, unless they are allowed to have that personal interest or duty under the company's constitution, or the interest or duty has been disclosed to, and approved by, the company in general meeting.

In this section we would like you to tell us about your experiences in relation to directors' fiduciary duties, and about any potential or actual conflicts of interest which may arise between them and a director's personal interests.

14. Does your company have procedures for dealing with a potential conflict between a director's interests and his or her duty to the company? (Please circle appropriate answer)

Yes	No	Don't know
-----	----	------------

If yes, please give brief details.

.....

.....

.....

15. To your knowledge on how many occasions, if any, in the past three years has your company been involved in litigation concerning the performance by directors of their directors' duties? (If none, enter 'Nil' in the box) .....

If relevant, please give brief details.

.....

.....

.....

16. To your knowledge, on how many occasions if any, in the past three years has a director of your company given up an investment opportunity of personal benefit on the grounds of a potential conflict between his or her personal interests and their fiduciary duty to the company? (If none, enter 'Nil' in the box) .....

17. The present law requires directors to disclose to the board the details of transactions involving the company in which they have a personal interest. To your knowledge, how many such disclosures, if any, have been made to your board in the past three years? (If none, enter 'Nil' in the box) .....

18. Company law permits a director to benefit from the use of company property, information or opportunities if there is prior disclosure to and approval by the company in general meeting.  
 To your knowledge, how many such disclosures, if any, have taken place in the past three years? (If none, enter 'Nil' in the box) .....

--

19. To your knowledge, on how many occasions has your company in the past three years entered into a contract with a present or former director to allow him or her to take a personal benefit from the use of company property, information or opportunities?  
 (If none, enter 'Nil' in the box) .....

--

If relevant, please give brief details.

.....

.....

.....

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**SECTION C DIRECTORS' SERVICE CONTRACTS**

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20. Do the executive directors in your company have service contracts? (Please circle one box) .....

All	Some	None	Don't know
-----	------	------	------------

**If no executive directors have service contracts please go to question 28**

21. Are these service contracts in writing?  
 (Please circle one box) .....

Always	Sometimes	Never	Don't know
--------	-----------	-------	------------

22. What is the normal length of an executive director's service contract in your company? .....

yrs	Don't know
-----	------------

23. Is it the practice in your company for an executive director's service contract to be terminable on notice?  
 (Please circle one box) .....

Always	Sometimes	Never	Don't know
--------	-----------	-------	------------

24. Is it the practice in your company for an executive director to be employed on a 'rolling' service contract?  
 (Please circle one box) .....

Always	Sometimes	Never	Don't know
--------	-----------	-------	------------

25. What is the normal length of notice required to terminate the contract of service of an executive director employed by your company? .....

mths	Don't know
------	------------

26. Is it the practice in your company for the terms of an executive director's service contract to be disclosed to:  
(Please circle one box in each row)

The board as a whole (including non-executives)	Always	Sometimes	Never	Don't know
The executive directors .....	Always	Sometimes	Never	Don't know
The non-executive directors .....	Always	Sometimes	Never	Don't know
A remuneration committee of the board .....	Always	Sometimes	Never	Don't know
The shareholders in general meeting.....	Always	Sometimes	Never	Don't know
The shareholders by inspection of a register .....	Always	Sometimes	Never	Don't know
Another person or body (please specify) .....	Always	Sometimes	Never	Don't know
.....				

27. Is it the practice in your company for the terms of an executive director's service contract to be approved by:  
(Please circle one box in each row)

The board as a whole (including non-executives)	Always	Sometimes	Never	Don't know
The executive directors .....	Always	Sometimes	Never	Don't know
The non-executive directors .....	Always	Sometimes	Never	Don't know
A remuneration committee of the board .....	Always	Sometimes	Never	Don't know
The shareholders in general meeting.....	Always	Sometimes	Never	Don't know
Another person or body (please specify).....	Always	Sometimes	Never	Don't know
.....				

28. Is it the practice in your company for the approval of shareholders to be sought for the following payments to executive directors? (Please circle one box in each row)

Payments for compensation for loss of office .....	Always	Sometimes	Never	Don't know
Payments for compensation for reduction in the director's term of office or notice period .....	Always	Sometimes	Never	Don't know
Increased pension payments.....	Always	Sometimes	Never	Don't know

29. What would you estimate the cost to your company to be of holding the following number of board meetings per year in addition to your normal number of meetings?

Cost of one additional meeting .....	£
Cost of three additional meetings .....	£

30. What would you estimate the extra cost to your company to be of holding one additional meeting of shareholders each year?.....

£
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**SECTION D      DUTY OF CARE**

In this section we would like to learn about your views on the Law Commissions' proposals for reforming the duty of care

Directors owe a duty of care to the company, and so may be personally liable for the consequences of negligence in the performance of their duties. The Law Commissions have proposed a number of options for reforming the duty of care, as explained below.

Under Option A, a director would owe the company a duty to exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having the knowledge and experience which that director had.

Under Option B, a director would owe the company a duty to exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having the knowledge and experience that might reasonably be expected of a person in the same position as the director, regardless of the degree of knowledge and experience which that director had.

Under Option C, a director would owe the company a duty to exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having both the knowledge and experience that might reasonably be expected of a person in the same position as the director, and the knowledge and experience which that director had.

31. Of these three options, which in your view as a director best represents the standard of care which should be applied. (Please enter either A, B or C in the box. If you believe that none of these options is appropriate, please enter NONE in the box.).....

**SECTION E      LAW REFORM**

In this section we would like to learn your views about the proposed statement relating to Directors' Duties proposed by the Law Commissions.

In the Law Commissions' Consultation Paper, there is a draft Statement Relating to Directors' Duties, a copy of which is reproduced on the inside back cover of this questionnaire. The draft is very much subject to consultees' comments. The Statement summarises the main duties of a director to his or her company. It is not a complete statement of directors' duties and it does not rule out future changes in the law.

32. In terms of its content, do you consider that the Law Commissions' Statement is: (Please circle appropriate answer)

Too detailed	Not detailed enough	About right
--------------	---------------------	-------------

33. Do you consider that the Law Commissions' Statement Relating to Directors' Duties would assist directors in practice? Please answer by circling appropriate number on this scale of 1-5 where 1= of no assistance, 5=of very great assistance.

of no assistance	of very little assistance	of some assistance	of great assistance	of very great assistance
1	2	3	4	5

34. The Law Commissions have outlined a number of options for the use of the Statement Relating to Directors' Duties. Please consider whether the following would assist directors in practice (in each case circle yes or no in the box provided):

The Statement should be compulsorily annexed to the company's articles.....	Yes	No
The Statement should be included in the Directors' Report attached to the Company's annual accounts .....	Yes	No
A director should be required to sign that he or she has read the Statement when signing a return confirming that they have been appointed as a director.....	Yes	No
A director should be required to sign that he or she has read the Statement when the company submits its annual return .....	Yes	No
The Statement should appear in all statutory returns made by the company .....	Yes	No

35. Another option for reform is for some but not all of the duties listed in the Law Commissions' Statement Relating to Directors' Duties to be set out in a Companies Act. Please indicate how important it is to you as a director that *each* of these duties should be set out in a Companies Act by circling the appropriate number in each row below, where 1 = of no importance and 5 = of very great importance. The paragraph numbers below correspond to the Law Commissions' Statement Relating to Directors' Duties, which is reproduced on the inside back cover of this questionnaire.

	of no importance	of very little importance	of some importance	of great importance	of very great importance
Para. 3: Duty of loyalty .....	1	2	3	4	5
Para. 4: Duty of obedience.....	1	2	3	4	5
Para. 5: No secret profits .....	1	2	3	4	5
Para. 6: Independence .....	1	2	3	4	5
Para. 7: Conflict of interest .....	1	2	3	4	5
Para. 8: Care, skill and diligence .....	1	2	3	4	5
Para. 9: Interests of employees etc.....	1	2	3	4	5
Para. 10: Fairness .....	1	2	3	4	5

36. Would it be helpful to you as a director if the Law Commissions' Statement Relating to Directors' Duties were set out in a Companies Act even though the Statement is not a complete statement of directors' duties and does not rule out future changes in the law? (Please circle yes or no in the box provided.).....

Yes	No
-----	----

THANK YOU FOR YOUR HELP

## **LAW COMMISSIONS' DRAFT STATEMENT RELATING TO DIRECTORS' DUTIES TO THEIR COMPANIES**

### **General**

- (1) The law imposes duties on directors. If a person does not comply with his duties as a director he may be liable to civil or criminal proceedings and he may be disqualified from acting as a director.
- (2) Set out below there is a summary of the main duties of a director to his company. It is not a complete statement of a director's duties, and the law may change anyway. If a person is not clear about his duties as a director in any situation he should seek advice.

### **Loyalty**

- (3) A director must act in good faith in what he considers to be the interests of the company.

### **Obedience**

- (4) A director must act in accordance with the company's constitution (such as the articles of association) and must exercise his powers only for the purposes allowed by law.

### **No secret profits**

- (5) A director must not use the company's property, information or opportunities for his own or anyone else's benefit unless he is allowed to by the company's constitution or the use has been disclosed to the company in general meeting and the company has consented to it.

### **Independence**

- (6) A director must not agree to restrict his power to exercise an independent judgement. But if he considers in good faith that it is in the interests of the company for a transaction to be entered into and carried into effect, he may restrict his power to exercise an independent judgement by agreeing to act in a particular way to achieve this.

### **Conflict of interest**

- (7) If there is a conflict between an interest or duty of a director and an interest of the company in any transaction, he must account to the company for any benefit he receives from the transaction. This applies whether or not the company sets aside the transaction. But he does not have to account for the benefit if he is allowed to have the interest or duty by the company's constitution or the interest or duty has been disclosed to and approved by the company in general meeting.

### **Care, skill and diligence**

- (8) A director owes the company a duty to exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having both
  - (a) the knowledge and experience that may reasonably be expected of a person in the same position as the director, and
  - (b) the knowledge and experience which the director has.

### **Interests of employees etc**

- (9) A director must have regard to the interests of the company's employees in general and its members.

### **Fairness**

- (10) A director must act fairly as between different members.

### **Effect of this statement**

- (11) The law stating the duties of directors is not affected by this statement or by the fact that, by signing this document, a director acknowledges that he has read the statement.

Source: *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties. A Joint Consultation Paper.* Law Commission Consultation Paper No.153, Scottish Law Commission Discussion Paper No. 105, September 1998 pp344-345.

# **APPENDIX C**

## **PART X, SCHEDULE 6, PARTS II AND III, SCHEDULE 9, PART IV AND SCHEDULE 13**

### **COMPANIES ACT 1985, PART X**

#### **ENFORCEMENT OF FAIR DEALING BY DIRECTORS**

##### ***Restrictions on directors taking financial advantage***

#### **SECTION 311: PROHIBITION ON TAX-FREE PAYMENTS TO DIRECTORS**

311.— (1) It is not lawful for a company to pay a director remuneration (whether as director or otherwise) free of income tax, or otherwise calculated by reference to or varying with the amount of his income tax, or to or with any rate of income tax.

(2) Any provision contained in a company's articles, or in any contract, or in any resolution of a company or a company's directors, for payment to a director of remuneration as above mentioned has effect as if it provided for payment, as a gross sum subject to income tax, of the net sum for which it actually provides.

#### **SECTION 312: PAYMENT TO DIRECTOR FOR LOSS OF OFFICE, ETC**

312.— It is not lawful for a company to make to a director of the company any payment by way of compensation for loss of office, or as consideration for or in connection with his retirement from office, without particulars of the proposed payment (including its amount) being disclosed to members of the company and the proposal being approved by the company.

#### **SECTION 313: COMPANY APPROVAL FOR PROPERTY TRANSFER**

313.— (1) It is not lawful, in connection with the transfer of the whole or any part of the undertaking or property of a company, for any payment to be made to a director of the company by way of compensation for loss of office, or as consideration for or in connection with his retirement from office, unless particulars of the proposed payment (including its amount) have been disclosed to members of the company and the proposal approved by the company.

(2) Where a payment unlawful under this section is made to a director, the amount received is deemed to be received by him in trust for the company.

#### **SECTION 314: DIRECTOR'S DUTY OF DISCLOSURE ON TAKEOVER, ETC**

314.—(1) This section applies where, in connection with the transfer to any persons of all or any of the shares in a company, being a transfer resulting from—

- (a) an offer made to the general body of shareholders; or
- (b) an offer made by or on behalf of some other body corporate with a view to the company becoming its subsidiary or a subsidiary of its holding company; or
- (c) an offer made by or on behalf of an individual with a view to his obtaining the right to exercise or control the exercise of not less than one-third of the voting power at any general meeting of the company; or
- (d) any other offer which is conditional on acceptance to a given extent,



a payment is to be made to a director of the company by way of compensation for loss of office, or as consideration for or in connection with his retirement from office.

(2) It is in those circumstances the director's duty to take all reasonable steps to secure that particulars of the proposed payment (including its amount) are included in or sent with any notice of the offer made for their shares which is given to any shareholders.

(3) If—

- (a) the director fails to take those steps, or
- (b) any person who has been properly required by the director to include those particulars in or send them with the notice required by subsection (2) fails to do so,

he is liable to a fine.

### **SECTION 315: CONSEQUENCES OF NON-COMPLIANCE WITH SECTION 314**

315.—(1) If in the case of any such payment to a director as is mentioned in section 314 (1) —

- (a) his duty under that section is not complied with, or
- (b) the making of the proposed payment is not, before the transfer of any shares in pursuance of the offer, approved by a meeting (summoned for the purpose) of the holders of the shares to which the offer relates and of other holders of shares of the same class as any of those shares,

any sum received by the director on account of the payment is deemed to have been received by him in trust for persons who have sold their shares as a result of the offer made; and the expenses incurred by him in distributing that sum amongst those persons shall be borne by him and not retained out of that sum.

(2) Where—

- (a) the shareholders referred to in subsection (1)(b) are not all the members of the company, and
- (b) no provision is made by the articles for summoning or regulating the meeting referred to in that paragraph,

the provisions of this Act and of the company's articles relating to general meetings of the company apply (for that purpose) to the meeting either without modification or with such modifications as the Secretary of State on the application of any person concerned may direct for the purpose of adapting them to the circumstances of the meeting.

(3) If at a meeting summoned for the purpose of approving any payment as required by subsection (1)(b) a quorum is not present and, after the meeting has been adjourned to a later date, a quorum is again not present, the payment is deemed for the purposes of that subsection to have been approved.

### **SECTION 316: PROVISIONS SUPPLEMENTING SECTIONS 312-315**

316.—(1) Where in proceedings for the recovery of any payment as having, by virtue of section 313 (2) or 315 (1) been received by any person in trust, it is shown that—

- (a) the payment was made in pursuance of any arrangement entered into as part of the agreement for the transfer in question, or within one year before or two years after that agreement or the offer leading to it; and
- (b) the company or any person to whom the transfer was made was privy to that arrangement,

the payment is deemed, except in so far as the contrary is shown, to be one to which the provisions mentioned above in this subsection apply.

(2) If in connection with any such transfer as is mentioned in any of sections 313 to 315—

- (a) the price to be paid to a director of the company whose office is to be abolished or who is to retire from office for any shares in the company held by him is in excess of the price which could at the time have been obtained by other holders of the like shares; or
- (b) any valuable consideration is given to any such director,

the excess or the money value of the consideration (as the case may be) is deemed for the purposes of that section to have been a payment made to him by way of compensation for loss of office or as consideration for or in connection with his retirement from office.

(3) References in sections 312 to 315 to payments made to a director by way of compensation for loss of office or as consideration for or in connection with his retirement from office, do not include any bona fide payment by way of damages for breach of contract or by way of pension in respect of past services.

“Pension” here includes any superannuation allowance, superannuation gratuity or similar payment.

(4) Nothing in sections 313 to 315 prejudices the operation of any rule of law requiring disclosure to be made with respect to such payments as are there mentioned, or with respect to any other like payments made or to be made to a company's directors.

#### **SECTION 317: DIRECTORS TO DISCLOSE INTEREST IN CONTRACTS**

317.—(1) It is the duty of a director of a company who is in any way, whether directly or indirectly, interested in a contract or proposed contract with the company to declare the nature of his interest at a meeting of the directors of the company.

(2) In the case of a proposed contract, the declaration shall be made—

- (a) at the meeting of the directors at which the question of entering into the contract is first taken into consideration; or
- (b) if the director was not at the date of that meeting interested in the proposed contract, at the next meeting of the directors held after he became so interested;

and, in a case where the director becomes interested in a contract after it is made, the declaration shall be made at the first meeting of the directors held after he becomes so interested.

(3) For purposes of this section, a general notice given to the directors of a company by a director to the effect that—

- (a) he is a member of a specified company or firm and is to be regarded as interested in any contract which may, after the date of the notice, be made with that company or firm; or
- (b) he is to be regarded as interested in any contract which may after the date of the notice be made with a specified person who is connected with him (within the meaning of section 346 below),

is deemed a sufficient declaration of interest in relation to any such contract.

(4) However, no such notice is of effect unless either it is given at a meeting of the directors or the director takes reasonable steps to secure that it is brought up and read at the next meeting of the directors after it is given.

(5) A reference in this section to a contract includes any transaction or arrangement (whether or not constituting a contract) made or entered into on or after 22nd December 1980.

(6) For purposes of this section, a transaction or arrangement of a kind described in section 330 (prohibition of loans, quasi-loans etc to directors) made by a company for a director of the company or a person connected with such a director is treated (if it would not otherwise be so treated, and whether or not it is prohibited by that section) as a transaction or arrangement in which that director is interested.

(7) A director who fails to comply with this section is liable to a fine.

(8) This section applies to a shadow director as it applies to a director, except that a shadow director shall declare his interest, not at a meeting of the directors, but by a notice in writing to the directors which is either—

- (a) a specific notice given before the date of the meeting at which, if he had been a director, the declaration would be required by subsection (2) to be made; or
- (b) a notice which under subsection (3) falls to be treated as a sufficient declaration of that interest (or would fall to be so treated apart from subsection (4)).

(9) Nothing in this section prejudices the operation of any rule of law restricting directors of a company from having an interest in contracts with the company.

### **SECTION 318: DIRECTORS' SERVICE CONTRACTS TO BE OPEN TO INSPECTION**

318. —(1) Subject to the following provisions, every company shall keep at an appropriate place—

- (a) in the case of each director whose contract of service with the company is in writing, a copy of that contract;
- (b) in the case of each director whose contract of service with the company is not in writing, a written memorandum setting out its terms; and
- (c) in the case of each director who is employed under a contract of service with a subsidiary of the company, a copy of that contract or, if it is not in writing, a written memorandum setting out its terms.

(2) All copies and memoranda kept by a company in pursuance of subsection (1) shall be kept at the same place.

(3) The following are appropriate places for the purposes of subsection (1)—

- (a) the company's registered office;
- (b) the place where its register of members is kept (if other than its registered office);
- (c) its principal place of business, provided that is situated in that part of Great Britain in which the company is registered.

(4) Every company shall send notice in the prescribed form to the registrar of companies of the place where copies and memoranda are kept in compliance with subsection (1), and of any change in that place, save in a case in which they have at all times been kept at the company's registered office.

(5) Subsection (1) does not apply to a director's contract of service with the company or with a subsidiary of it if that contract required him to work wholly or mainly outside the United Kingdom; but the company shall keep a memorandum—

- (a) in the case of a contract of service with the company, giving the director's name and setting out the provisions of the contract relating to its duration;
- (b) in the case of a contract of service with a subsidiary, giving the director's name and the name and place of incorporation of the subsidiary, and setting out the provisions of the contract relating to its duration,

at the same place as copies and memoranda are kept by the company in pursuance of subsection (1).

(6) A shadow director is treated for purposes of this section as a director.

(7) Every copy and memorandum required by subsection (1) or (5) to be kept shall, ... , be open to inspection of any member of the company without charge.

(8) If—

- (a) default is made in complying with subsection (1) or (5), or
- (b) an inspection required under subsection (7) is refused, or
- (c) default is made for 14 days in complying with subsection (4),

the company and every officer of it who is in default is liable to a fine and, for continued contravention, to a daily default fine.

(9) In the case of a refusal of an inspection required under subsection (7) of a copy or memorandum, the court may by order compel an immediate inspection of it.

(10) Subsections (1) and (5) apply to a variation of a director's contract of service as they apply to the contract.

(11) This section does not require that there be kept a copy of, or memorandum setting out the terms of, a contract (or its variation) at a time when the unexpired portion of the term for which the contract is to be in force is less than 12 months, or at a time at which the contract can, within the next ensuing 12 months, be terminated by the company without payment of compensation.

### **SECTION 319: DIRECTOR'S CONTRACT OF EMPLOYMENT FOR MORE THAN 5 YEARS**

319. —(1) This section applies in respect of any term of an agreement whereby a director's employment with the company of which he is a director or, where he is the director of a holding company, his employment within the group is to continue, or may be continued, otherwise than at the instance of the company (whether under the original agreement or under a new agreement entered into in pursuance of it), for a period of more than 5 years during which the employment—

- (a) cannot be terminated by the company by notice; or
- (b) can be so terminated only in specified circumstances.

(2) In any case where—

- (a) a person is or is to be employed with a company under an agreement which cannot be terminated by the company by notice or can be so terminated only in specified circumstances; and
- (b) more than 6 months before the expiration of the period for which he is or is to be so employed, the company enters into a further

agreement (otherwise than in pursuance of a right conferred by or under the original agreement on the other party to it) under which he is to be employed with the company or, where he is a director of a holding company, within the group,

this section applies as if to the period for which he is to be employed under that further agreement there were added a further period equal to the unexpired period of the original agreement.

(3) A company shall not incorporate in an agreement such a term as is mentioned in subsection (1), unless the term is first approved by a resolution of the company in general meeting and, in the case of a director of a holding company, by a resolution of that company in general meeting.

(4) No approval is required to be given under this section by any body corporate unless it is a company within the meaning of this Act, or is registered under section 680, or if it is a wholly-owned subsidiary of any body corporate, wherever incorporated.

(5) A resolution of a company approving such a term as is mentioned in subsection (1) shall not be passed at a general meeting of the company unless a written memorandum setting out the proposed agreement incorporating the term is available for inspection by members of the company both—

- (a) at the company's registered office for not less than 15 days ending with the date of the meeting; and
- (b) at the meeting itself.

(6) A term incorporated in an agreement in contravention of this section is, to the extent that it contravenes the section, void; and that agreement and, in a case where subsection (2) applies, the original agreement are deemed to contain a term entitling the company to terminate it at any time by the giving of reasonable notice.

(7) In this section—

- (a) "employment" includes employment under a contract for services; and
- (b) "group", in relation to a director of a holding company, means the group which consists of that company and its subsidiaries;

and for purposes of this section a shadow director is treated as a director.

### **SECTION 320: SUBSTANTIAL PROPERTY TRANSACTIONS INVOLVING DIRECTORS, ETC**

320.—(1) With the exceptions provided by the section next following, a company shall not enter into an arrangement—

- (a) whereby a director of a company or its holding company, or a person connected with such a director, acquires or is to acquire one or more non-cash assets of the requisite value from the company; or
- (b) whereby the company acquires or is to acquire one or more non-cash assets of the requisite value from such a director or a person so connected,

unless the arrangement is first approved by a resolution of the company in general meeting and, if the director or connected person is a director of its holding company or a person connected with such a director, by a resolution in general meeting of the holding company.

(2) For this purpose a non-cash asset is of the requisite value if at the time the arrangement in question is entered into its value is not less than [£2,000] but (subject to that) exceeds [£100,000] or 10 per cent of the company's asset value, that is—

- (a) except in a case falling within paragraph (b) below, the value of the company's net assets determined by reference to the accounts prepared and laid under Part VII in respect of the last preceding financial year in respect of which such accounts were so laid; and
- (b) where no accounts have been so prepared and laid before that time, the amount of the company's called-up share capital.

(3) For purposes of this section and sections 321 and 322, a shadow director is treated as a director.

### **SECTION 321: EXCEPTIONS FROM SECTION 320**

321.—(1) No approval is required to be given under section 320 by any body corporate unless it is a company within the meaning of this Act or registered under section 680 or, if it is a wholly-owned subsidiary of any body corporate, wherever incorporated.

(2) Section 320(1) does not apply to an arrangement for the acquisition of a non-cash asset—

- (a) if the asset is to be acquired by a holding company from any of its wholly-owned subsidiaries or from a holding company by any of its wholly-owned subsidiaries, or by one wholly-owned subsidiary of a holding company from another wholly-owned subsidiary of that same holding company, or
- (b) if the arrangement is entered into by a company which is being wound up, unless the winding up is a members' voluntary winding up.

(3) Section 320(1)(a) does not apply to an arrangement whereby a person is to acquire an asset from a company of which he is a member, if the arrangement is made with that person in his character as a member.

[(4) Section 320(1) does not apply to a transaction on a recognised investment exchange which is effected by a director, or a person connected with him, through the agency of a person who in relation to the transaction acts as an independent broker.

For this purpose an "independent broker" means—

- (a) in relation to a transaction on behalf of a director, a person who independently of the director selects the person with whom the transaction is to be effected, and
- (b) in relation to a transaction on behalf of a person connected with a director, a person who independently of that person or the director selects the person with whom the transaction is to be effected;

and "recognised", in relation to an investment exchange, means recognised under the Financial Services Act 1986.]

### **SECTION 322: LIABILITIES ARISING FROM CONTRAVENTION OF SECTION 320**

322.—(1) An arrangement entered into by a company in contravention of section 320, and any transaction entered into in pursuance of the arrangement (whether by the company or any other person) is voidable at the instance of the company unless one or more of the conditions specified in the next subsection is satisfied.

(2) Those conditions are that—

- (a) restitution of any money or other asset which is the subject-matter of the arrangement or transaction is no longer possible or the company has been indemnified in pursuance of this section by any other person for the loss or damage suffered by it; or
- (b) any rights acquired bona fide for value and without actual notice of the contravention by any person who is not a party to the arrangement or transaction would be affected by its avoidance; or
- (c) the arrangement is, within a reasonable period, affirmed by the company in general meeting and, if it is an arrangement for the transfer of an asset to or by a director of its holding company or a person who is connected with such a director, is so affirmed with the approval of the holding company given by a resolution in general meeting.

(3) If an arrangement is entered into with a company by a director of the company or its holding company or a person connected with him in contravention of section 320, that director and the person so connected, and any other director of the company who authorised the arrangement or any transaction entered into in pursuance of such an arrangement, is liable—

- (a) to account to the company for any gain which he has made directly or indirectly by the arrangement or transaction, and
- (b) (jointly and severally with any other person liable under this subsection) to indemnify the company for any loss or damage resulting from the arrangement or transaction.

(4) Subsection (3) is without prejudice to any liability imposed otherwise than by that subsection, and is subject to the following two subsections; and the liability under subsection (3) arises whether or not the arrangement or transaction entered into has been avoided in pursuance of subsection (1).

(5) If an arrangement is entered into by a company and a person connected with a director of the company or its holding company in contravention of section 320, that director is not liable under subsection (3) if he shows that he took all reasonable steps to secure the company's compliance with that section.

(6) In any case, a person so connected and any such other director as is mentioned in subsection (3) is not so liable if he shows that, at the time the arrangement was entered into, he did not know the relevant circumstances constituting the contravention.

#### **[SECTION 322A: INVALIDITY OF CERTAIN TRANSACTIONS INVOLVING DIRECTORS, ETC**

322A.—(1) This section applies where a company enters into a transaction to which the parties include—

- (a) a director of the company or of its holding company, or
- (b) a person connected with such a director or a company with whom such a director is associated,

and the board of directors, in connection with the transaction, exceed any limitation on their powers under the company's constitution.

(2) The transaction is voidable at the instance of the company.

(3) Whether or not it is avoided, any such party to the transaction as is mentioned in subsection (1)(a) or (b), and any director of the company who authorised the transaction, is liable—

- (a) to account to the company for any gain which he has made directly or indirectly by the transaction, and
- (b) to indemnify the company for any loss or damage resulting from the transaction.

(4) Nothing in the above provisions shall be construed as excluding the operation of any other enactment or rule of law by virtue of which the transaction may be called in question or any liability to the company may arise.

(5) The transaction ceases to be voidable if—

- (a) restitution of any money or other asset which was the subject-matter of the transaction is no longer possible, or
- (b) the company is indemnified for any loss or damage resulting from the transaction, or
- (c) rights acquired bona fide for value and without actual notice of the directors' exceeding their powers by a person who is not party to the transaction would be affected by the avoidance, or
- (d) the transaction is ratified by the company in general meeting, by ordinary or special resolution or otherwise as the case may require.

(6) A person other than a director of the company is not liable under subsection (3) if he shows that at the time the transaction was entered into he did not know that the directors were exceeding their powers.

(7) This section does not affect the operation of section 35A in relation to any party to the transaction not within subsection (1)(a) or (b).

But where a transaction is voidable by virtue of this section and valid by virtue of that section in favour of such a person, the court may, on the application of that person or of the company, make such order affirming, severing or setting aside the transaction, on such terms, as appear to the court to be just.

(8) In this section "transaction" includes any act; and the reference in subsection (1) to limitations under the company's constitution includes limitations deriving—

- (a) from a resolution of the company in general meeting or a meeting of any class of shareholders, or
- (b) from any agreement between the members of the company or of any class of shareholders.]

### **[SECTION 322B: CONTRACTS WITH SOLE MEMBERS WHO ARE DIRECTORS**

322B.—(1) Subject to subsection (2), where a private company limited by shares or by guarantee having only one member enters into a contract with the sole member of the company and the sole member is also a director of the company, the company shall, unless the contract is in writing, ensure that the terms of the contract are either set out in a written memorandum or are recorded in the minutes of the first meeting of the directors of the company following the making of the contract.

(2) Subsection (1) shall not apply to contracts entered into in the ordinary course of the company's business.

(3) For the purposes of this section a sole member who is a shadow director is treated as a director.



(4) If a company fails to comply with subsection (1), the company and every officer of it who is in default is liable to a fine.

(5) Subject to subsection (6), nothing in this section shall be construed as excluding the operation of any other enactment or rule of law applying to contracts between a company and a director of that company.

(6) Failure to comply with subsection (1) with respect to a contract shall not affect the validity of that contract.]

### ***Share dealings by directors and their families***

#### **SECTION 323: PROHIBITION ON DIRECTORS DEALING IN SHARE OPTIONS**

323.—(1) It is an offence for a director of a company to buy—

- (a) a right to call for delivery at a specified price and within a specified time of a specified number of relevant shares or a specified amount of relevant debentures; or
- (b) a right to make delivery at a specified price and within a specified time of a specified number of relevant shares or a specified amount of relevant debentures; or
- (c) a right (as he may elect) to call for delivery at a specified price and within a specified time or to make delivery at a specified price and within a specified time of a specified number of relevant shares or a specified amount of relevant debentures.

(2) A person guilty of an offence under subsection (1) is liable to imprisonment or a fine, or both.

(3) In subsection (1) —

- (a) “relevant shares”, in relation to a director of a company, means shares in the company or in any other body corporate, being the company's subsidiary or holding company, or a subsidiary of the company's holding company, being shares as respects which there has been granted a listing on a stock exchange (whether in Great Britain or elsewhere);
- (b) “relevant debentures”, in relation to a director of a company, means debentures of the company or of any other body corporate, being the company's subsidiary or holding company or a subsidiary of the company's holding company, being debentures as respects which there has been granted such a listing; and
- (c) “price” includes any consideration other than money.

(4) This section applies to a shadow director as to a director.

(5) This section is not to be taken as penalising a person who buys a right to subscribe for shares in, or debentures of, a body corporate or buys debentures of a body corporate that confer upon the holder of them a right to subscribe for, or to convert the debentures (in whole or in part) into, shares of that body.

#### **SECTION 324: DUTY OF DIRECTOR TO DISCLOSE SHAREHOLDINGS IN OWN COMPANY**

324.—(1) A person who becomes a director of a company and at the time when he does so is interested in shares in, or debentures of, the company or any other body corporate,

being the company's subsidiary or holding company or a subsidiary of the company's holding company, is under obligation to notify the company in writing—

- (a) of the subsistence of his interests at that time; and
- (b) of the number of shares of each class in, and the amount of debentures of each class of, the company or other such body corporate in which each interest of his subsists at that time.

(2) A director of a company is under obligation to notify the company in writing of the occurrence, while he is a director, of any of the following events—

- (a) any event in consequence of whose occurrence he becomes, or ceases to be, interested in shares in, or debentures of, the company or any other body corporate, being the company's subsidiary or holding company or a subsidiary of the company's holding company;
- (b) the entering into by him of a contract to sell any such shares or debentures;
- (c) the assignment by him of a right granted to him by the company to subscribe for shares in, or debentures of, the company; and
- (d) the grant to him by another body corporate, being the company's subsidiary or holding company or a subsidiary of the company's holding company, of a right to subscribe for shares in, or debentures of, that other body corporate, the exercise of such a right granted to him and the assignment by him of such a right so granted;

and notification to the company must state the number or amount, and class, of shares or debentures involved.

(3) Schedule 13 has effect in connection with subsections (1) and (2) above; and of that Schedule—

- (a) Part I contains rules for the interpretation of, and otherwise in relation to, those subsections and applies in determining, for purposes of those subsections, whether a person has an interest in shares or debentures;
- (b) Part II applies with respect to the periods within which obligations imposed by the subsections must be fulfilled; and
- (c) Part III specifies certain circumstances in which obligations arising from subsection (2) are to be treated as not discharged;

and subsections (1) and (2) are subject to any exceptions for which provision may be made by regulations made by the Secretary of State by statutory instrument.

(4) Subsection (2) does not require the notification by a person of the occurrence of an event whose occurrence comes to his knowledge after he has ceased to be a director.

(5) An obligation imposed by this section is treated as not discharged unless the notice by means of which it purports to be discharged is expressed to be given in fulfilment of that obligation.

(6) This section applies to shadow directors as to directors; but nothing in it operates so as to impose an obligation with respect to shares in a body corporate which is the wholly-owned subsidiary of another body corporate.

(7) A person who—

- (a) fails to discharge, within the proper period, an obligation to which he is subject under subsection (1) or (2), or

- (b) in purported discharge of an obligation to which he is so subject, makes to the company a statement which he knows to be false, or recklessly makes to it a statement which is false,

is guilty of an offence and liable to imprisonment or a fine, or both.

(8) Section 732 (restriction on prosecutions) applies to an offence under this section.

### **SECTION 325: REGISTER OF DIRECTORS' INTERESTS NOTIFIED UNDER SECTION 324**

325. —(1) Every company shall keep a register for the purposes of section 324.

(2) Whenever a company receives information from a director given in fulfilment of an obligation imposed on him by that section, it is under obligation to enter in the register, against the director's name, the information received and the date of the entry.

(3) The company is also under obligation, whenever it grants to a director a right to subscribe for shares in, or debentures of, the company to enter in the register against his name—

- (a) the date on which the right is granted,
- (b) the period during which, or time at which, it is exercisable,
- (c) the consideration for the grant (or, if there is no consideration, that fact), and
- (d) the description of shares or debentures involved and the number or amount of them, and the price to be paid for them (or the consideration, if otherwise than in money).

(4) Whenever such a right as is mentioned above is exercised by a director, the company is under obligation to enter in the register against his name that fact (identifying the right), the number or amount of shares or debentures in respect of which it is exercised and, if they were registered in his name, that fact and, if not, the name or names of the person or persons in whose name or names they were registered, together (if they were registered in the names of two persons or more) with the number or amount of the shares or debentures registered in the name of each of them.

(5) Part IV of Schedule 13 has effect with respect to the register to be kept under this section, to the way in which entries in it are to be made, to the right of inspection, and generally.

(6) For purposes of this section, a shadow director is deemed a director.

### **SECTION 326: SANCTIONS FOR NON-COMPLIANCE**

326. —(1) The following applies with respect to defaults in complying with, and to contraventions of, section 325 and Part IV of Schedule 13.

(2) If default is made in complying with any of the following provisions—

- (a) section 325(1), (2), (3) or (4), or
- (b) Schedule 13, paragraph 21, 22 or 28,

the company and every officer of it who is in default is liable to a fine and, for continued contravention, to a daily default fine.

(3) If an inspection of the register required under paragraph 25 of the Schedule is refused, or a copy required under paragraph 26 is not sent within the proper period, the company and every officer of it who is in default is liable to a fine and, for continued contravention, to a daily default fine.

(4) If default is made for 14 days in complying with paragraph 27 of the Schedule (notice to registrar of where register is kept), the company and every officer of it who is in default is liable to a fine and, for continued contravention, to a daily default fine.

(5) If default is made in complying with paragraph 29 of the Schedule (register to be produced at annual general meeting), the company and every officer of it who is in default is liable to a fine.

(6) In the case of a refusal of an inspection of the register required under paragraph 25 of the Schedule, the court may by order compel an immediate inspection of it; and in the case of failure to send within the proper period a copy required under paragraph 26, the court may by order direct that the copy be sent to the person requiring it.

#### **SECTION 327: EXTENSION OF SECTION 323 TO SPOUSES AND CHILDREN**

327.—(1) Section 323 applies to—

- (a) the wife or husband of a director of a company (not being herself or himself a director of it), and
- (b) an infant son or infant daughter of a director (not being himself or herself a director of the company),

as it applies to the director; but it is a defence for a person charged by virtue of this section with an offence under section 323 to prove that he (she) had no reason to believe that his (her) spouse or, as the case may be, parent was a director of the company in question.

(2) For purposes of this section—

- (a) “son” includes step-son, and “daughter” includes step-daughter (“parent” being construed accordingly),
- (b) “infant” means, in relation to Scotland, [person under the age of 18 years], and
- (c) a shadow director of a company is deemed a director of it.

#### **SECTION 328: EXTENSION OF SECTION 324 TO SPOUSES AND CHILDREN**

328.—(1) For the purposes of section 324—

- (a) an interest of the wife or husband of a director of a company (not being herself or himself a director of it) in shares or debentures is to be treated as the director's interest; and
- (b) the same applies to an interest of an infant son or infant daughter of a director of a company (not being himself or herself a director of it) in shares or debentures.

(2) For those purposes—

- (a) a contract, assignment or right of subscription entered into, exercised or made by, or a grant made to, the wife or husband of a director of a company (not being herself or himself a director of it) is to be treated as having been entered into, exercised or made by, or (as the case may be) as having been made to, the director; and
- (b) the same applies to a contract, assignment or right of subscription entered into, exercised or made by, or grant made to, an infant son or infant daughter of a director of a company (not being himself or herself a director of it).

(3) A director of a company is under obligation to notify the company in writing of the occurrence while he or she is a director, of either of the following events, namely—

- (a) the grant by the company to his (her) spouse, or to his or her infant son or infant daughter, of a right to subscribe for shares in, or debentures of, the company; and
- (b) the exercise by his (her) spouse or by his or her infant son or infant daughter of such a right granted by the company to the wife, husband, son or daughter.

(4) In a notice given to the company under subsection (3) there shall be stated—

- (a) in the case of the grant of a right, the like information as is required by section 324 to be stated by the director on the grant to him by another body corporate of a right to subscribe for shares in, or debentures of, that other body corporate; and
- (b) in the case of the exercise of a right, the like information as is required by that section to be stated by the director on the exercise of a right granted to him by another body corporate to subscribe for shares in, or debentures of, that other body corporate.

(5) An obligation imposed by subsection (3) on a director must be fulfilled by him before the end of 5 days beginning with the day following that on which the occurrence of the event giving rise to it comes to his knowledge; but in reckoning that period of days there is disregarded any Saturday or Sunday, and any day which is a bank holiday in any part of Great Britain.

(6) A person who—

- (a) fails to fulfil, within the proper period, an obligation to which he is subject under subsection (3), or
- (b) in purported fulfilment of such an obligation, makes to a company a statement which he knows to be false, or recklessly makes to a company a statement which is false,

is guilty of an offence and liable to imprisonment or a fine, or both.

(7) The rules set out in Part I of Schedule 13 have effect for the interpretation of, and otherwise in relation to, subsections (1) and (2); and subsections (5), (6) and (8) of section 324 apply with any requisite modification.

(8) In this section, “son” includes step-son, “daughter” includes step-daughter, and “infant” means, in relation to Scotland, [person under the age of 18 years].

(9) For purposes of section 325, an obligation imposed on a director by this section is to be treated as if imposed by section 324.

#### **SECTION 329: DUTY TO NOTIFY STOCK EXCHANGE OF MATTERS NOTED UNDER PRECEDING SECTIONS**

329.—(1) Whenever a company whose shares or debentures are listed on a [recognised investment exchange other than an overseas investment exchange within the meaning of the Financial Services Act 1986] is notified of any matter by a director in consequence of the fulfilment of an obligation imposed by section 324 or 328, and that matter relates to shares or debentures so listed, the company is under obligation to notify [that investment exchange] of that matter; and [the investment exchange] may publish, in such manner as it may determine, any information received by it under this subsection.

(2) An obligation imposed by subsection (1) must be fulfilled before the end of the day next following that on which it arises; but there is disregarded for this purpose a day which is a Saturday or a Sunday or a bank holiday in any part of Great Britain.

(3) If default is made in complying with this section, the company and every officer of it who is in default is guilty of an offence and liable to a fine and, for continued contravention, to a daily default fine.

Section 732 (restriction on prosecutions) applies to an offence under this section.

***Restrictions on a company's power to make loans, etc, to directors and persons connected with them***

**SECTION 330: GENERAL RESTRICTION ON LOANS ETC TO DIRECTORS AND PERSONS CONNECTED WITH THEM**

330.— (1) The prohibitions listed below in this section are subject to the exceptions in sections 332 to 338.

(2) A company shall not—

- (a) make a loan to a director of the company or of its holding company;
- (b) enter into any guarantee or provide any security in connection with a loan made by any person to such a director.

(3) A relevant company shall not—

- (a) make a quasi-loan to a director of the company or of its holding company;
- (b) make a loan or a quasi-loan to a person connected with such a director;
- (c) enter into a guarantee or provide any security in connection with a loan or quasi-loan made by any other person for such a director or a person so connected.

(4) A relevant company shall not—

- (a) enter into a credit transaction as creditor for such a director or a person so connected;
- (b) enter into any guarantee or provide any security in connection with a credit transaction made by any other person for such a director or a person so connected.

(5) For purposes of sections 330 to 346, a shadow director is treated as a director.

(6) A company shall not arrange for the assignment to it, or the assumption by it, of any rights, obligations or liabilities under a transaction which, if it had been entered into by the company, would have contravened subsection (2), (3) or (4); but for the purposes of sections 330 to 347 the transaction is to be treated as having been entered into on the date of the arrangement.

(7) A company shall not take part in any arrangement whereby—

- (a) another person enters into a transaction which, if it had been entered into by the company, would have contravened any of subsections (2), (3), (4) or (6); and
- (b) that other person, in pursuance of the arrangement, has obtained or is to obtain any benefit from the company or its holding company or a subsidiary of the company or its holding company.

**SECTION 331: DEFINITIONS FOR SECTION 330 AND SUBSEQUENT SECTIONS**

331.—(1) The following subsections apply for the interpretation of sections 330 to 346.

(2) “Guarantee” includes indemnity, and cognate expressions are to be construed accordingly.

(3) A quasi-loan is a transaction under which one party (“the creditor”) agrees to pay, or pays otherwise than in pursuance of an agreement, a sum for another (“the borrower”) or agrees to reimburse, or reimburses otherwise than in pursuance of an agreement, expenditure incurred by another party for another (“the borrower”) —

- (a) on terms that the borrower (or a person on his behalf) will reimburse the creditor; or
- (b) in circumstances giving rise to a liability on the borrower to reimburse the creditor.

(4) Any reference to the person to whom a quasi-loan is made is a reference to the borrower; and the liabilities of a borrower under a quasi-loan include the liabilities of any person who has agreed to reimburse the creditor on behalf of the borrower.

(5) ...

(6) “Relevant company” means a company which—

- (a) is a public company, or
- (b) is a subsidiary of a public company, or
- (c) is a subsidiary of a company which has as another subsidiary a public company, or
- (d) has a subsidiary which is a public company.

(7) A credit transaction is a transaction under which one party (“the creditor”)—

- (a) supplies any goods or sells any land under a hire-purchase agreement or a conditional sale agreement;
- (b) leases or hires any land or goods in return for periodical payments;
- (c) otherwise disposes of land or supplies goods or services on the understanding that payment (whether in a lump sum or instalments or by way of periodical payments or otherwise) is to be deferred.

(8) “Services” means anything other than goods or land.

(9) A transaction or arrangement is made “for” a person if—

- (a) in the case of a loan or quasi-loan, it is made to him;
- (b) in the case of a credit transaction, he is the person to whom goods or services are supplied, or land is sold or otherwise disposed of, under the transaction;
- (c) in the case of a guarantee or security, it is entered into or provided in connection with a loan or quasi-loan made to him or a credit transaction made for him;
- (d) in the case of an arrangement within subsection (6) or (7) of section 330, the transaction to which the arrangement relates was made for him; and
- (e) in the case of any other transaction or arrangement for the supply or transfer of, or of any interest in, goods, land or services, he is the person to whom the goods, land or services (or the interest) are supplied or transferred.

(10) “Conditional sale agreement” means the same as in the Consumer Credit Act 1974.

### **SECTION 332: SHORT-TERM QUASI-LOANS**

332.—(1) Subsection (3) of section 330 does not prohibit a company (“the creditor”) from making a quasi-loan to one of its directors or to a director of its holding company if—

- (a) the quasi-loan contains a term requiring the director or a person on his behalf to reimburse the creditor his expenditure within 2 months of its being incurred; and
- (b) the aggregate of the amount of that quasi-loan and of the amount outstanding under each relevant quasi-loan does not exceed [£5,000].

(2) A quasi-loan is relevant for this purpose if it was made to the director by virtue of this section by the creditor or its subsidiary or, where the director is a director of the creditor's holding company, any other subsidiary of that company; and "the amount outstanding" is the amount of the outstanding liabilities of the person to whom the quasi-loan was made.

### **SECTION 333: INTER-COMPANY LOANS IN SAME GROUP**

333.— In the case of a relevant company which is a member of a group of companies (meaning a holding company and its subsidiaries), paragraphs (b) and (c) of section 330(3) do not prohibit the company from—

- (a) making a loan or quasi-loan to another member of that group; or
- (b) entering into a guarantee or providing any security in connection with a loan or quasi-loan made by any person to another member of the group,

by reason only that a director of one member of the group is associated with another.

### **SECTION 334: LOANS OF SMALL AMOUNTS**

334.— Without prejudice to any other provision of sections 332 to 338, paragraph (a) of section 330(2) does not prohibit a company from making a loan to a director of the company or of its holding company if the aggregate of the relevant amounts does not exceed [£5,000].

### **SECTION 335: MINOR AND BUSINESS TRANSACTIONS**

335.—(1) Section 330(4) does not prohibit a company from entering into a transaction for a person if the aggregate of the relevant amounts does not exceed [£10,000].

(2) Section 330(4) does not prohibit a company from entering into a transaction for a person if—

- (a) the transaction is entered into by the company in the ordinary course of its business; and
- (b) the value of the transaction is not greater, and the terms on which it is entered into are no more favourable, in respect of the person for whom the transaction is made, than that or those which it is reasonable to expect the company to have offered to or in respect of a person of the same financial standing but unconnected with the company.

### **SECTION 336: TRANSACTIONS AT BEHEST OF HOLDING COMPANY**

336.— The following transactions are excepted from the prohibitions of section 330 —

- (a) a loan or quasi-loan by a company to its holding company, or a company entering into a guarantee or providing any security in



- connection with a loan or quasi-loan made by any person to its holding company;
- (b) a company entering into a credit transaction as creditor for its holding company, or entering into a guarantee or providing any security in connection with a credit transaction made by any other person for its holding company.

**SECTION 337: FUNDING OF DIRECTOR'S EXPENDITURE ON DUTY TO COMPANY**

337.—(1) A company is not prohibited by section 330 from doing any thing to provide a director with funds to meet expenditure incurred or to be incurred by him for the purposes of the company or for the purpose of enabling him properly to perform his duties as an officer of the company.

(2) Nor does the section prohibit a company from doing any thing to enable a director to avoid incurring such expenditure.

(3) Subsections (1) and (2) apply only if one of the following conditions is satisfied —

- (a) the thing in question is done with prior approval of the company given at a general meeting at which there are disclosed all the matters mentioned in the next subsection;
- (b) that thing is done on condition that, if the approval of the company is not so given at or before the next annual general meeting, the loan is to be repaid, or any other liability arising under any such transaction discharged, within 6 months from the conclusion of that meeting;

but those subsections do not authorise a relevant company to enter into any transaction if the aggregate of the relevant amounts exceeds [£20,000].

(4) The matters to be disclosed under subsection (3)(a) are—

- (a) the purpose of the expenditure incurred or to be incurred, or which would otherwise be incurred, by the director,
- (b) the amount of the funds to be provided by the company, and
- (c) the extent of the company's liability under any transaction which is or is connected with the thing in question.

**SECTION 338: LOAN OR QUASI-LOAN BY MONEY-LENDING COMPANY**

338.—(1) There is excepted from the prohibitions in section 330—

- (a) a loan or quasi-loan made by a money-lending company to any person; or
- (b) a money-lending company entering into a guarantee in connection with any other loan or quasi-loan.

(2) "Money-lending company" means a company whose ordinary business includes the making of loans or quasi-loans, or the giving of guarantees in connection with loans or quasi-loans.

(3) Subsection (1) applies only if both the following conditions are satisfied—

- (a) the loan or quasi-loan in question is made by the company, or it enters into the guarantee, in the ordinary course of the company's business; and
- (b) the amount of the loan or quasi-loan, or the amount guaranteed, is not greater, and the terms of the loan, quasi-loan or guarantee are not more favourable, in the case of the person to whom the loan or

quasi-loan is made or in respect of whom the guarantee is entered into, than that or those which it is reasonable to expect that company to have offered to or in respect of a person of the same financial standing but unconnected with the company.

(4) But subsection (1) does not authorise a relevant company (unless it is [a banking company]) to enter into any transaction if the aggregate of the relevant amounts exceeds [£100,000].

(5) In determining that aggregate, a company which a director does not control is deemed not to be connected with him.

(6) The condition specified in subsection (3)(b) does not of itself prevent a company from making a loan to one of its directors or a director of its holding company—

- (a) for the purpose of facilitating the purchase, for use as that director's only or main residence, of the whole or part of any dwelling-house together with any land to be occupied and enjoyed with it;
- (b) for the purpose of improving a dwelling-house or part of a dwelling-house so used or any land occupied and enjoyed with it;
- (c) in substitution for any loan made by any person and falling within paragraph (a) or (b) of this subsection,

if loans of that description are ordinarily made by the company to its employees and on terms no less favourable than those on which the transaction in question is made, and the aggregate of the relevant amounts does not exceed [£100,000].

### **SECTION 339: “RELEVANT AMOUNTS” FOR PURPOSES OF SECTION 334 AND SUBSEQUENT SECTIONS**

339.—(1) This section has effect for defining the “relevant amounts” to be aggregated under sections 334, 335(1), 337(3) and 338(4); and in relation to any proposed transaction or arrangement and the question whether it falls within one or other of the exceptions provided by those sections, “the relevant exception” is that exception; but where the relevant exception is the one provided by section 334 (loan of small amount), references in this section to a person connected with a director are to be disregarded.

(2) Subject as follows, the relevant amounts in relation to a proposed transaction or arrangement are—

- (a) the value of the proposed transaction or arrangement,
- (b) the value of any existing arrangement which—
  - (i) falls within subsection (6) or (7) of section 330, and
  - (ii) also falls within subsection (3) of this section, and
  - (iii) was entered into by virtue of the relevant exception by the company or by a subsidiary of the company or, where the proposed transaction or arrangement is to be made for a director of its holding company or a person connected with such a director, by that holding company or any of its subsidiaries;
- (c) the amount outstanding under any other transaction—
  - (i) falling within subsection (3) below, and
  - (ii) made by virtue of the relevant exception, and

- (iii) made by the company or by a subsidiary of the company or, where the proposed transaction or arrangement is to be made for a director of its holding company or a person connected with such a director, by that holding company or any of its subsidiaries.

(3) A transaction falls within this subsection if it was made—

- (a) for the director for whom the proposed transaction or arrangement is to be made, or for any person connected with that director; or
- (b) where the proposed transaction or arrangement is to be made for a person connected with a director of a company, for that director or any person connected with him;

and an arrangement also falls within this subsection if it relates to a transaction which does so.

(4) But where the proposed transaction falls within section 338 and is one which [a banking company] proposes to enter into under subsection (6) of that section (housing loans, etc), any other transaction or arrangement which apart from this subsection would fall within subsection (3) of this section does not do so unless it was entered into in pursuance of section 338(6).

(5) A transaction entered into by a company which is (at the time of that transaction being entered into) a subsidiary of the company which is to make the proposed transaction, or is a subsidiary of that company's holding company, does not fall within subsection (3) if at the time when the question arises (that is to say, the question whether the proposed transaction or arrangement falls within any relevant exception), it no longer is such a subsidiary.

(6) Values for purposes of subsection (2) of this section are to be determined in accordance with the section next following; and “the amount outstanding” for purposes of subsection (2)(c) above is the value of the transaction less any amount by which that value has been reduced.

#### **SECTION 340: “VALUE” OF TRANSACTIONS AND ARRANGEMENTS**

340.—(1) This section has effect for determining the value of a transaction or arrangement for purposes of sections 330 to 339.

(2) The value of a loan is the amount of its principal.

(3) The value of a quasi-loan is the amount, or maximum amount, which the person to whom the quasi-loan is made is liable to reimburse the creditor.

(4) The value of a guarantee or security is the amount guaranteed or secured.

(5) The value of an arrangement to which section 330(6) or (7) applies is the value of the transaction to which the arrangement relates less any amount by which the liabilities under the arrangement or transaction of the person for whom the transaction was made have been reduced.

(6) The value of a transaction or arrangement not falling within subsections (2) to (5) above is the price which it is reasonable to expect could be obtained for the goods, land or services to which the transaction or arrangement relates if they had been supplied (at the time the transaction or arrangement is entered into) in the ordinary course of business and on the same terms (apart from price) as they have been supplied, or are to be supplied, under the transaction or arrangement in question.

(7) For purposes of this section, the value of a transaction or arrangement which is not capable of being expressed as a specific sum of money (because the amount of any liability arising under the transaction or arrangement is unascertainable, or for any other reason), whether or not any liability under the transaction or arrangement has been reduced, is deemed to exceed [£100,000].

#### **SECTION 341: CIVIL REMEDIES FOR BREACH OF SECTION 330**

341.—(1) If a company enters into a transaction or arrangement in contravention of section 330, the transaction or arrangement is voidable at the instance of the company unless—

- (a) restitution of any money or any other asset which is the subject matter of the arrangement or transaction is no longer possible, or the company has been indemnified in pursuance of subsection (2)(b) below for the loss or damage suffered by it, or
- (b) any rights acquired bona fide for value and without actual notice of the contravention by a person other than the person for whom the transaction or arrangement was made would be affected by its avoidance.

(2) Where an arrangement or transaction is made by a company for a director of the company or its holding company or a person connected with such a director in contravention of section 330, that director and the person so connected and any other director of the company who authorised the transaction or arrangement (whether or not it has been avoided in pursuance of subsection (1)) is liable—

- (a) to account to the company for any gain which he has made directly or indirectly by the arrangement or transaction; and
- (b) (jointly and severally with any other person liable under this subsection) to indemnify the company for any loss or damage resulting from the arrangement or transaction.

(3) Subsection (2) is without prejudice to any liability imposed otherwise than by that subsection, but is subject to the next two subsections.

(4) Where an arrangement or transaction is entered into by a company and a person connected with a director of the company or its holding company in contravention of section 330, that director is not liable under subsection (2) of this section if he shows that he took all reasonable steps to secure the company's compliance with that section.

(5) In any case, a person so connected and any such other director as is mentioned in subsection (2) is not so liable if he shows that, at the time the arrangement or transaction was entered into, he did not know the relevant circumstances constituting the contravention.

#### **SECTION 342: CRIMINAL PENALTIES FOR BREACH OF SECTION 330**

342.—(1) A director of a relevant company who authorises or permits the company to enter into a transaction or arrangement knowing or having reasonable cause to believe that the company was thereby contravening section 330 is guilty of an offence.

(2) A relevant company which enters into a transaction or arrangement for one of its directors or for a director of its holding company in contravention of section 330 is guilty of an offence.

(3) A person who procures a relevant company to enter into a transaction or arrangement knowing or having reasonable cause to believe that the company was thereby contravening section 330 is guilty of an offence.

(4) A person guilty of an offence under this section is liable to imprisonment or a fine, or both.

(5) A relevant company is not guilty of an offence under subsection (2) if it shows that, at the time the transaction or arrangement was entered into, it did not know the relevant circumstances.

### **SECTION 343: RECORD OF TRANSACTIONS NOT DISCLOSED IN COMPANY ACCOUNTS**

343. —(1) The following provisions of this section—

- (a) apply in the case of a company which is [a banking company, or is the holding company of a credit institution,] and
- (b) are subject to the exceptions provided by section 344.

[(2) Where such a company takes advantage of the provisions of paragraph 2 of Part IV of Schedule 9 in relation to a financial year, that company shall keep a register containing a copy of every transaction, arrangement or agreement of which particulars would, but for that paragraph, be required to be disclosed in the company's accounts or group accounts for that financial year and for each financial year in the preceding 10 in relation to which the company has taken advantage of the provisions of that paragraph.]

(3) In the case of a transaction, arrangement or agreement which is not in writing, there shall be contained in the register a written memorandum setting out its terms.

[(4) Where such a company takes advantage of the provisions of paragraph 2 of Part IV of Schedule 9 in relation to the last complete financial year preceding its annual general meeting, that company shall before that meeting make available at its registered office for not less than 15 days ending with the date of the meeting a statement containing the particulars of transactions, arrangements and agreements which the company would, but for that paragraph, be required to disclose in its accounts or group accounts for that financial year.]

(5) The statement shall be so made available for inspection by members of the company; and such a statement shall also be made available for their inspection at the annual general meeting.

(6) It is the duty of the company's auditors to examine the statement before it is made available to members of the company and to make a report to the members on it; and the report shall be annexed to the statement before it is made so available.

(7) The auditors' report shall state whether in their opinion the statement contains the particulars required by subsection (4); and, where their opinion is that it does not, they shall include in the report, so far as they are reasonably able to do so, a statement giving the required particulars.

(8) If a company fails to comply with any provision of subsections (2) to (5), every person who at the time of the failure is a director of it is guilty of an offence and liable to a fine; but—

- (a) it is a defence in proceedings against a person for this offence to prove that he took all reasonable steps for securing compliance with the subsection concerned, and
- (b) a person is not guilty of the offence by virtue only of being a shadow director of the company.

(9) For purposes of the application of this section to loans and quasi-loans made by a company to persons connected with a person who at any time is a director of the

company or of its holding company, a company which a person does not control is not connected with him.

## **SECTION 344: EXCEPTIONS FROM SECTION 343**

344.—(1) Section 343 does not apply in relation to—

- (a) transactions or arrangements made or subsisting during a financial year by a company or by a subsidiary of a company for a person who was at any time during that year a director of the company or of its holding company or was connected with such a director, or
- (b) an agreement made or subsisting during that year to enter into such a transaction or arrangement,

if the aggregate of the values of each transaction or arrangement made for that person, and of each agreement for such a transaction or arrangement, less the amount (if any) by which the value of those transactions, arrangements and agreements has been reduced, did not exceed [£2,000] at any time during the financial year.

For purposes of this subsection, values are to be determined as under section 340.

(2) Section 343(4) and (5) do not apply to [a banking company] which is the wholly-owned subsidiary of a company incorporated in the United Kingdom.

### ***Supplementary***

## **SECTION 345: POWER TO INCREASE FINANCIAL LIMITS**

345.—(1) The Secretary of State may by order in a statutory instrument substitute for any sum of money specified in this Part a larger sum specified in the order.

(2) An order under this section is subject to annulment in pursuance of a resolution of either House of Parliament.

(3) Such an order does not have effect in relation to anything done or not done before its coming into force; and accordingly, proceedings in respect of any liability (whether civil or criminal) incurred before that time may be continued or instituted as if the order had not been made.

## **SECTION 346: “CONNECTED PERSONS”, ETC**

346.—(1) This section has effect with respect to references in this Part to a person being “connected” with a director of a company, and to a director being “associated with” or “controlling” a body corporate.

(2) A person is connected with a director of a company if, but only if, he (not being himself a director of it) is—

- (a) that director’s spouse, child or step-child; or
- (b) except where the context otherwise requires, a body corporate with which the director is associated; or
- (c) a person acting in his capacity as trustee of any trust the beneficiaries of which include—
  - (i) the director, his spouse or any children or step-children of his, or
  - (ii) a body corporate with which he is associated,

or of a trust whose terms confer a power on the trustees that may be exercised for the benefit of the director, his spouse, or any children or step-children of his, or any such body corporate; or

- (d) a person acting in his capacity as partner of that director or of any person who, by virtue of paragraph (a), (b) or (c) of this subsection, is connected with that director; or
- (e) a Scottish firm in which—
  - (i) that director is a partner,
  - (ii) a partner is a person who, by virtue of paragraph (a), (b) or (c) above, is connected with that director, or
  - (iii) a partner is a Scottish firm in which that director is a partner or in which there is a partner who, by virtue of paragraph (a), (b) or (c) above, is connected with that director.

(3) In subsection (2)—

- (a) a reference to the child or step-child of any person includes an illegitimate child of his, but does not include any person who has attained the age of 18; and
- (b) paragraph (c) does not apply to a person acting in his capacity as trustee under an employees' share scheme or a pension scheme.

(4) A director of a company is associated with a body corporate if, but only if, he and the persons connected with him, together—

- (a) are interested in shares comprised in the equity share capital of that body corporate of a nominal value equal to at least one-fifth of that share capital; or
- (b) are entitled to exercise or control the exercise of more than one-fifth of the voting power at any general meeting of that body.

(5) A director of a company is deemed to control a body corporate if, but only if—

- (a) he or any person connected with him is interested in any part of the equity share capital of that body or is entitled to exercise or control the exercise of any part of the voting power at any general meeting of that body; and
- (b) that director, the persons connected with him and the other directors of that company, together, are interested in more than one-half of that share capital or are entitled to exercise or control the exercise of more than one-half of that voting power.

(6) For purposes of subsections (4) and (5)—

- (a) a body corporate with which a director is associated is not to be treated as connected with that director unless it is also connected with him by virtue of subsection (2)(c) or (d); and
- (b) a trustee of a trust the beneficiaries of which include (or may include) a body corporate with which a director is associated is not to be treated as connected with a director by reason only of that fact.

(7) The rules set out in Part I of Schedule 13 apply for the purposes of subsections (4) and (5).

(8) References in those subsections to voting power the exercise of which is controlled by a director include voting power whose exercise is controlled by a body corporate controlled by him; but this is without prejudice to other provisions of subsections (4) and (5).



**SECTION 347: TRANSACTIONS UNDER FOREIGN LAW**

347.— For purposes of sections 319 to 322 and 330 to 343, it is immaterial whether the law which (apart from this Act) governs any arrangement or transaction is the law of the United Kingdom, or of a part of it, or not.

## **COMPANIES ACT 1985, SCHEDULE 6, PARTS II AND III**

### **[PART II: LOANS, QUASI-LOANS AND OTHER DEALINGS IN FAVOUR OF DIRECTORS]**

[15.] [The group accounts of a holding company, or if it is not required to prepare group accounts its individual accounts,] shall contain the particulars required by this Schedule of—

- (a) any transaction or arrangement of a kind described in section 330 entered into by the company or by a subsidiary of the company for a person who at any time during the financial year was a director of the company or its holding company, or was connected with such a director;
- (b) an agreement by the company or by a subsidiary of the company to enter into any such transaction or arrangement for a person who was at any time during the financial year a director of the company or its holding company, or was connected with such a director; and
- (c) any other transaction or arrangement with the company or a subsidiary of it in which a person who at any time during the financial year was a director of the company or its holding company had, directly or indirectly, a material interest.

[16.] The accounts prepared by a company other than a holding company shall contain the particulars required by this Schedule of—

- (a) any transaction or arrangement of a kind described in section 330 entered into by the company for a person who at any time during the financial year was a director of it or of its holding company or was connected with such a director;
- (b) an agreement by the company to enter into any such transaction or arrangement for a person who at any time during the financial year was a director of the company or its holding company or was connected with such a director; and
- (c) any other transaction or arrangement with the company in which a person who at any time during the financial year was a director of the company or of its holding company had, directly or indirectly, a material interest.

[17.] (1) For purposes of paragraphs [15](c) and [16](c), a transaction or arrangement between a company and a director of it or of its holding company, or a person connected with such a director, is to be treated (if it would not otherwise be so) as a transaction, arrangement or agreement in which that director is interested.

(2) An interest in such a transaction or arrangement is not “material” for purposes of those sub-paragraphs if in the board's opinion it is not so; but this is without prejudice to the question whether or not such an interest is material in a case where the board have not considered the matter.

“The board” here means the directors of the company preparing the accounts, or a majority of those directors, but excluding in either case the director whose interest it is.

[18.] Paragraphs [15] and [16] do not apply in relation to the following transactions, arrangements and agreements—

- (a) a transaction, arrangement or agreement between one company and another in which a director of the former or of its subsidiary or holding company is interested only by virtue of his being a director of the latter;

- (b) a contract of service between a company and one of its directors or a director of its holding company, or between a director of a company and any of that company's subsidiaries;
- (c) a transaction, arrangement or agreement which was not entered into during the financial year and which did not subsist at any time during that year.

[19.] Paragraphs [15] and [16] apply whether or not—

- (a) the transaction or arrangement was prohibited by section 330;
- (b) the person for whom it was made was a director of the company or was connected with a director of it at the time it was made;
- (c) in the case of a transaction or arrangement made by a company which at any time during a financial year is a subsidiary of another company, it was a subsidiary of that other company at the time the transaction or arrangement was made.

[20.] Neither paragraph [15](c) nor paragraph [16](c) applies in relation to any transaction or arrangement if—

- (a) each party to the transaction or arrangement which is a member of the same group of companies (meaning a holding company and its subsidiaries) as the company entered into the transaction or arrangement in the ordinary course of business, and
- (b) the terms of the transaction or arrangement are not less favourable to any such party than it would be reasonable to expect if the interest mentioned in that sub-paragraph had not been an interest of a person who was a director of the company or of its holding company.

[21.] Neither paragraph [15](c) nor paragraph [16](c) applies in relation to any transaction or arrangement if—

- (a) the company is a member of a group of companies (meaning a holding company and its subsidiaries), and
- (b) either the company is a wholly-owned subsidiary or no body corporate (other than the company or a subsidiary of the company) which is a member of the group of companies which includes the company's ultimate holding company was a party to the transaction or arrangement, and
- (c) the director in question was at some time during the relevant period associated with the company, and
- (d) the material interest of the director in question in the transaction or arrangement would not have arisen if he had not been associated with the company at any time during the relevant period.

### ***The particulars required by this Part***

[22.] (1) Subject to the next paragraph, the particulars required by this Part are those of the principal terms of the transaction, arrangement or agreement.

(2) Without prejudice to the generality of sub-paragraph (1), the following particulars are required—

- (a) a statement of the fact either that the transaction, arrangement or agreement was made or subsisted (as the case may be) during the financial year;
- (b) the name of the person for whom it was made and, where that person is or was connected with a director of the company or of its holding company, the name of that director;
- (c) in a case where paragraph [15](c) or [16](c) applies, the name of the director with the material interest and the nature of that interest;
- (d) in the case of a loan or an agreement for a loan or an arrangement within section 330(6) or (7) of this Act relating to a loan—
  - (i) the amount of the liability of the person to whom the loan was or was agreed to be made, in respect of principal and interest, at the beginning and at the end of the financial year;
  - (ii) the maximum amount of that liability during that year;
  - (iii) the amount of any interest which, having fallen due, has not been paid; and
  - (iv) the amount of any provision (within the meaning of Schedule 4 to this Act) made in respect of any failure or anticipated failure by the borrower to repay the whole or part of the loan or to pay the whole or part of any interest on it;
- (e) in the case of a guarantee or security or an arrangement within section 330(6) relating to a guarantee or security—
  - (i) the amount for which the company (or its subsidiary) was liable under the guarantee or in respect of the security both at the beginning and at the end of the financial year;
  - (ii) the maximum amount for which the company (or its subsidiary) may become so liable; and
  - (iii) any amount paid and any liability incurred by the company (or its subsidiary) for the purpose of fulfilling the guarantee or discharging the security (including any loss incurred by reason of the enforcement of the guarantee or security); and
- (f) in the case of any transaction, arrangement or agreement other than those mentioned in sub-paragraphs (d) and (e), the value of the transaction or arrangement or (as the case may be) the value of the transaction or arrangement to which the agreement relates.

[23.] In paragraph [22](2) above, sub-paragraphs (c) to (f) do not apply in the case of a loan or quasi-loan made or agreed to be made by a company to or for a body corporate which is either—

- (a) a body corporate of which that company is a wholly-owned subsidiary, or

- (b) a wholly-owned subsidiary of a body corporate of which that company is a wholly-owned subsidiary, or
- (c) a wholly-owned subsidiary of that company,

if particulars of that loan, quasi-loan or agreement for it would not have been required to be included in that company's annual accounts if the first-mentioned body corporate had not been associated with a director of that company at any time during the relevant period.

### ***[Excluded transactions]***

[24.] (1) In relation to a company's accounts for a financial year, compliance with this Part is not required in the case of transactions of a kind mentioned in the following subparagraph which are made by the company or a subsidiary of it for a person who at any time during that financial year was a director of the company or of its holding company, or was connected with such a director, if the aggregate of the values of each transaction, arrangement or agreement so made for that director or any person connected with him, less the amount (if any) by which the liabilities of the person for whom the transaction or arrangement was made has been reduced, did not at any time during the financial year exceed £5,000.

(2) The transactions in question are—

- (a) credit transactions,
- (b) guarantees provided or securities entered into in connection with credit transactions,
- (c) arrangements within subsection (6) or (7) of section 330 relating to credit transactions,
- (d) agreements to enter into credit transactions.

[25.] In relation to a company's accounts for a financial year, compliance with this Part is not required by virtue of paragraph [15](c) or [16](c) in the case of any transaction or arrangement with a company or any of its subsidiaries in which a director of the company or its holding company had, directly or indirectly, a material interest if—

- (a) the value of each transaction or arrangement within paragraph [15](c) or [16](c) (as the case may be) in which that director had (directly or indirectly) a material interest and which was made after the commencement of the financial year with the company or any of its subsidiaries, and
- (b) the value of each such transaction or arrangement which was made before the commencement of the financial year less the amount (if any) by which the liabilities of the person for whom the transaction or arrangement was made have been reduced,

did not at any time during the financial year exceed in the aggregate £1,000 or, if more, did not exceed £5,000 or 1 per cent of the value of the net assets of the company preparing the accounts in question as at the end of the financial year, whichever is the less.

For this purpose a company's net assets are the aggregate of its assets, less the aggregate of its liabilities ("liabilities" to include any provision for liabilities or charges within paragraph 89 of Schedule 4).

[26.] Section 345 of this Act (power of Secretary of State to alter sums by statutory instrument subject to negative resolution in Parliament) applies as if the money sums specified in paragraph [24] or [25] above were specified in Part X.

### ***Interpretation***

[27.] [(1)] The following provisions of this Act apply for purposes of this Part of this Schedule—

- (a) section 331(2), . . . and (7), as regards the meaning of “guarantee”, . . . and “credit transaction”;
- (b) section 331(9), as to the interpretation of references to a transaction or arrangement being made “for” a person;
- (c) section 340, in assigning values to transactions and arrangements, and
- (d) section 346, as to the interpretation of references to a person being “connected with” a director of a company.

[(2) In this Part of this Schedule “director” includes a shadow director.]

### **[PART III: OTHER TRANSACTIONS, ARRANGEMENTS AND AGREEMENTS]**

[28.] This Part of this Schedule applies in relation to the following classes of transactions, arrangements and agreements—

- (a) loans, guarantees and securities relating to loans, arrangements of a kind described in subsection (6) or (7) of section 330 of this Act relating to loans and agreements to enter into any of the foregoing transactions and arrangements;
- (b) quasi-loans, guarantees and securities relating to quasi-loans, arrangements of a kind described in either of those subsections relating to quasi-loans and agreements to enter into any of the foregoing transactions and arrangements;
- (c) credit transactions, guarantees and securities relating to credit transactions, arrangements of a kind described in either of those subsections relating to credit transactions and agreements to enter into any of the foregoing transactions and arrangements.

[29.] - (1) To comply with this Part of this Schedule, the accounts must contain a statement, in relation to transactions, arrangements and agreements [made by the company or a subsidiary of it for persons who at any time during the financial year were officers of the company (but not directors or shadow directors)], of—

- (a) the aggregate amounts outstanding at the end of the financial year under transactions, arrangements and agreements within sub-paragraphs (a), (b) and (c) respectively of paragraph [28] above, and
- (b) the numbers of officers for whom the transactions, arrangements and agreements falling within each of those sub-paragraphs were made.

(2) This paragraph does not apply to transactions, arrangements and agreements made by the company or any of its subsidiaries for an officer of the company if the aggregate amount outstanding at the end of the financial year under the transactions, arrangements and agreements so made for that officer does not exceed £2,500.

(3) Section 345 of this Act (power of Secretary of State to alter money sums by statutory instrument subject to negative resolution in Parliament) applies as if the money sum specified above in this paragraph were specified in Part X.

[30.] The following provisions of this Act apply for purposes of this Part—

- (a) section 331(2), (3), . . . and (7), as regards the meaning of “guarantee”, “quasi-loan”, . . . and “credit transaction”, and

(b) section 331(9), as to the interpretation of references to a transaction or arrangement being made "for" a person;

and "amount outstanding" means the amount of the outstanding liabilities of the person for whom the transaction, arrangement or agreement was made or, in the case of a guarantee or security, the amount guaranteed or secured.

## COMPANIES ACT 1985, SCHEDULE 9, PART IV

### [PART IV: ADDITIONAL DISCLOSURE: EMOLUMENTS AND OTHER BENEFITS OF DIRECTORS AND OTHERS

1. The provisions of this Part of this Schedule have effect with respect to the application of Schedule 6 (additional disclosure: emoluments and other benefits of directors and others) to a banking company or [the holding company of a credit institution].

#### *Loans, quasi-loans and other dealings*

[2. Where a banking company, or a company which is the holding company of a credit institution, prepares annual accounts for a financial year, it need not comply with the provisions of Part II of Schedule 6 (loans, quasi-loans and other dealings) in relation to a transaction or arrangement of a kind mentioned in section 330, or an agreement to enter into such a transaction or arrangement, to which that banking company or (as the case may be) credit institution is a party.]

#### *Other transactions, arrangements and agreements*

3. (1) [Where a banking company, or a company which is the holding company of a credit institution, takes advantage of the provisions of paragraph 2 of this Part of this Schedule for the purposes of its annual accounts for a financial year, then, in preparing those accounts, it shall comply with the provisions of Part III of Schedule 6 (other transactions, arrangements and agreements) only in relation to a transaction, arrangement or agreement made by that banking company or (as the case may be) credit institution for —]

- (a) a person who was a director of the company preparing the accounts or who was connected with such a director, or
- (b) a person who was a chief executive or manager (within the meaning of the Banking Act 1987) of that company or its holding company.

(2) References in that Part to officers of the company shall be construed accordingly as including references to such persons.

(3) In this paragraph "director" includes a shadow director.

(4) For the purposes of that Part as it applies by virtue of this paragraph, a [body corporate] which a person does not control shall not be treated as connected with him.

(5) Section 346 of this Act applies for the purposes of this paragraph as regards the interpretation of references to a person being connected with a director or controlling a [body corporate.]



## COMPANIES ACT 1985, SCHEDULE 13

### PROVISIONS SUPPLEMENTING AND INTERPRETING SECTIONS 324 TO 328

#### PART I: RULES FOR THE INTERPRETATION OF THE SECTIONS AND ALSO SECTION 346 (4) AND (5)

1.—(1) A reference to an interest in shares or debentures is to be read as including any interest of any kind whatsoever in shares or debentures.

(2) Accordingly, there are to be disregarded any restraints or restrictions to which the exercise of any right attached to the interest is or may be subject.

2.— Where property is held on trust and any interest in shares or debentures is comprised in the property, any beneficiary of the trust who (apart from this paragraph) does not have an interest in the shares or debentures is to be taken as having such an interest; but this paragraph is without prejudice to the following provisions of this Part of this Schedule.

3.—(1) A person is taken to have an interest in shares or debentures if—

- (a) he enters into a contract for their purchase by him (whether for cash or other consideration), or
- (b) not being the registered holder, he is entitled to exercise any right conferred by the holding of the shares or debentures, or is entitled to control the exercise of any such right.

(2) For purposes of sub-paragraph (1)(b), a person is taken to be entitled to exercise or control the exercise of a right conferred by the holding of shares or debentures if he—

- (a) has a right (whether subject to conditions or not) the exercise of which would make him so entitled, or
- (b) is under an obligation (whether or not so subject) the fulfilment of which would make him so entitled.

(3) A person is not by virtue of sub-paragraph (1)(b) taken to be interested in shares or debentures by reason only that he—

- (a) has been appointed a proxy to vote at a specified meeting of a company or of any class of its members and at any adjournment of that meeting, or
- (b) has been appointed by a corporation to act as its representative at any meeting of a company or of any class of its members.

4.— A person is taken to be interested in shares or debentures if a body corporate is interested in them and—

- (a) that body corporate or its directors are accustomed to act in accordance with his directions or instructions, or
- (b) he is entitled to exercise or control the exercise of one-third or more of the voting power at general meetings of that body corporate.

As this paragraph applies for the purposes of section 346(4) and (5), “more than one-half” is substituted for “one-third or more”.

5.— Where a person is entitled to exercise or control the exercise of one-third or more of the voting power at general meetings of a body corporate, and that body corporate is entitled to exercise or control the exercise of any of the voting power at general meetings of another body corporate (“the effective voting power”), then, for purposes of paragraph 4(b), the effective voting power is taken to be exercisable by that person.

As this paragraph applies for the purposes of section 346(4) and (5), “more than one-half” is substituted for “one-third or more”.

6.—(1) A person is taken to have an interest in shares or debentures if, otherwise than by virtue of having an interest under a trust—

- (a) he has a right to call for delivery of the shares or debentures to himself or to his order, or
- (b) he has a right to acquire an interest in shares or debentures or is under an obligation to take an interest in shares or debentures;

whether in any case the right or obligation is conditional or absolute.

(2) Rights or obligations to subscribe for shares or debentures are not to be taken, for purposes of sub-paragraph (1), to be rights to acquire, or obligations to take, an interest in shares or debentures.

This is without prejudice to paragraph 1.

7.— Persons having a joint interest are deemed each of them to have that interest.

8.— It is immaterial that shares or debentures in which a person has an interest are unidentifiable.

9.— So long as a person is entitled to receive, during the lifetime of himself or another, income from trust property comprising shares or debentures, an interest in the shares or debentures in reversion or remainder or (as regards Scotland) in fee, are to be disregarded.

10. —A person is to be treated as uninterested in shares or debentures if, and so long as, he holds them under the law in force in England and Wales as a bare trustee or as a custodian trustee, or under the law in force in Scotland, as a simple trustee.

11.— There is to be disregarded an interest of a person subsisting by virtue of—

- [(a) any unit trust scheme which is an authorised unit trust scheme within the meaning of the Financial Services Act 1986];
- (b) a scheme made under section 22 [or 22A] of the Charities Act 1960 [or section 24 or 25 of the Charities Act 1993], section 11 of the Trustee Investments Act 1961 or section 1 of the Administration of Justice Act 1965; or
- (c) the scheme set out in the Schedule to the Church Funds Investment Measure 1958.

12. — There is to be disregarded any interest—

- (a) of the Church of Scotland General Trustees or of the Church of Scotland Trust in shares or debentures held by them;
- (b) of any other person in shares or debentures held by those Trustees or that Trust otherwise than as simple trustees.

“The Church of Scotland General Trustees” are the body incorporated by the order confirmed by the Church of Scotland (General Trustees) Order Confirmation Act 1921; and “the Church of Scotland Trust” is the body incorporated by the order confirmed by the Church of Scotland Trust Order Confirmation Act 1932.

13.— Delivery to a person’s order of shares or debentures in fulfilment of a contract for the purchase of them by him or in satisfaction of a right of his to call for their delivery, or failure to deliver shares or debentures in accordance with the terms of such a contract or on which such a right falls to be satisfied, is deemed to constitute an event in

consequence of the occurrence of which he ceases to be interested in them, and so is the lapse of a person's right to call for delivery of shares or debentures.

**PART II: PERIODS WITHIN WHICH OBLIGATIONS IMPOSED BY SECTION 324 MUST BE FULFILLED**

14.—(1) An obligation imposed on a person by section 324(1) to notify an interest must, if he knows of the existence of the interest on the day on which he becomes a director, be fulfilled before the expiration of the period of 5 days beginning with the day following that day.

(2) Otherwise, the obligation must be fulfilled before the expiration of the period of 5 days beginning with the day following that on which the existence of the interest comes to his knowledge.

15.—(1) An obligation imposed on a person by section 324(2) to notify the occurrence of an event must, if at the time at which the event occurs he knows of its occurrence and of the fact that its occurrence gives rise to the obligation, be fulfilled before the expiration of the period of 5 days beginning with the day following that on which the event occurs.

(2) Otherwise, the obligation must be fulfilled before the expiration of a period of 5 days beginning with the day following that on which the fact that the occurrence of the event gives rise to the obligation comes to his knowledge.

16.— In reckoning, for purposes of paragraphs 14 and 15, any period of days, a day that is a Saturday or Sunday, or a bank holiday in any part of Great Britain, is to be disregarded.

**PART III: CIRCUMSTANCES IN WHICH OBLIGATION IMPOSED BY SECTION 324 IS NOT DISCHARGED**

17.—(1) Where an event of whose occurrence a director is, by virtue of section 324(2)(a), under obligation to notify a company consists of his entering into a contract for the purchase by him of shares or debentures, the obligation is not discharged in the absence of inclusion in the notice of a statement of the price to be paid by him under the contract.

(2) An obligation imposed on a director by section 324(2)(b) is not discharged in the absence of inclusion in the notice of the price to be received by him under the contract.

18.—(1) An obligation imposed on a director by virtue of section 324(2)(c) to notify a company is not discharged in the absence of inclusion in the notice of a statement of the consideration for the assignment (or, if it be the case that there is no consideration, that fact).

(2) Where an event of whose occurrence a director is, by virtue of section 324(2)(d), under obligation to notify a company consists in his assigning a right, the obligation is not discharged in the absence of inclusion in the notice of a similar statement.

19.—(1) Where an event of whose occurrence a director is, by virtue of section 324(2)(d), under obligation to notify a company consists in the grant to him of a right to subscribe for shares or debentures, the obligation is not discharged in the absence of inclusion in the notice of a statement of—

- (a) the date on which the right was granted,
- (b) the period during which or the time at which the right is exercisable,
- (c) the consideration for the grant (or, if it be the case that there is no consideration, that fact), and

(d) the price to be paid for the shares or debentures.

(2) Where an event of whose occurrence a director is, by section 324(2)(d), under obligation to notify a company consists in the exercise of a right granted to him to subscribe for shares or debentures, the obligation is not discharged in the absence of inclusion in the notice of a statement of—

- (a) the number of shares or amount of debentures in respect of which the right was exercised, and
- (b) if it be the case that they were registered in his name, that fact, and, if not, the name or names of the person or persons in whose name or names they were registered, together (if they were registered in the names of 2 persons or more) with the number or amount registered in the name of each of them.

20.— In this Part, a reference to price paid or received includes any consideration other than money.

#### **PART IV: PROVISIONS WITH RESPECT TO REGISTER OF DIRECTORS' INTERESTS TO BE KEPT UNDER SECTION 325**

21.— The register must be so made up that the entries in it against the several names appear in chronological order.

22.— An obligation imposed by section 325(2) to (4) must be fulfilled before the expiration of the period of 3 days beginning with the day after that on which the obligation arises; but in reckoning that period, a day which is a Saturday or Sunday or a bank holiday in any part of Great Britain is to be disregarded.

23.— The nature and extent of an interest recorded in the register of a director in any shares or debentures shall, if he so requires, be recorded in the register.

24.— The company is not, by virtue of anything done for the purposes of section 325 or this Part of this Schedule, affected with notice of, or put upon enquiry as to, the rights of any person in relation to any shares or debentures.

25.— The register shall—

- (a) if the company's register of members is kept at its registered office, be kept there;
- (b) if the company's register of members is not so kept, be kept at the company's registered office or at the place where its register of members is kept;

and shall ... be open to the inspection of any member of the company without charge and of any other person on payment of [such fee as may be prescribed].

26.—(1) Any member of the company or other person may require a copy of the register, or of any part of it, on payment of [such fee as may be prescribed].

(2) The company shall cause any copy so required by a person to be sent to him within the period of 10 days beginning with the day after that on which the requirement is received by the company.

27.— The company shall send notice in the prescribed form to the registrar of companies of the place where the register is kept and of any change in that place, save in a case in which it has at all times been kept at its registered office.

28.— Unless the register is in such a form as to constitute in itself an index, the company shall keep an index of the names inscribed in it, which shall—

- (a) in respect of each name, contain a sufficient indication to enable the information entered against it to be readily found; and
- (b) be kept at the same place as the register;

and the company shall, within 14 days after the date on which a name is entered in the register, make any necessary alteration in the index.

29.— The register shall be produced at the commencement of the company's annual general meeting and remain open and accessible during the continuance of the meeting to any person attending the meeting.

# **APPENDIX D**

## **LIST OF RESPONDENTS TO CONSULTATION PAPER NO 153/ DISCUSSION PAPER NO 105**

### **Judges**

Lord Justice Chadwick

Mr Justice G L Davies (Court of Appeal, Queensland, Australia)

Lord Hoffmann

Lord Millett

Mr Justice G K F Santow (Supreme Court of New South Wales, Australia)

### **Solicitors**

Richard Allnutt (Simmons & Simmons)

Alan Berg

James Birrell (Shepherd & Wedderburn WS, SLC Advisory Group)

Marian J Boyle (Denton Hall)

Harriet Creamer (Freshfields)

Lawrence Collins QC (Herbert Smith)

Peter Graham

Christopher Hale (Travers Smith Braithwaite)

H W Higginson

The Law Society (Company Law Committee)

The Law Society of Scotland

James Lewis (Titmuss Sainer Dechert)

Michael Livingston (Maclay, Murray & Spens, SLC Advisory Group)

Michael Mathews (Clifford Chance)

A J Mezzetti (Gregory Rowcliffe & Milners)

Philip L R Mitchell (Druces & Attlee)

Morag McNeill (McGrigor Donald, SLC Advisory Group)

Giles Ridley (Slaughter & May)

Royal Faculty of Procurators (Glasgow)

Scottish Law Agents' Society

Dr Stephen Kenyon-Slade (Shearman & Sterling)

William Simmons (Tods Murray WS, SLC Advisory Group)

Campbell Smith (Biggart Baillie, SLC Advisory Group)

George Staple QC (Clifford Chance)

Richard Smerdon (Osborne Clarke)

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T M Ashe QC (9 Stone Buildings, Lincoln's Inn)

The Commercial Bar Association

Michael Crystal QC (3/4 South Square, Gray's Inn)

Anthony Ellera QC (St James's Chambers, Manchester)

The Faculty of Advocates (Edinburgh)

Ian Leeming QC (9 St John Street, Manchester)

David Mabb (Erskine Chambers, Lincoln's Inn Fields)

Simon Mortimore QC (3/4 South Square, Gray's Inn)

Howard Page QC (One Hare Court, Temple)

Robin Potts QC (Erskine Chambers, Lincoln's Inn Fields)

David Richards QC (Erskine Chambers, Lincoln's Inn Fields)

David Sellar (Advocate, Edinburgh, SLC Advisory Group)

Sir Thomas Stockdale (Erskine Chambers, Lincoln's Inn Fields)

Richard Sykes QC (Erskine Chambers, Lincoln's Inn Fields)

### **Academic Lawyers and Research Groups**

Richard Alexander (Institute of Advanced Legal Studies)

Emilios Avgouleas (Centre for Law and Business, University of Manchester)

Margarita Sweeney-Baird (University of Birmingham Business School)

Robert Bertram (Heriot-Watt & Edinburgh Universities, SLC Advisory Group)

Professor John Birds (University of Sheffield)

Professor A J Boyle (Queen Mary & Westfield College, University of London)

Professor Brian R Cheffins (SJ Berwin Professor of Corporate Law, Cambridge University)

Professor Victor Brudney (Weld Professor of Law, Harvard University, USA)

Stephen Copp (European Centre for Corporate Governance, Bournemouth University)

Professor Paul L Davies (Cassel Professor of Commercial Law, London School of Economics)

I J Dawson (University of Newcastle)

Professor Deborah DeMott (Duke University, USA)

Professor Janet Dine (University of Essex)

Luca Enriques (Università Bocconi, Milan, Italy)

Faculty of Law Working Party (University of Aberdeen)  
Dr Eilís Ferran (St Catharine's College, Cambridge University)  
Judith Freedman (London School of Economics)  
Stephen Griffin (University of Wales, Aberystwyth)  
Andrew Griffiths (Centre for Law and Business, University of Manchester)  
Jason Haines (Research Fellow, Institute of Advanced Legal Studies)  
Professor Hannigan (Southampton University)  
Andrew Hicks (University of Exeter)  
Professor Klaus J Hopt (Max-Planck-Institut, Hamburg, Germany)  
Professor S Letza (European Centre for Corporate Governance, Bournemouth University)  
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Dr Leslie J Moran (Birkbeck College, University of London)  
Dr Chizu Nakajima (City University Business School)  
Richard Nolan (St John's College, Cambridge University)  
Professor J E Parkinson University of Bristol  
Professor Dan Prentice (Pembroke College, Oxford University & Erskine Chambers)  
Giles Proctor (Manchester Metropolitan University)  
Professor Rees (Institute of Advanced Legal Studies)  
C A Riley (University of Newcastle)  
Lee Roach (University of Bristol)  
Professor Dr Erich Schanze (Professor of Private, Comparative and International Business Law, Philipps-Universität Marburg, Germany)  
Len Sealy (University of Cambridge)  
Professor Sir John Smith, CBE, QC, FBA, (University of Nottingham)  
G S Stapledon (University of Melbourne, Australia)  
Charlotte Villiers (Centre for Research into Law Reform, University of Glasgow)  
Professor Lord Wedderburn of Charlton QC, FBA (London School of Economics)  
Professor Sally Wheeler (University of Leeds)  
Dr C J Whelan (University of Warwick)  
Gary Wilson (University of Leeds)  
Professor F Wooldridge (Notre Dame University, London)  
Sarah Worthington (LSE)



**Accountants**

KPMG

PricewaterhouseCoopers

**Companies and Representative Organisations**

Barclays plc

British Airways

CISCO

Confederation of British Industry

Federation of Small Businesses

GKN plc

Jordans Limited

NatWest Group

Rio Tinto plc

**Company Directors, Company Secretaries and Representative Organisations**

Peter Van Duzer (Company Secretary & Senior Solicitor, Jordans Ltd)

Rodney Insall (Controller, Company Secretary's Office, British Petroleum Company plc)

Institute of Chartered Secretaries & Administrators

Institute of Directors

Christina McLellan (Director, The Zarak Group)

Colin Perry (Chairman & CEO, LTE Scientific Ltd)

**Other Organisations and Representative Organisations**

Association of British Insurers

The Association of Chartered Certified Accountants

British Bankers' Association

The Charity Commission for England and Wales

Institute of Chartered Accountants in England & Wales

The Institute of Chartered Accountants of Scotland

National Association of Pension Funds

Panel Executive of the Panel on Takeovers and Mergers

Pensions Investment Research Consultants Ltd

Society of Practitioners of Insolvency

The Royal Institution of Chartered Surveyors

London Stock Exchange Limited

Trades Union Congress

UK Shareholders' Association

**Government Departments and Organisations**

Committee on Standards in Public Life

Crown Prosecution Service

Financial Services Authority

Insolvency Service

Law Reform Advisory Committee for Northern Ireland

Law Reform & Tribunals Policy Division, Lord Chancellor's Department

Serious Fraud Office

The Treasury Solicitor's Office

**Individuals**

Colin Bamford (Chief Executive, Financial Law Panel)

Jonathan Bates (British Petroleum Company plc)

Allan Cook (Technical Director, Accounting Standards Board)

R W B Davies (Hiscox Syndicates Ltd)

Jeff Fisher (Head of Corporate Law, BT Group)

Ian West (R E Brown & Others, Syndicate 702, Lloyds)

Rosalind Wright (Director, Serious Fraud Office)