# Directors' Duties: Empirical Findings

Report to the Law Commissions

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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.[1] 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

[1] 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.[2] 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).

[2] 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**

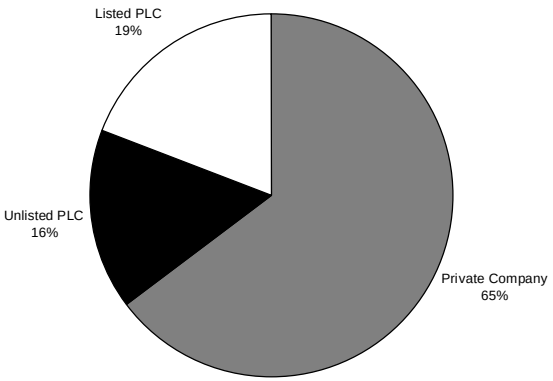



**Chart 2 - The Sample Classified by Company Type**

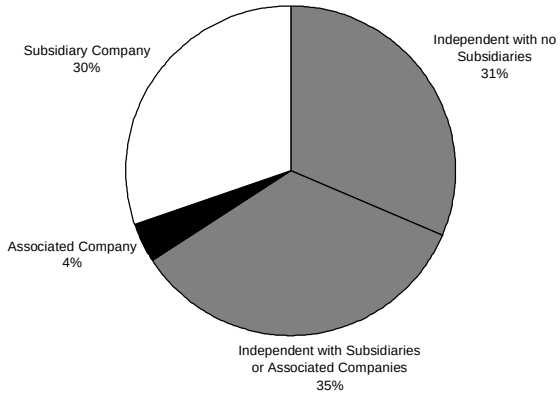



**Chart 3 - The Respondents by Type of Position held**

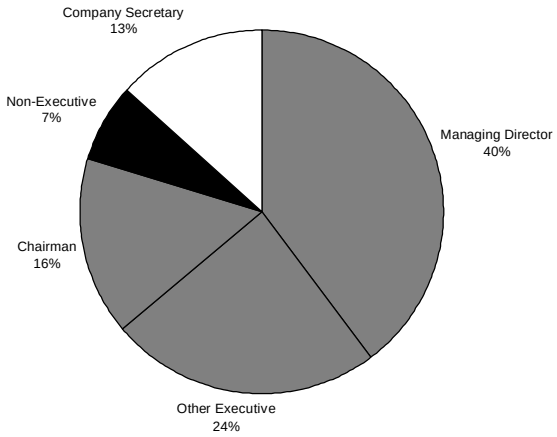
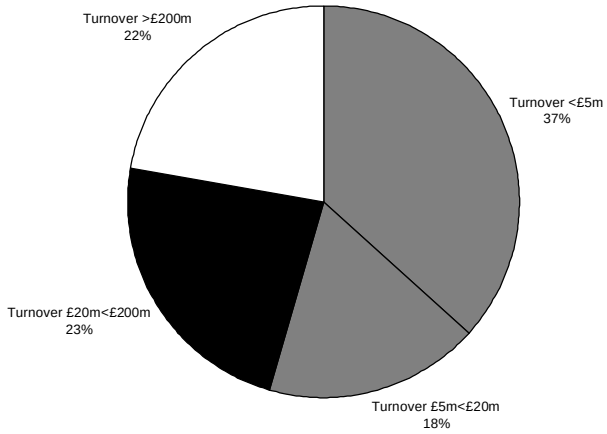



**Chart 4 - The Size of Independent Companies in the Sample**



When we analyse differences in responses between these sub categories we use standard statistical techniques to test for their statistical significance.[3] 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[4]. 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

[3] 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*, 2nd Edition (New York: John Wiley & Sons, 1980)).

[4] 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.[5] 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

[5] 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.[6]

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'

[6] See F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991).

firms in the United Kingdom.[7]

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 unisted 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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[7] 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 takes 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.[8]

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.

[8] 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 |
| % No Service Contracts | 34 | 58 ** | 22 | 25 | 13 | 43 ** | 3 | 59 ** | 12 | 43 ** | 24 | 62 ** | 13 | 13 | 16 ** | 47 |
| % Don't Know | 1 | 1 | 1 | 1 | 0 | 1 | 1 | 1 | 0 | 1 | 1 | 1 | 0 | 1 | 1 | 0 |
| 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)**

| | All | | Turnover Size Group (£m) | | | | Type of Company | | Number of Directors | | Number of Board Meetings | | Proportion of Non-Executives | | | Board Shareholding | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Length of Contract | 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% |
| 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 |
| 1year | 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 |
| 2years | 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 % |
| **Always Disclosed to (%)** | | | | | | | | | | | | | | | | |
| 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 |
| **Always or sometimes disclosed to (%)** | | | | | | | | | | | | | | | | |
| 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% |
| **Always approved by (%)** | | | | | | | | | | | | | | | | |
| 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 |
| **Always or sometimes approved by (%)** | | | | | | | | | | | | | | | | |
| 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.[9]

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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[9] 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% |
| **Always Seeking Shareholder Approval for** | | | | | | | | | | | | | | | | |
| 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 |
| **Always or Sometimes Seeking Shareholder Approval for** | | | | | | | | | | | | | | | | |
| 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, the 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*[10] – 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

[10] *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**

| | All | Turnover Size Group (£m) | | | | Type of Company | | Number of Directors | | Number of Board Meetings | | Proportion of Non-Executives | | | Board Shareholding | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| % Preferring | | <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 |
| Total | 856 | 309 | 152 | 200 | 193 | 669 | 182 | 398 | 452 | 421 | 417 | 360 | 268 | 215 | 343 | 347 |

*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% |
| **% yes to** | | | | | | | | | | | | | | | | |
| 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.

Restitutionary 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 that 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**

| | England | | | Scotland | | | Northern Ireland | | |
|---|---|---|---|---|---|---|---|---|---|
| Turnover Size Class | 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**

| % Preferring | Executives | Non-executives |
|---|---|---|
| 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**

| | Executives | Non-executives |
|---|---|---|
| % 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**

| | Executives | Non-executives |
|---|---|---|
| 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)**

| | Executives | Non-executives |
|---|---|---|
| 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)**

| | Executives | Non-executives |
|---|---|---|
| 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**

| | Executives | Non-executives |
|---|---|---|
| % yes | 62 | 58 |
| Total respondents | 669 | 114 |
| Missing values | 14 | 2 |
| Total | 683 | 116 |

**A9 Options for Use of Statement Related to Duties**

| % yes to | Executives | Non-executives |
|---|---|---|
| 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**

## SECTION A GENERAL INFORMATION ABOUT YOU AND YOUR COMPANY

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 | |
| A public limited company with a listing on the London Stock Exchange | |
| A public limited company without a listing on the London Stock Exchange | |

2. Is your company one of the following? (Please tick one box)

| | |
|---|---|
| An independent company with no subsidiaries or associated companies | |
| A parent company | |
| An associated company | |
| A subsidiary company | |

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 | Yes No |
| Other executive director | Yes No |
| Chairman | Yes No |
| Non-executive director | Yes No |
| Company secretary | Yes No |

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? ..... |

## 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.

.....

.....

.....

## SECTION C DIRECTORS' SERVICE CONTRACTS

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?..... £

## 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.