TRANS-TASMAN REGULATION OF FINANCIAL INVOLVEMENT OF DIRECTORS - The Aftermath of the Corporate Collapse

JONATHAN HORSFALL TURNER

Allen & Overy
Solicitors, London

The attitude of the United Kingdom Parliament and the general public to the degree of disclosure and accountability required of directors has changed dramatically in the last twenty years and is undoubtedly set to change still further before the year 2000. Many fortunes in the last century were founded on practices which would now be unacceptable: non-disclosure, insider dealing and conflict of interest to name but a few. How different was the world at the time of the South Sea Bubble to the world, and in particular Southwark Crown Court during the ***Guinness*** trial.

Much of this has come about by reason of the high profile which corporate matters now assume in the light of the man in the street. The days of the FT, the city page in the ***Times***, and the short late evening slot on ***Radio 4*** regarding the world of business has given way to financial analysis and comment in all but the most tabloid of the tabloids, which in any event make up for this shortcoming by examining the private lives and secret passions of many of the businessmen of the day. Thus the business and private life of Mr Halpern and Mr Nadir have become as big news as the private lives of the Hollywood stars of yesteryear and indeed they would appear to be as extravagant. The city programme on TV has a large viewing audience and bingo games are played linked to share prices on the London Stock Exchange.

Three factors have I think given rise to this increased interest and awareness of the world of business. First, the Thatcherite policy of wider share ownership and privatisation, the popular shares - Telecom, British Gas and others - which are now owned by a large investing public. Second, the massive explosion in pay for top executives and the yuppie in the city which has stimulated envy among the rest of the population. Third, the sensational collapse of some companies linked with the revelation that a number of those who have benefited most from the high remuneration have also manipulated their companies for their own financial advantage. Charges of theft and fraud abound in cases which are being investigated by the Serious Fraud Office. Barlow Clowes, Polly Peck, Guinness and others. Accordingly, the law in relation to directors and their morality is now headline news; a matter of public interest and public envy and therefore a matter of public concern.

Company law reform does not win votes, was often said in the 1960s and the early 1970s. Now the opposite is probably true. The Labour Party has bayed for blood and the Tories have had to bow to the pressure.

In the time allocated to me I have the opportunity of addressing only a few items relating to the UK in any detail, and accordingly I have selected insider dealing, service contracts and emoluments of directors, the role of the Serious Fraud Office, and the Fifth EEC Directive and the potential effect on UK law. All of these are instances of controls being or likely to be imposed on UK companies and their directors, but they are by no means the only ones. Indeed, the regulatory system imposed by the Financial Services Act is a particular example in the financial sector of a regime passed to try and eliminate the scandals of the past.

In broad terms, the Company Securities (Insider Dealing) Act 1985 made it a criminal offence for an individual who is an insider (or who has obtained relevant information from an insider) while in possession of unpublished price sensitive information of a confidential character which relates to securities falling within certain categories, to deal within those securities on the Stock Exchange or off-exchange, with or through a recognised market maker or on a foreign stock exchange. You should have in mind that in a number of continental jurisdictions there are no such restrictions. The use of insider information might almost be regarded as obligatory! An important point is that what the Act prohibits is not making use of unpublished price sensitive information to deal, but dealing while in possession of such information. To have required the prosecution to prove that the defendant had actually used the information would have made it extremely difficult to secure convictions.

One of the key concepts under the Insider Dealing Act is unpublished price sensitive information. A second key concept is that of being "connected with" a particular company. In effect this is the Act's definition of "an insider". Any director of A plc is so connected as is any director of a company in the same group and any employee whose position gives him access to information which is unpublished price sensitive information in relation to A plc's securities. The passing of this Act coupled with stricter Stock Exchange Rules than before on disclosure of share dealings by directors, and curbs on the ability to hide behind nominee names when a company requires disclosure of the name of the ultimate beneficiary of shares, has been a material limitation on directors in the context of their share dealings. Prosecutions under the Act have however not been particularly successful - politicians have complained in the House of Commons that the law is being brought into disrepute by some of the bungled prosecutions brought.

The Association of British Insurers, which is the body that represents most of the institutional shareholders in the UK and has considerable power in that its members hold the key to the passing of many of the resolutions proposed to companies in general meeting, published a discussion paper in June of last year covering, ***inter alia***, the question of service contracts and emoluments to directors. Copies of all directors' service contracts are required by law to be made available in an accessible place for inspection by shareholders and may not be entered into for a period in excess of five years without the consent of the company in general meeting. The unexpired period of any service contract must be disclosed where a director is being proposed for re-election. The Association has suggested, and I would hasten to add that these suggestions have not yet been acted upon, that service contracts should be approved by a Remuneration Committee, a majority of which is comprised of non-executive directors. The Committee has also made proposals for a number of non-executive directors to be appointed to every board of a public company, the composition of this Committee to be disclosed in the annual report. Any rolling form of contract should run for a period of not more than three years. Service contracts should permit the executive directors to engage in or have an interest in any business similar to that carried on by any group company only with the approval of the board (though the ability to hold shares in listed companies carrying on such business is accepted). Service contracts should prohibit the director from disclosing confidential information about the company both during his employment and following its termination.

Disclosure is required in the annual report of directors' emoluments (which is fairly widely interpreted) and of any compensation payments in respect of loss of office made to directors. The Companies Act and the Stock Exchange impose certain requirements governing such payments including the issue of shares and the grant of loans and guarantees.

It is however suggested by the Association that:

(a) The emoluments of executive directors including the provisions governing performance linked remuneration schemes and share option and share incentive schemes should be determined by the Remuneration Committee.

(b) A limit should be placed on the directors' fees under the Articles. This may take the form of either a limit on aggregate fees or a limit on the fees of the highest-paid director.

(c) Details of any performance linked remuneration schemes and of any share option incentive schemes should be disclosed in the annual report.

To what extent these recommendations will be taken by companies as good practice, incorporated into the rules of the Stock Exchange or into future legislation remains to be seen.

The premises off Berkeley Square were described as a veritable Aladdin's cave, furnished in a style striving to achieve the atmosphere of an English country house rather than the offices of Polly Peck and Mr Azil Nadir. The Administrators have now sold the antique contents for some £4m against the purchase price paid of approximately £7m. But of more concern have been the missing millions within the company itself in respect of which the Administrators seem unable to obtain information. Much of it is in Northern Cyprus, and in respect of which the finance director admitted he did not know where it went.

With the spate of corporate collapses, the Serious Fraud Office has leapt into the spotlight, mainly because of the growing criticism of the abuse by that office of the incredible powers given to it under s2 of the Criminal Justice Act of 1987. Anyone served with such a notice has no right of silence which must be contrasted with the usual right of no reply when one is questioned by the police. The recipient of a notice is required to attend interviews and answer any questions that may be put to him. In addition, one can be required to supply and explain documents. If the person served fails to answer the questions without reasonable excuse one can be convicted on a criminal offence and gaoled for a period of up to six months. If one makes a statement that one knows to be false or misleading in a material particular one can be imprisoned for up to two years and be fined an unlimited amount. If individuals falsify, conceal or destroy documents which they suspect may be relevant, they can be gaoled for up to seven years.

There is growing concern among lawyers at the use of s2 notices. On commencing its work the Serious Fraud Office had a caseload of 39 investigations which built up to 66 by the end of its first year of operation. In the first year 233 s2 notices were served, while the number rose to 574 in the following year and in the first eight months of the third year, the number stood at 468.

The government is showing increasingly that it means to take corporate fraud seriously, in part from an electoral standpoint and in part to protect the somewhat tarnished image of the City of London as a place where one's word was one's bond. In doing so, however, there have been accusations that white collar fraud suspects are not being given the same protection as ordinary suspects. Perhaps this is because in theory at any rate they have access to better legal advice. However, when you hear it is alleged that most weeks somebody from Mr Nadir's office was sent to the bank and asked to collect many thousands of pounds in cash which were then delivered to Mr Nadir personally, one wonders who needs the real protection!

As with potato crisps (which the EEC have recently directed shall have no other flavour but natural, with a possible relaxation to include salt and vinegar), so too the liability of company directors is the object of regulation in Brussels. The Commission has produced an amended proposal for a Fifth Directive on the management and structure of plc's relating to harmonisation of company law. An amended text produced in 1989 is now the subject of discussion. If implemented it will considerably extend the liability of directors under English law.

The UK government is known to oppose some aspects of this Directive, particularly relating to worker participation. However, also under these proposals there is a mandatory distinction required between executive and non-executive directors and it requires the latter to be in a majority. The Committee on Company Law of the Law Society of England and Wales has stated that it supports efforts to promote the appointment of non-executive directors, but believes that a rule requiring a majority or any particular number of non-executive directors is inflexible, could be impractical in many cases, and is thus opposed.

Article 14 of the draft Directive provides for the joint and several liability of directors for damage sustained by the company as a result of breaches of duty by one or more of them. A director may exonerate himself if he proves that no fault is attributable to him personally. However, the fact that the act giving rise to damage does not fall within a field for which he is personally responsible does not of itself suffice to exonerate him. The Law Society Committee has stated that it continues to believe that the liability of each director should depend on his own conduct and therefore it does not consider that the burden of proof currently required by UK law should be reversed. It believes that the court should retain its wide powers to grant relief under the Companies Act.

Article 16 gives minority shareholders the right to initiate proceedings on behalf of the company to enforce the liability that is based on article 14 provided that such shareholders hold shares of more than 10 per cent of the subscribed capital. This is at least an improvement on the 5% that was proposed in the initial draft of the Directive. The Law Society Committee in an earlier memorandum said that it believed that an independent majority of shareholders should have the power to release directors from liability in cases which do not involve illegal or ***ultra vires*** acts.

Article 21r provides for meetings of the board to be held once at least in every three months. This should not, the Committee feels, apply to companies which are wholly-owned subsidiaries.

Article 21s states that member states "may provide that the execution of certain types of transactions may not be delegated to the executive members of the administrative organ". The Law Society Committee stated that this does not make any sense. Every transaction must be executed by somebody and it would not be right to by-pass senior executives for important transactions. The Committee commented that what is surely intended is that the right of ***decision*** may be removed from certain executive members.

To find the roots of the Fifth Directive one has to look at the current corporate law of other countries in the EEC, particularly France and Germany. And it may well be that the proposals are based on the supposition that things will work rather more as they do in those civil law jurisdictions where the atmosphere is essentially non-litigious, short of a winding up.

When and whether the Fifth Directive will be passed I do not know. But it and the remainder of the other things I have mentioned are just instances in the UK and the EEC whereby the civil and criminal law have been and will in the future be moving towards greater control of directors. I believe that we as lawyers have a part to play in making sure that the public is adequately protected against what is, I hope and believe, a small element of dishonesty and negligence compared to the good work done by many thousands of directors who carry out a conscientious job. But there is perceived by the public to be a problem and that perception must be changed if necessary by still tighter controls. Small wonder, however, that partners in the major law firms in the City of London have an almost unalterable policy of not accepting appointments to the boards of their client companies!