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Reimagining the Role, Duties and Liabilities of Non-Executive Directors in 2020; 15 Years of the Companies Act 2006 and the Pathway to the UK Corporate Governance Code 2018. Part two: the Most Current Approach.

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Key Terms: Directors, Non-Executive Directors, UK Corporate Governance Code 2018, Companies Act 2006, Coronavirus 2020, Duties and Liabilities, English Law.

## **Introduction**

The extent to which, if at all, Non-Executive Directors (NED) and Shadow Directors (SD) owe duties and liabilities to a company under English law has been the subject of rigorous debate between lawyers for many years. In contrast, the duties and liabilities of Executive Directors (ED) under English law were quite well defined. Part one of this duo of articles explored how the Companies Act 2006 put those duties and liabilities on a statutory footing rendering the distinction between the two types of directors defunct. Part two examines whether the role of the NED, in corporate governance terms, has been strengthened by the UK Corporate Governance Code 2018 which focusses on modern notions of enlightened shareholder value, long-term sustainability and pandemic response (Coronavirus). Embedding the former into codified director duties as part of the new Companies Act was a popular recommendation that was adopted in the 2006 statute by the UK government.<sup>4</sup> The rationale behind the current changes made to the role of the NED in the Corporate Governance Code 2018 and how, if at all, this impacts on the director duties set out in the 2006 statute.

## The Role of Company Directors in the United Kingdom

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<sup>4</sup> House of Commons Trade and Industry Committee. The White Paper on Modernising Company Law. 2003. CM 5553-I. London: HMSO. Pp.7 – 8.

Before considering the changes made by the Corporate Governance Code 2018, we start by summarising the definitions of director types that are the subject of this research.

### Executive Directors (ED)

Part 10A of the Companies Act 2006 deals with directors. Whilst the provisions set out some of the requirements i.e. appointment, minimum age and residence (etc.), and the duties they do not define the 'director', a matter that will be discussed in more depth later given its expansion in the application of the law to EDs, NEDs and Shadow Directors (SD). Section 250 of the Companies Act 2006 states that a director 'includes any person occupying the position of director, by whatever name called.' In short, these are the person(s) responsible for the management of a company set up in accordance with English Law.<sup>5</sup>

### Shadow Directors (SD)

Section 251 of the CA 2006, as amended by the Small Business, Enterprise and Employment Act 2015 (SBEEA), provides that a shadow director is 'a person in accordance with whose directions or instructions the directors of the company are accustomed to act.'<sup>6</sup> SDs may not wish to be identified as directors for a number of reasons; they may for instance be disqualified.<sup>7</sup> In *Re Hydrodam (Corby Ltd)*<sup>8</sup> Millet J described

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<sup>5</sup> It is salient to note that the directors of charities are known as 'trustees', that said they are also subject to the Companies Act 2006 and the relevant duties but are also subject to Charity Law and other regulation. For an interesting cross-jurisdictional comparison on directors' duties see: Ma, F. (2014). Director's Duties in China: The Corporate Opportunity Doctrine. *The Company Lawyer*, 35(11), 340-346. [Accessed 29 April 2020].

<sup>6</sup> Sections 90(3) and 164(3)(g)(iii) of the Small Business, Enterprise and Employment Act 2015 (SBEEA) amended s.251(2) of the Companies Act 2006. Subsection (2) provides that a 'person is not to be regarded as a shadow director by reason only that the directors act ... (a) on advice given by that person in a professional capacity; (b) in accordance with instructions, a direction, guidance or advice given by that person in the exercise of a function conferred by or under an enactment; (c) in accordance with guidance or advice given by that person in that person's capacity as a Minister of the Crown (within the meaning of the Ministers of the Crown Act 1975) ... (3) A body corporate is not to be regarded as a shadow director of any of its subsidiary companies for the purposes of ... Chapter 2 (general duties of directors) ... by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions.' Note also: Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business. BIS/13/959. This is a discussion paper by the Department of Business, Innovation and Skills (BIS) from July 2013, it focusses on proposals to reform company law in the United Kingdom so that those in actual control of a company could be properly held to account. The paper discusses the control exercised by nominee directors but not SDs.

<sup>7</sup> Disqualification of directors may take place under the Company Directors Disqualification Act 1996 and may be for a variety of reasons i.e. misconduct (s.2 – 5A), unfitness (s.6 – 8), wrongful trading (s.10) and competition infringements (s.9A).

<sup>8</sup> [1994] B.C.C. 161; [1994] 2 BCLC 180. In this case it was decided that liability for wrongful trading extended to de-facto, de-jure and shadow directors. It was also stated

SDs as 'He [who] lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself.'<sup>9</sup>

In the *Secretary of State for Trade and Industry v Deverell*,<sup>10</sup> Morritt, L. J. gave what is considered, in practise, to be the leading judicial analysis of shadow directors stressing that '... interpretation [of what amounts to shadow directorship] may depend on the statutory context (e.g. a stricter construction may be more appropriate in a criminal or quasi-criminal provision); that the purpose of the legislation is to identify those with 'real influence' in the corporate affairs of the company, or part of them; that advice (other than professional advice) is capable of coming within the phrase 'directions or instructions'; and that it is not necessary that the board should be reduced to a subservient role or surrender its discretion'.<sup>11</sup>

In *Ultraframe (UK) Ltd v Fielding* (2005)<sup>12</sup> the court held that SDs do not 'normally' owe duties. However, s.170(5) of the CA 2006 now provides that the 'general duties [of directors] apply to a shadow director of a company where and to the extent that they are capable of so applying.'<sup>13</sup> The offending terms 'where and to the extent that they are capable of so applying' has resulted in the application of those duties and liabilities being limited. It is salient to note that an individual can become a SDs even where his or her directions or instructions do not cover, all or most of the company's affairs or activities. The practical effect of the s.170(5) has been to limit the instances in which SD owes the company a fiduciary duty to the nature and extent of the directions or instructions given.

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that a shadow director and de-facto director are mutually exclusive terms. Section 251(3) of the CA 2006 adopts the position from *Hydrodam* that directors of a parent company are not necessarily shadow directors of a subsidiary.

<sup>9</sup> *Ibid* note 8, *Hydrodam* at paragraph 163.

<sup>10</sup> [2001] Ch. 340.

<sup>11</sup> Palmer, F. B. and Morse, G. (2020). *Palmer's Company Law*. Volume 2. London, England: Sweet and Maxwell. See: Part 8, chapter 8.217. [Accessed 09 May 2020].

<sup>12</sup> [2005] EWHC 2506 (Ch). Note, this case fell within the Companies Act 1985, in particular matters related to s.741(2). See also: *Yukong Line of Korea Ltd v Rendsburg Corp Investments of Liberia Inc* [1998] 1 WLR 294, here the SD was a de-facto director and therefore the consideration of SD duties and liabilities must be set against that.

<sup>13</sup> Section 170(5) in its original form stated that 'the general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles so apply'. This was amended to its current form by the SBEEA 2015. The explanatory note to the 2015 Act reads; '603. At present the general duties of directors can only apply to shadow directors in the same way as the corresponding common law rules and equitable principles can. In future, the starting point for shadow directors will be that the general duties apply to them unless they are not capable of applying (removing the current restriction). This is achieved by replacing section 170(5) of the CA 2006. This change in default position is neither intended to preclude the courts from looking at the application of the duties on a case by case basis, nor from drawing on existing case law in any given case.'

Contrary to academic discourse<sup>14</sup> suggesting otherwise, the CA 2006 does not extend to them the full range of duties and obligations that are owed by both EDs and NEDs to SDs.

In contrast to *Ultraframe*, in *Vivendi SA v Richards* (2013)<sup>15</sup> it was held that they 'should owe duties ... at [the very] least to some degree'. The court clarified that the duty of loyalty (good faith) in what the SD considers to be the best interests of the company<sup>16</sup> will apply when he or she is giving directions or instructions, but also that this is a matter for the court to decide on the merits of each individual case.<sup>17</sup> Although the matter in *Vivendi* concerned de-jure directors the reasoning shed some light on how the courts approach the question of an SDs duties and the interpretation of s.170(5); any person that gives directions or instructions to a company's directors with the belief that they will act upon them can be said to have assumed responsibility for those affairs.

It is interesting to note that s.89(3) of SBEEA 2015 allows for the '...prescribed general duties of directors to apply to shadow directors with such adaptations as may be prescribed; (b) for prescribed general duties of directors not to apply to shadow directors.' The duties may therefore be made applicable in an adapted form, and of course inapplicable, but there has been no move towards this to date.

*Standish v The Royal Bank of Scotland Plc*<sup>18</sup> demonstrates the current position in law, as at 2019, but there is still a lack of clarity. In this case the court has held that there must be a causal link between the factors that give rise to a shadow directorship (directions or instructions) and the alleged wrong or loss, only then will the SD have breached, in relation to that, his or her duty to the company.<sup>19</sup> For practical purposes is it advisable for SDs, per English law, to act in accordance with the same duties that are imposed upon a de-jure director.

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<sup>14</sup> Moore, C. (2016). Obligations in the shade: The application of fiduciary directors' duties to shadow directors. *Legal Studies*, 36(2), 326-353. See also: Witney, S. (2016). Duties owed by shadow directors: closing in on the puppet masters? *Journal of Business Law*. UK: Sweet and Maxwell.

<sup>15</sup> [2017] EWHC 1581 (Ch).

<sup>16</sup> *Smithton Limited v Naggar* [2013] EWHC 1961 (Ch). Note: other than in the instances discussed the definition of a shadow director in English Company Law is still unclear.

<sup>17</sup> There are a number of express requirements in the CA 2006 that state SDs will be liable in the same manner as de-jure directors i.e. director disqualification and declaration of interests in existing transactions.

<sup>18</sup> [2019] EWHC 3116 (Ch). See also: *ibid* *Smithton*, note 16.

<sup>19</sup> S89(2) of the Small Business, Enterprise and Employment Act 2015 allows the secretary to state to '...by regulations make provision about the application of the general duties of directors to shadow directors. [S.89](3) The regulations may, in particular, make provision, (a) for prescribed general duties of directors to apply to shadow directors with such adaptations as may be prescribed; (b) for prescribed general duties of directors not to apply to shadow directors.'

## Non-Executive Directors (NED)<sup>20</sup>

In summary, the role of the NED as at 2020 has been strengthened. They must provide leadership, be involved in strategic decision making including the review of management performance and reporting of the same. They should also help set a company's values and standards. The purpose is also to lend objective and constructive challenge and aid the development of strategy. NEDs are involved in determining the remuneration of the EDs and appointing or removing senior management as well as planning for succession. They contribute to the management of risk and should be satisfied with the accuracy of financial information and adequacy of financial controls; such matters will be discussed with reference to the UK Corporate Governance Code 2019 later in this article.

To be clear; following the CA 2006, owe the same legal duties to a company as an ED. Thus, the law treats them 'similarly as a matter of principle ... but the difference ... can be important in practise'.<sup>21</sup> NEDs tend not to have the extent of actual authority<sup>22</sup> in representing the company and are far more easily replaced than EDs. The latter have substantial implicit protection because they can claim compensation for loss of office that can prove very expensive for a company. EDs will also be expected to work to a higher standard (skill and care) and will have access to information that the NED may not be given. Therefore, the NED will have to do less to discharge his or her duties under the statute in comparison to an ED because of his or her position within the company, the organisation type and the fact that EDs have their duties set out in their respective contracts of service (employment). The question of the standard expected of a NED in law is discussed later.

## Corporate Governance<sup>23</sup> and The Growing Importance of the NED

The role of the NED has not been defined in law, and therefore prior to the extensive in-roads made by the Corporate Governance Codes (Codes) in relation to the role of the NED a company could dictate what it desired

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<sup>20</sup> The Higgs Report was commissioned by the Department of Trade and Industry to review the role of NEDs within the corporate governance framework. Higgs, D. (2003). Review of the role and effectiveness of non-executive directors. London: DTI. See: <http://www.ecgi.org/codes/documents/higgsreport.pdf> [Accessed 07 May 2020].

<sup>21</sup> Ibid note 11, Palmer's Company Law at Part 8, chapter 8.2. It should also be noted that the Companies Act 1985 also made no distinction between EDs and NEDs.

<sup>22</sup> Note, s.40 of the CA 2006 allows directors to contract on a company's behalf without constitutional restriction. Where s.40 does not apply questions relating to whether a director has the power to do so is subject to the normal common law rules. See also: *The Royal British Bank v Turquand* (1856) 6 E. and B. 327, the rule 'Turquand's Rule' concerns an assumption by a person dealing with a company that there has been compliance with 'indoor management' rules i.e. the articles of association, this has generally become a synonym for the application of agency law to companies.

<sup>23</sup> The latest code, 2019, is applicable to all companies that have premium listing regardless of where they are incorporated.

him or her to do. The relationship was, and still is, governed or at worst left to the behest of the employment contract but there have been changes promoted by the Codes and, amongst other legislation, the Insolvency Act 1986 and the CA 2006.

## Corporate Governance Codes 2014 and 2018 in 2020

This version of the combined code (2014) places emphasis on the 'advisory' and 'consultative' role of NEDs,<sup>24</sup> requiring them to 'constructively challenge and help develop ... strategy, and 'scrutinise the performance of management'.<sup>25</sup> In contrast, the current UK Corporate Governance Code (2018), the most current version issued by the Financial Reporting Council, applies to premium listed companies from 01.01.2019.<sup>26</sup> This code is made up of 18 principles and 41 detailed provisions. The code is accompanied by the FRC's Guidance on Board Effectiveness (2019). The Financial Conduct Authority (FCA) Handbook states all companies with premium listed shares must publish, annually, a compliance or corporate governance statement – this sets out its application of the Corporate Governance Code.<sup>27</sup> Failure must be reasoned, the approach is; comply or explain. This approach, often termed as soft law,<sup>28</sup> is consistent with the principles-based regulation of financial services organisations. The rationale being that overburdening business<sup>29</sup> with law is counterproductive, inhibits creativity and innovation. An example of this can be seen with the loosening of regulation for American banks in the United States of America post the financial crisis, the banks argued that the American regulatory approach, hard law i.e. Dodd-Frank Wall Street Reform and Consumer Protection Act

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<sup>24</sup> See; Barrow C. (2001). The Role of Non-executive Directors in High-Tech SMEs. Corporate Governance Bradford. 1, 2, pp.34–37, for a discussion on how NEDs fare in small to medium sized enterprises.

<sup>25</sup> Financial Reporting Council. (2014). UK Corporate Governance Code. UK: HMSO. At pp.5 – 9.

<sup>26</sup> Financial Reporting Council. (2018). UK Corporate Governance Code. UK: HMSO. Note: other companies can choose whether to apply the code. Also, the European Union's European Commission has established a European Corporate Governance Forum which is designed to promote harmonisation of the various member state corporate governance codes. See: also the European Corporate Governance Institute.

<sup>27</sup> Financial Conduct Authority. (2020). Handbook. UK: HMSO. See: LR 9.8.6R(5) – (6). See also: Directive 2013/34/EU and FCA DTR 7.2 – 3 for the compliance statement requirements for large companies with regulated market traded transferable securities.

<sup>28</sup> For an interesting discussion on 'soft law', i.e. rules that do not have legal force, see; Liu J. (2017). Globalisation of Corporate Governance Depends on Both Soft Law and Hard Law. In: du Plessis J., Low C. (Eds.). Corporate Governance Codes for the 21st Century. USA: Springer. See also: Jackson, K. Global Corporate Governance: Soft Law and Reputational Accountability. 35 Brook. J. Int'l L. (2010).

<sup>29</sup> The FRC issued the Wates Corporate Governance Principles for Large Private Companies in 2018. These principles are designed to promote accountability, transparency and trust in large private companies. The principles are the result of a partnership between the FRC, Trade Unions and the Institute of Directors. James Wates CBE, chairman of the Wates Group led the collaboration.

2010, when compared to the European approach, which centred on a balance of principles and regulation, put them at a competitive disadvantage in the global market.<sup>30</sup>

The current code, as at May 2020, is far more succinct focussing on the tripart relationship between the company, its shareholders and stakeholders. The current code takes into account the work that the FRC has done on corporate culture and succession planning. It also pays heed to the governments Green Paper on Corporate Governance Reform and the Business, Energy and Industrial Strategy Committee (BEIS) Report on corporate governance.<sup>31</sup>

The changes to the code focus on compliance, culture, diversity and succession, stakeholders, and the recurrent remuneration. As at January 2020, 82 companies had adopted the 2018 code.<sup>32</sup>

### Compliance / Corporate Governance Statement

Companies that are valued over £200BN with a turnover of over £200Mn and/or over 2000 employees must publish a compliance statement in their Annual Directors Report.

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The code has retained its 'comply or explain' approach, perhaps this is something that may be revisit by the proposed Audit, Regulatory, Governance Authority<sup>33</sup> which is posed to replace the FRC. The change is subtle, what is called for is a more meaningful explanation on how the principles of the code have been applied. In addition, advisors and investors should take time to fully consider the explanations provided.

The purpose is to promote meaningful engagement with the code and ensure that it does not become a tick-box exercise.<sup>34</sup> Sir Jon Thompson, the Chief Executive of the FRC, stated that '... there are examples of high-

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<sup>30</sup> Noonan, L., Armstrong, R. and Fleming, S. Financial Times. European banks seek lighter-touch regulation in the US. September 25<sup>th</sup>, 2018. [Accessed 22 May 2020]. See also; Economic Growth, Regulatory Relief, and Consumer Protection Act (S.2155/P.L. 115-174) and the Financial Choice Act 2017.

<sup>31</sup> House of Commons. Business, Energy and Industrial Strategy Committee. Corporate Governance. Fourth Report of Session 2016–17. UK: HMSO.

<sup>32</sup> Review of the UK Corporate Governance Code. Financial Reporting Council, 2020. At p.2. See also: White, S. FRC Criticises Tick Box Mentality to Corporate Governance Code. Accounting Daily, 9<sup>th</sup> January 2020.

<sup>33</sup> Ibid note 25. Note, ARGGA was supposed to come into being in the first quarter of 2020, the Covid-19 pandemic has put this on hold.

<sup>34</sup> Boyle, D. (2020). Tick box. UK: Little Brown Book Group Limited.

quality governance reporting from early adopters ... we expect to see much greater insight into governance practices and outcomes reporting on ... key issues from diversity to climate change<sup>35</sup> and 'concentrating on achieving box-ticking compliance, at the expense of effective governance and reporting [pays] ... lip service to the spirit of the Code and does a disservice to the interests of ... stakeholders, including the public.'<sup>36</sup>

The interesting fact was that most companies confused their mission and vision with their purpose.<sup>37</sup> The restriction of purpose to maximum gain for shareholders and profit highlighted that perhaps many companies failed to understand the 2018 code, and the interrelationship, in corporate governance terms, with purpose, organisational strategy and culture.

## Culture

The code requires that of the company board create a culture that aligns values with strategy but with a focus on longevity or sustainability. The continual series of quite large failures; British Home Stores, Carillion,<sup>38</sup> Cath Kidston, Debenhams, Oasis and Warehouse, Thomas Cook and Patisserie Valerie, only seek to draw attention to the ineffectiveness of boards in balancing and reporting risks that they face in terms of their long-term suitability.

There is emphasis on corporate democracy i.e. the role of the board, and a focus on the culture within a company is more prominent in the 2018 code, but changes are yet to materialise. The way in which a company engages with its workforce is a concern that is gaining momentum but still lacks a meaningful place within the 2018 code. In addition, compliance with the code requires a level of greater engagement with the explanations or justifications that are proffered for remuneration policies although, again, evidence in relation to this is yet to sufficiently emerge. The aspirations of the 2018 code seem valiant yet coupled with the impact of the Covid-19 pandemic it seems to have moved down the list of priorities if not failed. There is a distinct lack of top-level management buy-in that should filter down to all stakeholders. The FRC commented that 'it was disappointing that only a small number of boards disclosed that they already receive reports on culture to aid discussions, especially as the importance of corporate culture was raised by the FRC more than

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<sup>35</sup> Improved Governance and Reporting Required to Promote Sustainability and Trust in Business. Financial Reporting Council. 9<sup>th</sup> January 2020. UK: FRC.

<sup>36</sup> Kinder, T. UK Companies are Only 'Paying Lip Service' to Governance Reform. Financial Times, 9<sup>th</sup> January 2020.

<sup>37</sup> Review of the UK Corporate Governance Code. Financial Reporting Council, 2020. At p.2. See also: White, S. FRC Criticises Tick Box Mentality to Corporate Governance Code. Accounting Daily, 9<sup>th</sup> January 2020, at p.9.

<sup>38</sup> Fleck, C. The Corporate Governance Lessons from Carillion's Collapse. Governance and Compliance, 8<sup>th</sup> March 2018. UK: The Chartered Governance Institute and ICSA.

three years ago ... only a few reported [they] ... had a specific agenda item on [the] alignment of culture with values and strategy.<sup>39</sup>

The FRC audit<sup>40</sup> highlights that that there is a lack of discussion at all levels on the assessment and monitoring of corporate culture. Where such practice did take place it was through employee engagement surveys with success being measured on the basis of completion rates, furthermore the evidence on dealing with 'concerns' was poor, with very few demonstrating how they dealt with them.<sup>41</sup> This is in no doubt a corporate governance failure given its limited use from which meaningful generalisations or contributions can be drawn. Clearly, further work is required in relation to this.

### Diversity and Succession

The 2018 code emphasised the need to refresh boards so that they demonstrated the right mix of experience, skills and diversity so as to provide constructive challenge to successfully plan succession. The board must consider the length of term that a chair remains in post ideally not beyond nine years.<sup>42</sup> The nomination committee has been given an enhanced role in succession planning and in helping to establish a board that is diverse. The role of the external board evaluator is also given more importance; therefore the reports of the nomination committee must include the details of evaluators engagement with the board and respective directors.

In the FTSE 100 companies, 98% had a clear policy on board diversity as compared to 85% in 2014. In 2018, 83% of those FTSE 100 companies did specify gender as part of their policy, as compared to 78% in 2014.<sup>43</sup> Considerable progress on the Davies Review (2011) and Hampton-Alexander Review (2016).<sup>44</sup> In terms of ethnic diversity on the board, as a result of the Parker Review, 33% of all FTSE 350 companies referred to ethnic diversity as part of the board's diversity policy.<sup>45</sup> The aim, in response to the recommendations of the Parker Review Steering Committee, was to have at least one director from an ethnic minority background (EMB), i.e. non-white person, on the board of the FTSE 100 companies by 2012, and 2024 for the FTSE 250 companies. There are

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<sup>39</sup> Ibid note 37, at p.10.

<sup>40</sup> Ibid note 37, at p.10.

<sup>41</sup> Ibid note 37, at p.10.

<sup>42</sup> The 2018 code, provision 18, requires that all directors are annually re-elected so as to maintain independence at board level (Principles K, L and Provisions 10 – 11).

<sup>43</sup> Board Diversity Reporting. Financial Reporting Council. September 2018.

<sup>44</sup> Lord Davies Review. Women on Boards. February 2011, URN 11/745; Hampton-Alexander Review. FTSE Women Leaders Improving gender balance in FTSE Leadership. November 2016.

<sup>45</sup> Parker, J. A Report into the Ethnic Diversity of UK Boards; One by 21. The Parker Review Committee, Final Report. 12<sup>th</sup> October 2017.

less than two years to go to achieve this, and what seemed achievable in 2017 seems impossible in 2020.<sup>46</sup> In addition, to have enhanced reporting and transparency in relation to diversity policy and reporting. It is salient to note that as at 2017/2018, 51% of FTSE 100 boards were white, where there was non-white or EMB representation a total of 85 EMB only 20% were UK nationals which equates to 2% of the overall board seats which stood at circa 1050. What is interesting is that only 7 FTSE 100 companies accounted for 40% of those EMB individuals, totalling 34; thus, 93 FTSE 100 companies account for the remaining (60%) EMB individuals (51 people) which equates to 5% of the remaining board 965 seats.

In short, since the Parker Review there has not been much of an improvement in terms of representation at board level of EMB individuals. The update to the Parker Review makes it clear that there is inertia where this matter is concerned. The committee puts this down to a failure to understand the benefits of diversity at board level, the second is the fact the British find it difficult to these matters because they are embarrassing, hard and sensitive but also the complacency of 'that which has worked in the past will continue to work in the future'.<sup>47</sup> The message of the committee is that boards must find the 'value' which is in the difference itself.<sup>48</sup>

The new code gives this issue new lifeblood therefore many companies will be considering how to implement this change since the code came into force as at January 2019.

## Stakeholders

The 2018 code introduced a provision for greater board engagement with employees. The aim was to facilitate greater understanding of their views; specifically the code requires companies to explain how they considered the interests of stakeholders in promoting the best interests of the company per s.172 of the CA 2006.<sup>49</sup> The provision imposes a general duty on all directors, EDs and NEDs included, to act in good faith in a way most likely promote the success of the company for its members. This meant to consider the broad implications of their decisions for a wider group of stakeholders including;

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<sup>46</sup> Ethnic Diversity Enriching Business Leadership: An Update Report from The Parker Review. 5<sup>th</sup> February 2020. At p.11.

<sup>47</sup> Ibid note 46, at p.12.

<sup>48</sup> It is salient to note that only 6.8% of all FTSE 350 companies have directors are of EMB, that figure includes directors whose ethnicity is not known. See also: Shropshire, T. and Rix, W. Parker Review on Ethnic Diversity: Driving Real Change. PLC Mag. 2020, 31(2), 8-10.

<sup>49</sup> Tsagas, G. (2017). Section 172 of the Companies Act 2006: Desperate Times Call for Soft Law Measures. In Boerger, N. and Villiers, C. (Eds.). (2018). Shaping the Corporate Landscape. UK: Hart Publications.

- Long-term consequences of decisions;
- Company employee interests;
- The need to continue fostering relationships with customers, supplier's etcetera;
- Impact on the community and environment;
- Reputational impact, desirable to maintain reputation for high business conduct standards;
- Acting fairly in terms of all members;
- Other relevant matters.

Here there is not a choice between stakeholder engagement and corporate culture, the two have a positive symbiotic relationship.<sup>50</sup> Wider stakeholder engagement is a firm part of the 2018 code, perhaps because of s.172 of the CA 2006, but there can be little doubt that it is seen as a healthy part of corporate democracy and one that promotes confidence in UK business. Specifically, the 2018 code, from the January 1<sup>st</sup>, 2019, requires the following;

- Large Public Limited Companies (Plcs) and Private Limited Companies (Ltds) must issue a 's.172 statement' as part of their strategic reports, this must set out what and how the matters set out above have been considered;
- Large and medium-sized Plcs and Ltds that have over 250 UK employees must include a statement in the directors' report how the EDs and NEDs have engaged with employees, their interests and the impact that this, if any, on the business;
- Large Plcs and Ltds must include a statement in the directors' report how the EDs and NEDs have had regard to fostering business relationships with customers, suppliers and others, and the impact that this, if any, on the business;
- An employee director should be appointed, a formal employee advisory panel set-up, or the recruitment of a NED designated to this matter. In the alternative to set out and explain the method the company has chosen to meet the engagement requirement.

## Remuneration

There has long been an issue with the upward spiral of director remuneration.<sup>51</sup> The various corporate governance reviews since Cadbury

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<sup>50</sup> For a discussion on this matter see; General Counsel 100 (GC100). Guidance on Directors' Duties, Section 172 and Stakeholder Considerations. Practical Law, 23<sup>rd</sup> October 2018. UK: Thomson Reuters.

<sup>51</sup> Harris, J. Shareholder Dissent hit a Quarter of FTSE all-share Companies in 2019. *Comp. Law.* 2020, 41(5), 125. See also: Align Directors' Pensions to those of Workforce by 2022 or Face Dissent, Companies Warned. *Comp. Law.* 2020, 41(1), 13-14. For a discussion at the European level see; MEPs endorse Draft Law giving Shareholders more say on Directors' Pay. *Comp. Law.* 2015, 36(8), 252-253. See also: Spira, L. F. and

and the work carried out by the Greenbury Committee, the introduction of greater numbers of NEDs to lend independence to this matter has not born fruit. The gap in the USA is far wider than that in the UK.<sup>52</sup> There is no doubt that various stakeholders pay different levels of concern to remuneration of EDs; institutional investors care about the notion of visible fairness and its impact on reputational value, the employee on value-and-exchange. The extent to which shareholders are concerned with director pay also varies depending on how they perceive their 'stake' or ownership i.e. shares as invest or property. It is suggested that the issue is far more complex than has been given credit and a single solution for the various stakeholders will be difficult, if not, impossible to achieve; it seems that in balancing these aims ultimately someone must fail.

The 2018 code makes a point to ensure that remuneration committees take into account employee pay and related policies when they set the remuneration of directors. It does not however suggest the adoption of performance related pay formulae and requests committees exercise their discretion when an outcome is not justified.

Other than setting the remuneration of EDs<sup>53</sup> there is a salient matter in relation to NEDs, pay is also an issue<sup>54</sup> because it is seen to erode independence, which is rather strange a contradiction when they are being expected to have more of a stake or play an active part in the proceedings at large.<sup>55</sup> NED remuneration<sup>56</sup> is often dependent upon the NED and his or her 'profile'<sup>57</sup> but also on company liquidity and perhaps risk and size,<sup>58</sup> often this will be token sum.<sup>59</sup> The measurement of the

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Bender, R. (2004). Compare and Contrast: Perspectives on Board Committees. *Corporate Governance: An International Review*, Vol.12, no.4, pp.489–99.

<sup>52</sup> Nakajima, C. Proposals for Corporate Governance Reform and Crack Down on Irresponsible Business in the UK. *Comp. Law*. 2017, 38(3), 93-94. Note: 'pay on say' introduced under the Dodd-Frank Act 2010.

<sup>53</sup> Higgs, D. (2003). Review of the role and effectiveness of non-executive directors. London: DTI, at p.8. See also: McNulty, T., Roberts, J. and Stiles, P. (2003). *Creating Accountability within the Board: The Work of the Effective Non-executive Director*. London: DTI, Higgs Review; Tassell, T. Shareholders and business sing same tune overboard reforms. *Financial Times*, 24 July 2003.

<sup>54</sup> Adithipyangkul, P and Leung, T. Y. Incentive Pay for Non-executive Directors: The Direct and Interaction Effects on Firm Performance. *Asia Pacific Journal of Management*. December 2018. Vol. 35, Issue 4, pp.943–964.

<sup>55</sup> Walther, A., Möltner, H. and Morner, M. Non-executive Directors' Motivation to Continue Serving on Boards: A Self-determination Theory Perspective. *Corporate Governance: The International Journal of Effective Board Performance*. 2017, Vol.17, Issue 1, pp.64–76.

<sup>56</sup> Zattoni, A. and Cuomo, F. (2010). How Independent, Competent and Incentivized Should Non-executive Directors Be? *British Journal of Management*, 21(1) 63–66.

<sup>57</sup> Goh, L. and Gupta, A. Remuneration of Non-executive Directors: Evidence from the UK. *British Accounting Review*. September 2016. Vol. 48, Issue 3, pp.379–399.

<sup>58</sup> Bugeja, M., Fohn, S., Matolcsy, Z., and Fargher, N. Determinants of the Levels and Changes in Non-executive Director Compensation. *Accounting & Finance*. September 2016. Vol. 56, Issue 3, pp.627–667.

contribution the NED makes as set out by the corporate governance codes, including the 2018 version, is arguably still obtuse.<sup>60</sup>

The 2018 code strengthens the accountability and transparency surrounding directors' remuneration for companies; the remuneration report must include a statement by the remuneration committee that sets out the remuneration policy and its implementation in the particular financial year.<sup>61</sup> It is salient to note that the policy is subject to shareholder approval via ordinary resolution every three years per s.439A(1) of the CA 2006. In addition to the Companies (Miscellaneous Reporting) Regulations, UK quoted companies are also subject to the Companies (Directors' Remuneration Policy and Directors' Remuneration Report) Regulations 2019. The regulations implement Directive 2007/36/EC, this applies to reporting in the financial year on or after the 10<sup>th</sup> June 2019 and relates to the exercise of shareholder rights in listed companies (the Shareholder Directive). Significant changes to the previous remuneration policy must be highlighted, where shareholders vote down a policy it must be revised and represented to them for a vote within a year. In addition to this, changes in the annual pay of directors' and the annual change employee pay (average) must be compared over a continuous five-year period.

## Independence

The importance placed on the independence of NEDs was set out clearly in the Higgs Review<sup>62</sup> as being of '... independent in character and judgement and there are no relationships or circumstances which could affect or appear to affect ... [his or her] judgement.'<sup>63</sup> The terms judging independence were discussed earlier.

One salient problem that successive codes impede the NED-ship as a career even though the 2014 code recognised that NEDs devote their time across organisations and in various roles. What was suggested was therefore that they should avoid taking more than one NED-ship in any

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<sup>59</sup> Roach, Lee. An Equitable Solution for Non-executive Directors? I.C.C.L.R. 2006, 17(4), 117-119.

<sup>60</sup> For a discussion on how this may render the role ineffective see; Boxer, R., Perren, L. and Berry, A. SME Managing Director and Non-executive Director Trust Relations: The Dynamic Interplay Between Structure and Agency. *International Small Business Journal: Researching Entrepreneurship*. May 2016, Vol. 34, Issue 3, pp.369–386.

<sup>61</sup> The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, these set out the new requirements for the remuneration report and policy for large and medium-sized companies. For further discussion see; Ezeani, E. C. and Williams, E. Regulating Corporate Directors' Pay and Performance: A Comparative Review. *A.J.I.C.L.* 2017, 25(4), 482–506.

<sup>62</sup> *Ibid* note 53, Higgs.

<sup>63</sup> Note the revisions in the Combined Code 2003, 2006 and 2008. The 2014 code sought a balance between EDs and NEDs so that neither dominate the board and its decision making.

FTSE 100 company and the 2018 code does the same. This to a limited extent circumvents the NED-ship being perceived as a full-time career but does not prevent it. Furthermore, it limits the pool of applicants and whilst it is beyond the scope of this article it could, like many policies, have the potential to have a greater indirect negative impact on the recruitment of minority representation at board level.<sup>64</sup> In reality 'career NEDs' hold more than one NED-ship,<sup>65</sup> circumventing the spirit of the code by perhaps holding one NED-ship in a FTSE 100, and the others outside of that range FTSE 100 – 250/300 etc.

Thirty-three percent of 260 FTSE 100 and 250 company annual reports show that their own board did not consider the NED to be independent when judged against the criteria laid down within the code.<sup>66</sup> The reasons for this included previous employment or business relationship, familial ties, length of service and additional remuneration i.e. company pension or share scheme. Another interesting declaration concerned current and previous connections with other EDs and NEDs on the board by reason of bodies or companies with which they both had links; this could lend some support the limited pool of NEDs available or individuals willing to undertake this role.<sup>67</sup> Representing a significant shareholder is an impediment to independence; a reversal of *Re Astec (BSR) Plc.*<sup>68</sup>

#### The Companies (Miscellaneous Reporting) Regulations 2018

These regulations apply to quoted companies and came into force on the 1<sup>st</sup> January 2019, they apply to reporting on financial years on or after that date. These introduce reporting requirements in relation to corporate governance, director regard to the duty under s.172(1)(a) – (f) of the CA 2006, and of course directors pay. The aim is to create confidence in the running of large quote, and private, companies. The regulations require the following;

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<sup>64</sup> Ibid note 59, Roach at p.2. Examples of NEDs in more than one NED-ship include Alan Leighton, former CEO of ASDA, who held at one time 11 NED-ships (4 as at 2003); Lord Marshal, former Chairman of British Airways held 7 NED-ships.

<sup>65</sup> Beale provides useful insight into NED-ship but also highlights that most NEDs would consider holding more than one position where they feel they can interpret and absorb the information relatively quickly. This in itself is problematic, especially so given the increased focus on the role they play. See: Beale, N. (2017). *Constructive Engagement: Directors and Investors in Action*. UK: Routledge.

<sup>66</sup> Poole, G. *Non-executive Directors: How Independent Do They Need to Be?* Stephens Scowns. 11<sup>th</sup> July 2018.

<sup>67</sup> See also the earlier discussion on diversity as a mechanism to expand the pool of NEDs at pp.21 – 32.

<sup>68</sup> [1998] 2 BCLC 556. See also: *Re Saul D Harrison & Sons Plc* [1995] 1 BCLC 14. See also the UK Stewardship Code 2019; Davies, G. and Mulley, G. *Shareholder activism – New Tactics, New Players and a Change in Tone*. *The In-House Lawyer*, Summer 2018, pp.84–5.

- Strategic report must include a statement of how directors complied with the duty to promote the success of the company for the members and other stakeholders (community, environment and employees), per s.172(1)(a) – (f) of the CA 2006;
- Directors report, for companies with +250 employees in the UK, must include a statement of how directors have engaged with employees and had regard to their interest but also the effect or outcome of having that regard;
- Directors report, for large companies, must include a statement of how directors have engaged with the need to foster business relationships with customers, suppliers and others and the effect or outcome of having that regard;
- Directors report, for very large Plcs and Ltds, must include a statement of which corporate governance code, if any, has been applied in the financial year and why that is or is not so. Any departure must be reasoned;
- Directors remuneration report, for companies with +250 employees in the UK, must include the ratio of their CEO's complete remuneration of their employees;<sup>69</sup>
- Directors remuneration report, for companies with +250 employees in the UK, reasons for changes in the above ratios and its compliance with the policies on employee pay, progression and reward;
- In the director's remuneration report, quoted companies, must set out the directors' remuneration policy etcetera.

Where EDs or NEDs do not comply then a criminal offence will be committed.

## Coronavirus and Disclosure of Risk 2020

The Covid-19 virus pandemic has created a lot of investor uncertainty, therefore as part of the financial reporting (end-year-accounts) requirements this risk (short, medium and long-term) to the business should also be disclosed.<sup>70</sup> The disclosure needs to focus on those with physical presence in severely affected areas but also those with supply chain links. The reason for this was as follows; to protect investors, to shield the company from future litigation,<sup>71</sup> and allow directors and members to mitigate risk. This forms part of the duties under ss.172 and 174 of the CA 2006; promote the success of the company and to act with

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<sup>69</sup> This would be a 25<sup>th</sup>, median (50<sup>th</sup>) and 75<sup>th</sup> percentile to a full-time equivalent employee.

<sup>70</sup> At the time the FRC was particularly concerned with those areas worst affected i.e. China and Italy.

<sup>71</sup> Litigation could be, amongst other things, on the ground that there was a failure to mitigate risk but also loss of value in stock.

reasonable care, diligence and skill.<sup>72</sup> The matter, therefore, equally applies to EDs and NEDs; business continuity planning is one way in which this can be allayed. The 2018 code states that NEDs should '[provide] constructive challenge [and] strategic guidance, offer specialist advice and hold management to account'.<sup>73</sup>

### NEDs Post Polly Peck International, Re Westmid Packing Services and the 2018 Code

The expectation that NEDs will do more is considered unrealistic, not least because the remuneration is lower (as discussed) but also because 'career NEDs' hold more than one directorship even when the code suggests restrictions in this regard. The principle that a NED, lending independent oversight, can assure that a board acts in the interests of a company is one of the factors that is central to their ever-increasing importance. Re Polly Peck International Plc (No.2)<sup>74</sup> provides a prime example of how unrealistic this can be where a powerful managing director is concerned.<sup>75</sup> The case concerned a managing director who raised large sums of cash from banks and shareholders which he then lent to subsidiaries who deposited them in banks within the Turkish Republic of Northern Cyprus from which they could not be recovered. The Secretary of State<sup>76</sup> sought to have the managing director, who had already failed to appear on criminal charges relating to the company's finances, disqualified along with the joint managing director, the finance director and two NEDs. The application was made out of time to commence proceedings was made out of time. Lindsay, J. pointed out that the actions of the four directors would have made little difference, the threat to resign would also have had little effect. The latter is per the 2018 code a matter that requires the NED to provide reasons to the board. There are many other examples of this; Secretary of State for Trade and Industry v Taylor.<sup>77</sup> Some relief is provided by Re Westmid Packing Services Ltd<sup>78</sup> where the court decided that ex-directors (EDs and NEDs) could not be excused for failing to keep themselves informed where the managing director was a dominant figure.<sup>79</sup> The salient question is whether the new code moves the position any farther forward than these cases and it is humbly suggested that adverts in the greater concern of institutional investors, notable resultant

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<sup>72</sup> For a discussion on the standard of care see; Re Brazilian Rubber Plantations and Estates Ltd [1911] 1 Ch 425 at pp.436 – 8; Dorchester Finance Co Ltd v Stebbing [1977] 7 WLUK 144; [1989] B.C.L.C. 498.

<sup>73</sup> Ibid note 32, at p.6.

<sup>74</sup> [1994] 1 BCLC 574.

<sup>75</sup> For an interesting discussion on this see: Hellinx, E. Steeplechase in the Boardroom: The Obstacles for Non-executive Directors to Fulfil their Role in Public Companies. Comp. Law. 2017, 38(1), 15-23.

<sup>76</sup> The Secretary of State's case was described as being weak. Ibid note 74, Polly Peck at p.604–605.

<sup>77</sup> [1997] 1 WLR 407.

<sup>78</sup> [1998] 2 All ER 124.

<sup>79</sup> See also: Re Park House Properties Ltd [1997] 2 BCLC 530.

company reputational issues, a greater balance of EDs and NEDs and the increased risk of NED liability<sup>80</sup> will have an effect but that needs to be measured, something beyond the scope of this article.

## Enhanced Shareholder Value and Social Duties

It has been stated that 'so far as concerns the wider social duties of public companies, English company law has made no movement at all ... the law states that their duties are owed to the company which for this purpose and so long as the company is a going concern means the long-term interests of its members and, as a result of the recent grudging admissions, its employees'.<sup>81</sup> Progression in corporate governance terms, as demonstrated throughout this article, renders this somewhat untrue in 2020.<sup>82</sup>

## Conclusion

NED-ship has gained more support since Cadbury in 1992 to 2020, some of this has been promoted by large organisational failures that have highlighted the importance of independence at board level. The NED-ship is significant in the modern commercial world and are crucial to long-term sustainability. The 2018 code is the most significant step forward in terms of the role of the NED but at the same time the risks, in terms of liability in law, have also increased albeit with some greater clarity. It still remains to be seen how this affects the quality or pool of NEDs willing to participate in the corporate democracy. This does not mean that the issues have been resolved, the role is still one that is subject to pressures and practical difficulties, as outlined in the article. Again, in-roads into access to information, individual competence, increasing diversity and clarity in relation to the role are all steps in the right direction. There are outstanding matters relating to the incentives for individuals to take up the role; remuneration being one and the creation of the NED-ship as a significant or alternative career path is another and balancing that with the need for engagement and independence.

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<sup>80</sup> It should be noted that other provisions also apply to directors i.e. Sections 212 – 214 and 230 of the Insolvency Act 1986; note liability of directors can also be concurrent with other provisions in this regard. See also: Directors Disqualification Act 1986.

<sup>81</sup> Davies, P. L. (1997). *Gower's Principles of Modern Company Law*. 6th Ed. UK: Sweet and Maxwell, at p.193.

<sup>82</sup> Wolfe, A. *The Modern Corporation: Private Agent or Public Actor?* (1993) 50 *Wash and Lee L Rev* 1673.

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