KEY FACTS COMPANY LAW

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HODDER EDUCATION

10

Corporate governance

Accountability of company directors

- The role of shareholders
- Auditors
- Non-executive directors

'COMPLY OR EXPLAIN'

The UK Corporate Governance Code

- Leadership
- Effectiveness
- Accountability
- Remuneration
- Dialogue with shareholders

10.1 Introduction

1. As described in chapter 3, a company is a separate legal person, able to conduct business. However, a company can only act through agents and, apart from small, owner-managed companies (quasi-partnerships), it is usual for shareholders to delegate management of the company to directors, who may or may not also be members of the company.
2. Company directors have extensive powers of management and shareholders need to be confident that a framework exists to restrict the ability of managers to abuse those powers. This chapter will note, with reference to the chapters that follow, those areas where shareholders themselves can control the conduct of directors and will briefly describe the system of regulation developed over the last two decades, culminating in the UK Corporate Governance Code.
3. It is important to bear in mind when considering corporate governance that there are big differences between large companies where the power to manage the company is delegated to directors on the one hand and quasi-partnerships where the shareholders are also the directors on the other.

10.2 Accountability of directors: issues and responses

1. In any company it will be in the shareholders' interest that the directors have the authority to develop strategies and make decisions to promote the success of the company, and there is a balance to be struck between allowing the directors the freedom to manage the company and ensuring that they do so in the company's best interest rather than their own. The Companies Act 2006 reserves certain rights to shareholders, but it has become apparent in recent years that there is a need for separate regulation, developed through a series of self-regulatory codes.
2. Corporate governance is about how companies are structured and regulated to ensure that those in control operate in such a way as to promote the long-term success of the company for the benefit of shareholders and other stakeholders. The sections that follow describe the relationship of the shareholders and the board of directors, internal mechanisms for control and the development of regulatory codes.

10.2.1 Shareholders and the board of directors

1. Corporate governance in the UK is centred on shareholders. There has been growing criticism of this approach as being too focused on shareholders to the exclusion of other stakeholders. Section 172 CA 2006 now requires directors to consider the interests of others, including employees, in the exercise of their duties; but as there is no direct way of enforcing these duties, this is not likely to make very much difference.
2. The balance of power between shareholders in general meeting and the board of directors is determined by the Companies Act 2006 and the articles of association (see chapter 11). The articles of association will usually delegate powers of management to the directors, but these may be qualified, for example there may be a provision requiring approval by the general meeting for certain acts.
3. The articles usually provide for election of directors by the general meeting and CA 2006 s 168 provides that shareholders may by ordinary resolution remove directors. However, because individual shareholders are widely dispersed in large companies and have relatively small holdings they are more likely to sell their shares if they are dissatisfied than to seek to remove directors.
4. Directors have certain duties, now contained in ss 171–178 CA 2006. Note particularly s 172, which requires directors to 'promote the success of the company'. However, these duties are owed to the company not to individual shareholders (see chapter 12).
5. Under the rule in *Foss v Harbottle*, if a wrong is done to the company, it is the company that has the right of action against the wrongdoer. The right to litigate is usually exercised by the board of directors, which causes difficulty if the wrongdoers are the directors themselves. CA 2006 s 260 provides that in certain circumstances a shareholder may bring a derivative claim against directors of the company. This is a new statutory provision and the extent to which it will be used is not yet known, but there are still significant barriers to the exercise of this right (see chapter 14).
6. In large public companies individual shareholders with relatively small holdings will not have any real influence on the management of the company. However, the increasing influence of institutional investors such as insurance companies and pension funds does have an impact, although not necessarily through voting in general meetings.

7. It can be seen that the power of shareholders to influence the conduct of directors is often theoretic rather than real in large companies where power to manage it is delegated.

10.2.2 Auditors

Unless they are exempt for reasons set out in the Companies Act 2006, companies are required to appoint auditors, who may be appointed by either the members or the directors. The role of the auditors is to ensure that the directors provide a 'true and fair view' of the company's financial state. The auditors' report must be sent to all members of a private company (under the 2006 Act, private companies are not required to hold annual general meetings) and must be presented to the annual general meeting of a public company.

10.2.3 Regulation

1. High profile examples of corporate mismanagement (for example, *BCCI*, *Maxwell*, *Enron*) reinforced the need for a framework of regulation which sets out principles of corporate governance.
2. This has been recommended by various reports:
   - In 1992 the Cadbury Committee published its *Report on the Financial Aspects of Corporate Governance.* In this report corporate governance was defined as 'the system by which companies are directed and controlled'.
   - This was followed in 1995 by the Greenbury *Report on Directors' Remuneration*.
   - In 1998 the Hampel Committee published its *Final Report* and, in consultation with the Stock Exchange, produced the *Combined Code* which contained principles of good governance and a code of good practice.
   - The Higgs *Report on Non-Executive Directors* was published in January 2003 and at the same time the Financial Reporting Council released new guidance for audit committees.
   - A revised version of the *Combined Code* was published in June 2006.
3. The UK Corporate Governance Code was published in June 2010 following review by the Financial Reporting Council. It applies to listed companies, but all companies are encouraged to have regard to the Code. This, like the combined code, does not have the force of legislation, but rather it is a framework for self-regulation (*Re Astec (BSR) plc* (1999)).

10.3 The UK Corporate Governance Code

10.3.1 Principles

In the introduction to the Code it is stated that the purpose of corporate governance is 'to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company'. The Code contains a number of principles under five sections, each of which contains supporting principles and more specific code provisions. The main principles may be summarised as follows:

1. ***Section A: Leadership.*** Every listed company should be headed by an effective board which provides entrepreneurial leadership; there should be a clear division of responsibility between the Chairman and Chief Executive and the board should include a balance of executive and non-executive directors, so that no individual or group of individuals can dominate the board's decision-making.

2. ***Section B: Effectiveness.*** This section is concerned with matters such as the appropriate balance of skills and experience on the board of directors, transparent procedures for appointment of new directors on the board, induction of new directors and the requirement for formal evaluation of its own performance annually. The Code sets out guidelines for the proportion of non-executive directors, who must be independent of the management of the company and who have a monitoring and strategic role on the board.

3. ***Section C: Accountability.*** It is the board's responsibility to present a balanced and understandable assessment of the company's position and prospects; effective controls should be in place to manage risks and the board is responsible for determining the extent of the risks it is willing to take to enable the company to meet its strategic objectives. Auditors play a key role in ensuring accountability for financial matters.

4. ***Section D: Remuneration.*** Levels of remuneration should be sufficient to attract, retain and motivate the directors needed to run the company successfully, but companies should avoid paying more than necessary; there should be a formal and transparent procedure for developing policy on executive remuneration and for fixing individual remuneration and no director should be involved in deciding his or her own remuneration.

5. ***Section E: Relations with shareholders.*** The board is responsible for ensuring that there is a satisfactory dialogue with shareholders and should use the AGM to communicate with shareholders and encourage shareholder participation.

10.3.2 'Comply or explain'

1. Companies have been required to disclose certain matters since 1844. The Companies Act 2006 requires that certain information is given to shareholders, for example, company accounts. The Code also requires listed companies to provide information about how and to what extent they comply with the principles of the Code.
2. The principle of 'comply or explain' has been in operation from the first corporate governance Code. It is an important feature of UK corporate governance, giving it a degree of flexibility. It is recognised that different companies have different needs and that good governance can be achieved in different ways. The Code is a statement of good practice but there may be circumstances where governance is achieved by other means. Thus if a company does not comply with the Code it is required to explain to shareholders in its Annual Report how its own actual practices are consistent with the principles of the Code and contribute to good governance.