APPENDICES

Preface

I am honoured to offer a few words to the preface of this book and, indeed, welcome the extensive coverage on a topic that has elicited much highlighted attention in the wake of the financial crisis.

The 5th edition comes at a timely moment. Increasingly, governments, pan-EU and international organisations, regulators and civil society at large are questioning existing corporate governance principles, their scope, precision and enforcement. As listed companies pursue international growth opportunities and shareholders become more culturally diverse, a study of the appropriateness of contemporary corporate governance in the United Kingdom, and in other jurisdictions, is to be lauded.

The worldwide financial crisis constituted a catalyst in driving corporate governance policy to prominence. The EU institutions have been active in the past five years in seeking to strengthen corporate governance, much of it focused on financial firms. There is, however, also a growing awareness of the importance of corporate governance best practice to all quoted companies, as well as to smaller companies, public interest entities and many voluntary organisations.

The book is intended as a reference work to guide practitioners in the field of corporate governance, including company secretaries, lawyers, fund managers, auditors, NEDs and other directors (actual and prospective). It is much to be hoped that the book will also assist those in business schools and other institutions who may guide practitioners through their careers. But, as the range of specialist authors of this book demonstrate, interest in corporate governance policy and principles has evolved beyond this traditional circle. A wider stakeholder interest has emerged since the financial crisis to embrace institutional shareholders and pension funds, NGOs, and regulators working domestically and internationally (including on a pan-EU basis).

Although empirical evidence does not seem to show that poor corporate governance by itself was directly responsible for the financial crisis, the lack of effective internal control mechanisms, coupled with mis-aligned remuneration packages, certainly seems significantly to have contributed to excessive risk-taking on the part of firms. A balance must be struck. Effective risk management should not necessarily be about eliminating risk-taking, a critical driving force in its own right in business and entrepreneurship. The aim of corporate governance, regardless of the sector, is, increasingly, and justifiably, dedicated to ensuring that risks are understood, managed and, when appropriate, disclosed. The proper and rigorous application of comply or explain principles has become rather more than simply a desirable ambition.

other market participants should bear any further burden in respect of the social and other expectations which may now be cast upon them for better and more far-reaching governance?[150] Legislative attempts to reduce levels of executive remuneration and (outside the UK) to promote diversity have not to date been outstandingly successful, but would more prescription in general be helpful in achieving some of the ends which governance may now seek to achieve?

[150] The position here is further complicated by the considerably reduced time frames over which investors now typically hold investments, a trend exacerbated by the current incidence of "HFT"—high frequency trading, electronically assisted, in which investments may be traded several times in periods reckoned by seconds or less.

CHAPTER 2

The Legal and Regulatory Regime in the United Kingdom

Michael Scargill[1]

INTRODUCTION

This chapter provides an overview of the regulators and the sources of law and regulation relevant to companies with equity securities listed or traded in the UK. The chapter concludes with a brief note on the relevance of corporate governance arrangements to some unlisted, private or family controlled companies. **2–001**

A number of the key features of UK corporate governance which are outlined in this chapter are discussed in greater detail elsewhere in this book; and cross-references are made to other chapters where appropriate.

This chapter analyses the UK corporate governance regime by considering how it applies to:

- different types of companies—whether "premium listed" or "standard listed",[2] or unlisted;
- the different markets on which companies have their equity traded in the UK[3]; and
- in different ways to UK incorporated and non-UK incorporated companies.

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Michael has over 30 years' experience in the City of London, advising both UK and international clients on matters of corporate law and corporate governance, and being engaged in a wide variety of transactional work. This includes both public and private M&A, privatisation, joint venture and capital markets transactions, as well as large scale outsourcing and restructuring matters. He is the UK and EU contributor to his firm's quarterly Governance & Securities newsletter and has written a number of articles on M&A developments, as well as having chaired or spoken at a number of legal conferences.

Michael Scargill has written and contributed this chapter in his personal capacity, not as part of his role with Shearman & Sterling LLC, and the views expressed in it are his own.

[2] For an explanation of the significance of these terms, and the differences between them, see paras 2–011 and 2–024 below.

[3] As will be seen below, these differences are mainly relevant in the case of "unlisted" securities where the markets on which such securities are traded generally have their own specific corporate governance requirements. "Listed" equity must be admitted to trading on a "regulated market" and these sorts of markets do not generally impose corporate governance requirements beyond those arising under the UK's listing rules. See para.2–010 below for further details.

THE REGULATORS

2–002 There are a number of different bodies or organisations that can be said to have some responsibility for regulating corporate governance in the UK. The most important of these are discussed as follows.

BIS

2–003 The Department of Business, Innovation and Skills ("BIS") has Government responsibility for UK company law, financial reporting and equity markets generally. Since the last edition of this book was published in 2010, BIS has promoted significant changes to corporate governance rules under the Companies Act 2006 (the "CA 2006") in the areas of director remuneration and narrative reporting. It also commissioned a detailed review by Professor John Kay of investment in UK equity markets and its impact on the long-term performance and governance of UK quoted companies (the "Kay Review"). The final report of the Kay Review was published in July 2012 and a number of its recommendations have already been followed up with a variety of developments which are discussed in paras 2–040 to 2–042 below under "Institutional shareholder corporate governance" and "The Kay Review".

More recently, BIS has been consulting about a number of proposed changes to UK company law, in connection the Government's June 2013 G8 Summit announcement of new rules which are designed to enhance transparency in UK company ownership.[4] The enhanced transparency proposals are driven more by concerns to avoid companies (particularly private, unlisted companies with hidden beneficial ownership structures) being used for illegal activities, than by corporate governance concerns. However, the BIS consultation also addresses the use of so-called nominee directors and the question whether corporate directors should be banned, as well as whether directors' statutory duties should be amended and expanded in certain sectors, such as banking.

The FCA

2–004 The Financial Conduct Authority ("FCA") is a body corporate established under the Financial Services and Markets Act 2000 (as amended) ("FSMA")[5] and has corporate governance regulatory responsibility when, as the United Kingdom Listing Authority, it is acting in its capacity as the UK's competent authority under the key EU securities markets directives which stem from the EU's

[4] See the BIS Discussion Paper, "Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business", published in 2013 and available at *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/212079/bis-13-959-transparency-and-trust-enhancing-the-transparency-of-uk-company-ownership-and-increaing-trust-in-uk-business.pdf* [Accessed April 28, 2014]. For some historical background to this, see Ch.24 (Companies and their Owners—How They Engage: A Historical and Personal Perspective). See also Ch.23 (Stewardship and Shareholder Activism).

[5] See FSMA Pt 1A Chs 1 and 3 and Sch.1ZA.

Financial Services Action Plan—the Transparency Directive,[6] the Prospectus Directive[7] and the Market Abuse Directive,[8] as well as the earlier Consolidated Admissions and Reporting Directive[9] ("CARD"). This responsibility extends to its rule-making powers under FSMA in relation to later directives such as the Transparency Directive or the corporate governance statement requirements of the amended Fourth Company Law Directive (together, the "EU Directives").

The FCA maintains pursuant to FSMA[10] the official list of securities,[11] admission to which results in the relevant securities being "listed securities" for various regulatory purposes. The FCA'S rule-making powers include certain "Part 6 rules" under Part VI of FSMA.[12] The Part 6 rules (which are set out in the FCA's Handbook (the "Handbook")[13] include the listing rules ("LRs"),[14] prospectus rules,[15] disclosure rules,[16] transparency rules[17] and corporate governance rules[18] made by the FCA pursuant to various EU Directives under powers given to it by FSMA. The disclosure, transparency and corporate governance rules are grouped together and referred to in the Handbook as the Disclosure and Transparency Rules ("DTRs"). The current Part 6 rules were largely made by the FCA's predecessor, the Financial Services Authority, which the FCA replaced as from 1 April 2013.

As far as on-going corporate governance requirements are concerned, the most important Part 6 rules are:

- LR 9.8—which sets out certain corporate governance related disclosures (including with respect to compliance with the UK Code) required to be made in a premium listed company's annual financial report ("AFR");[19]
- LR 9.2.7—which requires a premium listed company to ensure that no dealings in its securities, either by the company or its directors, take place when such dealings are prohibited by the provisions of a prescribed Model Code of securities dealings (the "Model Code");

[6] Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L390/38 (as amended).

[7] Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC [2003] OJ L345/64 (as amended).

[8] Directive 2003/6/EC of the European Parliament and of the Council on insider dealing and market manipulation (market abuse) [2003] OJ L96/16 (shortly to be replaced by a new Market Abuse Regulation and a Criminal Sanctions Market Abuse Directive).

[9] Directive 2001/34/EC of the European Parliament and of the Council on the admission of securities to official stock exchange listing and on information to be published on those securities [2001] OJ L184/1.

[10] FSMA s.74.

[11] As explained further in para.2–010 below under "Regulated and other markets".

[12] FSMA s.73A.

[13] A copy of the Handbook is available online at: *http://fshandbook.info/FS/html/FCA/* [Accessed April 28, 2014].

[14] See FSMA s.73A(2).

[15] See FSMA s.73A(4).

[16] See FSMA s.73A(3).

[17] See FSMA ss.89A(5) and 73A(6).

[18] See FSMA ss.89O(1) and 73A(6).

[19] For more on annual reports, see Ch.20 (Communicating with Shareholders: The Legal and Regulatory Framework, Ch.21 (Financial Reporting) and Ch.22 (Narrative Reporting).

- LRs 7, 10 and 11—which respectively set out certain general listing principles and significant corporate transaction and related party transaction requirements for premium listed companies;
- LR 14.3.24—which requires non-UK standard listed companies to comply with the DTR 7.2 requirement for UK companies to publish an annual corporate governance statement;
- DTR 7.1 and 7.2—which respectively require UK companies with securities traded on an EU regulated market, to establish an audit committee and to publish annually a statement about their corporate governance.

As is evident from the above, the LRs and DTRs apply differently depending on whether the company concerned has a premium or a standard listing in the UK, and whether it is UK incorporated or not. These differences (including between premium and standard listings) are explained in paras 2–010 to 2–024 below.

FCA's disciplinary powers

2–005 Any failure by a listed company to comply with the relevant LRs and/or DTRs would entitle the FCA to exercise its various disciplinary powers under the Handbook and under FSMA. In the area of corporate governance, it is perhaps unlikely that a company would fail to comply totally with the relevant rule, particularly when, as will be explained in para.2–016 below, companies subject to the UK Corporate Governance Code are at liberty, in the case of provisions under that Code, to decide not to comply with the relevant provision, provided that they offer a reasoned explanation for their particular non-compliance. For the FCA to be able to take disciplinary action against the company, the corporate governance breach would therefore have to involve a breach of one of the LRs or DTRs, rather than just non-compliance with the principles of the UK Corporate Governance Code.

Nevertheless, in the case of any serious non-compliance with the LRs or DTRs the FCA would have power:

- to impose a penalty, on the company[20] or on any director[21] who, at the material time "was knowingly concerned" in the relevant non-compliance; or
- instead of imposing a penalty, to publish a statement censuring the company (or director);[22] or
- (at least technically) to suspend the company's listing.[23]

[20] FSMA s.91(1) and (1B).
[21] FSMA s.91(2).
[22] FSMA s.91(3).
[23] See LR 5.1.2G(1) as an example where the FCA may suspend a listing when the relevant issuer has failed to meet its continuing obligations for listing. LR 5.2.2G(3) provides an example of where, after being suspended for more than six months, the listing of an issuer's securities might be cancelled by the FCA. Needless to say, in view of the other sanctions available to the FCA (including against the issuer's directors), in practice suspension or cancellation of a listing for a corporate governance breach that involved a breach of the Part 6 rules would be most unlikely.

FSMA requires the FCA to issue a warning notice to any person whom it is proposing to fine or censure[24] and a decision notice if it does decide to take action.[25] FSMA also requires the FCA to publish a statement of its policy with regards to imposing fines[26] and its procedures with regards to the giving of these notices.[27] These statements are currently contained in the Decision Procedure and Penalties Manual in the Handbook.[28] They need to be read in conjunction with the Enforcement Guide which the FCA also publishes as one of the Regulatory Guides in the Handbook and which describes the FCA's approach to exercising the main enforcement powers given to it by FSMA.

The FRC

2–006 The Financial Reporting Council (the "FRC") is an independent regulator in the UK with primary responsibility for promoting high quality corporate governance and financial reporting. The FRC authors and publishes the UK Corporate Governance Code,[29] which is the most important source of corporate governance regulation in the UK, as well as the UK Stewardship Code[30], and a range of informal guidance with respect to various aspects of the UK Corporate Governance Code.

The FRC is a private company, limited by guarantee, whose directors are also its only members. It is funded by Government grants and by levies on listed UK and non-UK companies and various public sector organisations. It has entered into a memorandum of understanding with BIS (as well as with the FCA and Prudential Regulation Authority), copies of which are available from its website.[31] The BIS MoU helps to explain both the nature of FRC's independence (while recognising the common interests that BIS and the FRC share), and the working relationship that exists between the two of them.

The FRC can trace its history back to the Dearing Committee (under the chairmanship of Sir Ron Dearing) and the report that it produced in September 1988[32] on accounting standards and the work of the then current Accounting Standards Committee (a joint committee of various accountancy bodies). The FRC was formed in 1990 with two subsidiaries—the Accounting Standards Board (which replaced the Accounting Standards Committee and was entrusted with statutory responsibility for issuing accounting standards) and the Financial Reporting Review Panel (charged with statutory responsibility for reviewing and taking action in respect of defective reports and accounts).

[24] FSMA s.92(1).
[25] FSMA s.92(4).
[26] FSMA s.93.
[27] FSMA s.395.
[28] See fn.13 above.
[29] Available at *https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx* [Accessed April 28, 2014].
[30] Available at *https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx* [Accessed April 28, 2014].
[31] See *https://frc.org.uk/About-the-FRC/Procedures/Memorandum-of-Understanding.aspx* [Accessed April 28, 2014].
[32] "The making of accounting standards: Report of the Review Committee" (CCAB) 1988. See further *http://www.icaew.com/en/library/subject-gateways/accounting-standards/knowledge-guide-to-uk-accounting-standards*, where a copy of the report is available [Accessed April 28, 2014].

In 2012, a major reform of the FRC[33] was carried out under which:

- its organisational structure was simplified, resulting in its then seven operating bodies being replaced by just two key committees—a Codes and Standards Committee and Conduct Committee—with various sub-committees or teams working beneath them, and an Executive Committee to advise the FRC board on strategic issues;
- the regulatory responsibilities previously entrusted to various operating bodies of the FRC were conferred on the FRC itself;[34]
- it was given a wider and more proportionate range of sanctions and procedures to use in its monitoring and enforcement activities (e.g. additional types of action which may be taken against a statutory auditor's professional body for securing that body's responsibilities properly to supervise its statutory auditor members[35]); and
- its independence from the accountancy professional bodies was strengthened.

A useful description of the FRC's approach to discharging its regulatory responsibilities is set out in its January 2014 publication: "The FRC and its Regulatory Approach".[36] Annex A to that publication lists the various regulatory responsibilities of the FRC, including those with regards to auditing and financial reporting conferred on it under the CA 2006 as well as its "non-statutory" responsibility for the UK Corporate Governance Code and the UK Stewardship Code.[37] Its various guidance notes with respect to the UK Corporate Governance Code and governance matters,[38] while not forming part of the Code and therefore not having the same regulatory importance as the Code itself, generally carries great weight in the investment community and is seen as providing best practice guidance in these areas.

In October 2010, the FRC published a brief description of the UK approach to corporate governance[39] and this gives a helpful overview of the key requirements

[33] See the joint BIS and FRC consultation: "Proposals to reform the Financial Reporting Council", October 2011 and the joint response to feedback received on that consultation, March 2012, both available from: *https://www.gov.uk/government/consultations/financial-reporting-council-reform* [Accessed April 28, 2014]; see also the FRC's "Future Structure and regulatory procedures", March 2012, available from: *https://frc.org.uk/About-the-FRC/FRC-structure/FRC-Reform.aspx* [Accessed April 28, 2014]; the necessary statutory reforms, involving amendments to the CA 2006 and revocation of various earlier statutory orders were made by the Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc.) Order 2012 (SI 2012/1741).

[34] Or in certain cases the FRC's Conduct Committee—see Annex A to the FRC publication "The FRC and its Regulatory Approach" referred to in fn.36 below.

[35] See art.4 of SI 2012/1741.

[36] Available online at: *https://frc.org.uk/Our-Work/Publications/FRC-Board/The-FRC-and-its-Regulatory-Approach.pdf* [Accessed April 28, 2014].

[37] It is the LRs (rather than the CA 2006) that effectively prescribe the UK Code issued by the FRC as the benchmark for the corporate governance disclosures required of premium-listed companies—see LR 9.8.6R(5) and (6) and LR 9.8.7R.

[38] See the guidance referred to under "FRC Guidance" below and discussed in fn.71 below.

[39] See "The UK Approach to Corporate Governance—October 2010": *https://frc.org.uk/Our-Work/Publications/Corporate-Governance/The-UK-Approach-to-Corporate-Governance.pdf* [Accessed April 28, 2014].

of the UK Corporate Governance Code and the thinking behind the UK's (i.e. the FRC's) approach. As we shall see in para.2–016 below, the key feature of the UK approach is "comply or explain".

The FRC's work is carried out by the three committees mentioned above and their respective sub-committees or councils. The Executive Committee is responsible for advice on strategic issues and general oversight of the FRC's work. The Code & Standards Committee has responsibility for the various codes that the FRC issues, including the UK Corporate Governance Code and the UK Stewardship Code, and the Conduct Committee focuses on promoting high-quality corporate reporting through its monitoring, investigative and disciplinary work. The focus of this work is largely on compliance with financial reporting requirements. The FRC publishes, on an annual basis, a report on the impact and implementation of the UK Corporate Governance Code and the UK Stewardship Code.[40]

ISBs

Various institutional shareholder or representative bodies ("ISBs"), which have no formal regulatory powers or standing in the UK, issue voting guidelines, recommendations and reports, which carry weight with companies subject to the UK Corporate Governance Code. These bodies include the Association of British Insurers (the "ABI"), the National Association of Pension Funds ("NAPF"), the Pensions Investments Research Consultants ("PIRC"), as well as certain investment fund managers such as Hermes Fund Managers.[41] With this group there should also be mentioned the Investor Forum which the Kay Review (see para.2–042 below) recommended should be established and is expected to be operational by June 2014. **2–007**

The ABI operates an Institutional Voting Information Service[42] ("IVIS"). This reviews UK FTSE company annual reports and accounts and AGM and other meeting notices for their compliance with UK corporate governance best practice, in the light of the UK Code and the ABI's own recommended practice. IVIS reviews are issued with a colour coding that ranges from red indicating the greatest concern with the company's report and/or AGM proposals, to amber indicating a lesser concern and blue, indicating that there are no areas of major concern. A green code indicates an issue that has been resolved.

Where company reports or proposals disregard the various published voting guidance and principles of other ISBs, such as PIRC or NAPF, those organisations may publicise their concerns and views as to how shareholders should vote on any relevant resolutions required to be passed at the company's AGM.

The activities of ISBs clearly play an important part in the maintenance of good governance, although it is arguable that in some cases they may interfere unhelpfully in the process of attempts to establish direct engagement between

[40] Its most recent report was published in December 2013: "Developments in Corporate Governance 2013": *https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2013.pdf* [Accessed April 28, 2014].

[41] See fnn.37 and 51 in Ch.1 (Definition, Background and Purpose of Corporate Governance).

[42] See *www.ivis.co.uk* [Accessed April 28, 2014].

investors and investee companies. For more about ISBs and their activities in the context of corporate governance, see paras 1-013 and 1-019, and also the concluding paragraph in para.1-037 of Ch.1 (Definition, Background and Purpose of Corporate Governance).

The Takeover Panel

2–008 For companies subject to the City Code on Takeovers and Mergers, the Panel on Takeovers and Mergers has included a number of provisions in the City Code that set governance-related requirements with respect to the conduct of a target's board in connection with a takeover offer. These include general principles requiring the board to act in the interests of the company as a whole and not to deny its shareholders the opportunity to decide on the merits of the offer, as well as rules requiring the target board to take independent advice, rules addressing possible conflict situations in the case of MBOs and restrictions and requirements with respect to management incentivisation arrangements and frustrating action.[43]

The European Commission[44]

2–009 Corporate governance in the United Kingdom is still mostly regulated by UK based law and rules, rather than by EU directives or regulations. However, there is an increasing focus on corporate governance at the EU level, spurred by the financial crisis of 2008/09 and the drive to find some international "solutions" to the problems (e.g. as regards executive remuneration) which have become more apparent in the wake of the crisis. This increasing focus[45] has already manifested itself in, for example, the following legislation which has been (or will have to be) implemented in the UK:

- the requirements of the Statutory Audit Directive for most companies with transferable securities admitted to trading on an EU-regulated market to appoint an audit committee[46] (now reflected in DTR 7.1);[47]
- the amendments to the Fourth Company Law Directive[48] requiring the inclusion in annual reports of companies with shares admitted to trading on an EU-regulated market of a corporate governance statement (now reflected in DTR 7.2);[49]

[43] A copy of the Takeover Code can be downloaded from the Takeover Panel's website at: *www.thetakeoverpanel.org.uk* [Accessed April 28, 2014]; see, in particular, General Principle 3 (B1) and rr.3, 16.2, 20 and 21. Takeover regulation is not generally discussed in this book.

[44] For a detailed discussion of corporate governance more generally within the EU and the direction of EU policy in this area, see Ch.3 (The EU Corporate Governance Legislative Environment).

[45] As discussed in para.1–029 of Ch.1 (Definition, Background and Purpose of Corporate Governance) and generally in Ch.3 (The EU Corporate Governance Legislative Environment).

[46] Directive 2006/43/EC of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC [2006] OJ L157/87.

[47] See further Ch.14 (External Audit, Internal Audit and the Audit Committee).

[48] Made by Directive 2006/46/EC of the European Parliament and of the Council amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings [2006] OJ L224/1.

[49] See further Ch.20 (Communicating with Shareholders: the Legal and Regulatory Framework) and Ch.22 (Narrative Reporting).

[50] Directive 2007/36/EC of the European Parliament and of the Council on the exercise of certain rights of shareholders in listed companies [2007] OJ L184/17.

[51] As discussed particularly in Ch.23 (The Annual General Meeting and Other Shareholder Meetings).

[52] See further Ch.10 (Gender Diversity on Boards) and para.3–057 of Ch.3 (The EU Corporate Governance Legislative Environment).

[53] See, for example, the discussion in paras 10–011 to 10–017 in Ch.10 (Gender Diversity on Boards).

[54] Admission and Disclosure Standards April 16, 2013; see: *http://www.londonstockexchange.com/companies-and-advisors/main-market/rules/regulations.htm* [Accessed April 28, 2014].

- the Shareholder Rights Directive[50] which has led to changes in certain shareholder rights with respect to meetings in the CA 2006;[51]
- the proposed directive on improving the gender balance among non-executive directors on listed company boards.[52]

In addition, the Commission has, from time to time, published various recommendations, reports or plans with relevance to corporate governance within the EU, as further discussed in Ch.3. The EU's role in this area has started to move beyond simply supporting corporate governance developments and initiatives, to propoPremium segment listings:sing new directives under which it will also be required to carry out a review of the working of the directives and to consider whether their scope needs to be broadened, etc. This has not, however, been universally welcomed or supported by some Member States, some of whom argue that the role itself is not consistent with the principle of subsidiarity and that a number of corporate governance initiatives that the Commission has taken up should best be left for individual Member States to pursue and implement as they think most appropriate for their own particular circumstances.[53]

REGULATED AND OTHER MARKETS

2–010 As can be seen from the table below and as indicated in para.2–001 above, corporate governance requirements for issuers of equity traded on public markets in the UK differ depending on whether the relevant equity has an official listing or not and, if it does not, the type of market on which it is traded. There are also some differences depending on whether the issuer is UK incorporated or not.

The official listing of securities and their admission to trading on a securities market are two separate things. The FCA deals with applications for listing and the operator of the relevant market deals with an application for admission to trading. The rules for applying for a listing are set out in the LRs; and the rules for applying for admission to trading will be set out in the relevant market operator's admission standards rules (e.g. the London Stock Exchange's Admissions and Disclosure Standards[54]).

CHAPTER 7

The Board: its Role, Structure and Composition

Mark Cardale[1]

INTRODUCTION

7–001

> "If the board is not taking the company purposefully into the future, who is?"[2]

> "It is board leadership which generates the drive on which the growth of individual companies and of the economy as a whole depends."[3]

The proper functioning of the board remains at the heart of good governance, and the sentiments underlying these statements, taken from a Department of Industry Report published in 2004, still reflect the basic premises of the UK Corporate Governance Code and its key opening Principles. Main Principle A.1 states that:

> "Every company should be headed by an effective board which is collectively responsible for the long-term success of the company"

and is backed by the Supporting Principle that:

> "The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed[4]. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met."

It is easy to say that all boards of directors should comprise a diverse group of experienced and talented individuals, each of whom espouses and practises the characteristics and values of good commercial sense, courage, openness and integrity—an ideal scenario which may not always be readily achieved. The UK

[1] See "About the Editor" at the front of this book.
[2] Sir John Harvey Jones, quoted in "Building Better Boards" published by the DTI in December 2004; available at *www.berr.gov.uk/files/file19615.pdf* [Accessed April 30, 2014].
[3] Sir Adrian Cadbury, quoted in Building Better Boards as referred to in fn.2.
[4] This sentence is repeated verbatim in para.1.1 of the FRC's Guidance on Board Effectiveness, available at *https://www.frc.org.uk/getattachment/c9ce2814-2806-4bca-a179-e390ecbed841/Guidance-on-Board-Effectiveness.aspx* [Accessed June 18, 2014].

Corporate Governance Code, together with the various reviews and reports and the earlier versions of the codes which preceded it, supplemented now by the FRC's Guidance on Board Effectiveness,[5] has sought to provide benchmarks and guidance as to structure, process and behaviour which are designed to assist boards towards the achievement of something like this ideal.

This chapter, together with Ch.9 (The Effective Board), seeks to describe the relevant benchmarks and guidance in current UK rules[6] and practice concerning boards and directors. This chapter looks particularly at the role of the board and the functions it performs, the composition of the board and the roles of those who act as board members, the delegation of the board's powers and responsibilities through the use of board committees and some related matters (including recruitment, succession and resignations and retirement). Part 1 of Ch.9 (The Effective Board) considers procedures used to support and enhance the board's performance (induction, training and evaluation), "challenge" and effectiveness, board information, insurance and other support; Part 2 of Ch.9 discusses some basic rules for board meetings.

The way of looking at much of all this has evolved significantly over the last ten years, as the words at the beginning of this Introduction may indicate; and many changes have been backed by a welter of research and words, both written and spoken. The financial crisis of 2007/09, as repeatedly remarked, has spurred changes in attitude, and undoubtedly a much greater degree of professionalism is apparent in boardrooms; the extent of structural changes flowing from the crisis are less easy to identify, and their overall impact less easy to see and foresee.

The requirements for companies to produce corporate governance reports, as summarised in Sch.B to the UK Corporate Governance Code,[7] and the focus they have given to governance arrangements, particularly in the boardroom, have (in the author's view) done much to foster the growth of professionalism noted above. Points previously taken for granted, or even ignored, now have to be addressed. Anecdotal evidence suggests, however, that board members now have too frequent cause for complaint that all of their time and attention as directors—and it is capable of being a lot of time—is taken up with governance

[5] See fn.4 above.

[6] In this chapter, the discussion is focused on the UK Corporate Governance Code, and the FRC guidance surrounding that. As explained in Ch.2, the UK Corporate Governance Code is of required application only to companies with a premium listing on the London Stock Exchange. But the UK Corporate Governance Code, and the FRC guidance, will certainly be used as a benchmark by other companies.

For companies which are not premium listed, see particularly Ch.5 (Delivering Proportionate and Effective Governance to Small and Medium-Size Quoted Companies) and note also paras 2–019 and 2–024 to 2–029 of Ch.2 (The Legal and Regulatory framework in the United Kingdom).

Much of what is said in this Part 3 of this book about boards and directors is also of application to boards and directors (or their equivalents) in companies and other organisations in the public, voluntary and community sectors (including the NHS), which are discussed generally in Ch.27 (Public Sector Governance), Ch.28 (The Voluntary and Community Sector) and Ch.27 (Governance in the NHS). See also para.12–023 of Ch.12 (Non-Executive Directors).

[7] The specific requirements are set out in the FSA Disclosure and Transparency Rules (sub-chs 7.1 and 7.2) which apply to premium and standard listed companies; the FSA Listing Rules 9.8.6R, 9.8.7R and 9.8.7AR applying to premium listed companies; and parts of the UK Corporate Governance Code listed in Sch.B set out in Appendix 8 at the end of this book. For more on the corporate governance report, see para.20–005 of Ch.20 (Communicating with Shareholders: the Legal and Regulatory Framework).

and compliance matters, leaving little opportunity for them to consider the proper direction of the company, its strategy and affairs. Some might like to remember that "even a megaton of governance is no substitute for invention, entrepreneurial skill, originality, and sheer managerial competence and integrity"[8] but sentiments like this, less than ten years old, are now hard to find openly expressed in quite such terms.

THE ROLE AND STATUS OF THE BOARD; DELEGATION OF THE BOARD'S POWERS

The overall purpose of the leadership expected of a board is set out in paragraph 1.2 of the FRC's Guidance on Board Effectiveness,[9] which states that: **7–002**

> "An effective board develops and promotes its collective vision of the company's purpose, its culture, its values and the behaviours wishes to promote in conducting its business. In particular it:
>
> - provides direction for management;
> - demonstrates ethical leadership, displaying—and promoting through the company—behaviours consistent with the culture and values it has defined for the organisation;
> - creates a performance culture that drives value creation without exposing the company to excessive risk of value destruction;
> - makes well-informed and high-quality decisions based on a clear line of sight into the business;
> - creates the right framework for helping directors meet their statutory duties under the Companies Act 2006, and/or other relevant statutory and regulatory regimes;
> - is accountable, particularly to those that provide the company's capital; and
> - thinks carefully about its governance arrangements and embraces evaluation of their effectiveness."

This principled statement of the board's role will find practical expression in the "formal schedule of matters specifically reserved for its decision", which a board should prepare pursuant to Code Provision A.1.1 of the UK Corporate Governance Code.[10] This will be reflected in the corporate governance statement of the company's annual report, which "should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management".[11] Notwithstanding the aspirations which underpin such statements, some involvement with the mundane is probably inevitable. As noted above in the Introduction (para.7–001), complaints now seem frequent about the amount of compliance

[8] From J. Charkham, *Keeping Better Company: Corporate Governance Ten Years On* (Oxford University Press, 2005).

[9] See fn.4 above.

[10] Available at *https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx* [Accessed April 30, 2014].

[11] Code Provision A.1.1 of the UK Corporate Governance Code. See further on this topic, para.9–020 of Ch.9 (The Effective Board).

work which a board must work through, even if as noted in this para.7–002 below much "hands-on" work is now dealt with by executive committees.

There is a basic legal principle that the directors should act collectively, as a board[12] and not as individuals. Consequently, all directors (whether executive or non-executive) share equal responsibility for the decisions of the board. This does not mean that individual directors are unable to express their own reservations or even disagreements with decisions made by the board as a whole where it has not been possible to find accommodation for different points of view in some particular decisions.[13] But a director who maintains sustained objection to board policy or principle, and is unable to reach any accommodation for his or her views with the rest of the board, should expect to resign, or perhaps to face dismissal.[14]

In the absence of express delegation of the board's powers,[15] or except where the doctrine of "holding out" applies,[16] individual directors (or a group of individual directors) do not normally have power to bind the company. Regular recourse to the use of delegation to specialist committees by the boards of major companies is now standard practice, and is indeed required for some purposes of the UK Corporate Governance Code. This practice is not only perceived as an effective way to lighten the load of boards as a whole, but ensures proper specialist consideration to be given to matters which would not necessarily benefit from the attention of the board as a whole.

In most discussion about the corporate governance of listed UK companies, attention naturally focuses on the role and effectiveness of board members. However, the proportion of the board which is composed of executive directors appears to have declined significantly,[17] and much "hands-on" work may be dealt with by executive committees, really working groups handling specific areas of the company's activities (e.g. HR or perhaps IT) or perhaps comprising divisional heads.

[12] *Re Haycraft Gold Reduction and Mining Co* [1900] 2 Ch 230. See also, for example, para.5.1 of Unilever's "The Governance of Unilever" (2013); available at *http://www.unilever.com/images/ir20100428TheGovernanceofUnilever200510tcm13216301.pdf* [Accessed April 30, 2014].

Note that in the UK companies operate with a single board: the "unitary" system, as distinct from the two-tier system found in parts of continental Europe (including Germany): see paras 1–029 to 1–031 of Ch.1 (Definition, Background and Purpose of Corporate Governance).

[13] It should be borne in mind that "An effective board should not necessarily be a comfortable place. Challenge, as well as teamwork, is an essential feature": see para.1.3 of the FRC Guidance on Board Effectiveness. See also Code Provision 4.4.3 of the UK Corporate Governance Code and para.9–011 in Ch.9 (The Effective Board).

[14] See further in para.7–012 below.

[15] Subject to, and in accordance with, the company's articles of association (see, for example, Articles 5 and 6 of the Model Articles for Public Companies referred to in fn.44 below) and the terms of any relevant board resolution.

[16] Put very simply, this means that where a company, expressly or by implication, holds a director out as having authority to bind the company in particular circumstances, a third party dealing with the director in such circumstances is entitled to rely on the director having such authority. It is normally the case that a "managing director" (or chief executive) will be considered to be "held out" by the company as having individual power to bind it generally. See, for example *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 Q.B. 480; [1964] 2 W.L.R. 618.

[17] See for example the 2009 study, "Who manages UK plc?", conducted by the corporate advisory firm Lintstock and published by the All Party Parliamentary Corporate Governance Group. See *http://appcgg.co.uk* [Accessed April 30, 2014].

As the authority and influence of the executive committee has grown, many companies are now making determined efforts to increase the exposure of their non-executive directors not just to the executive committee but to the "high potentials" in the layer below. And, in most instances, these efforts are taking place in the context of a drive to strengthen the board's oversight of risk and internal control, by providing more opportunities for non-executive directors to obtain a "gut feel" for the strengths and weaknesses inherent in their businesses. Non-executive directors are encouraged by para.1.18 of the FRC Guidance on Board Effectiveness "to visit, and talk with, senior and middle managers in these areas"; and this in turn should assist those in the "pipe-line" to develop their suitability for a board position:

> "Executive directors may be recruited from external sources, but companies should also develop internal talent and capability. Initiatives might include middle management development programmes, facilitating engagement from time to time with non-executive directors, and partnering and mentoring schemes."[18]

As far back as the Cadbury Report in 1992,[19] concerns had been expressed that boards had allowed decisions of a fundamental kind to be taken by executive management without reference to the board.

Accordingly, Code Provision A.1.1 of the UK Corporate Governance Code requires that:

> "The Annual Report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management."[20]

BOARD COMPOSITION

General configuration

Compliance with the UK Corporate Governance Code will entail a board comprised of the following: **7–003**

- a chairman (Main Principle A.3), whose role is discussed in detail in Ch.11 (The Chairman);
- a chief executive, who will be a different individual from the person who is chairman (Code Provision A.2.1),[21] and whose role is discussed further in para.7–005 below;

[18] Paragraph 4.6 of the FRC Guidance on Board Effectiveness. See further para.12–019 of Ch.12 (Non-Executive Directors).

[19] See para.1–014 in Ch.1 (Definition, Background and Purpose of UK Corporate Governance).

[20] See Appendix 5 at the end of this book setting out a list of such matters. See also the Guidance on matters reserved for the board, published by ICSA and available at *https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx* [Accessed April 30, 2014]. This also contains a suggested list of such matters.

[21] See further para.11–007 of Ch.11 (The Chairman).

- members with "the appropriate balance of skills, experience, independence and knowledge of the company to discharge their duties and responsibilities effectively (Main Principle B.1);
- "an appropriate combination of executive and non-executive directors (and, in particular, independent non-executive directors)" (Supporting Principle B.1), and a board appointed "on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender" (Supporting Principle B.2). None of the executive directors would have taken on more than one non-executive directorship in a FTSE 100 company nor the chairmanship of such a company (Code Provision B.3.3);
- at least half the board, (Provision B.1.2) excluding the chairman, would comprise non-executive directors determined by the board to be "independent" (defined in Code Provision B.1.1), as discussed further below in this paragraph. However, a smaller company[22] would have at least two independent non-executive directors (Code Provision B.1.2);
- the number of "independent" non-executive directors would be at least three (except in the case of smaller companies,[23] when two is the minimum) in order to comply with Code Provision D.2.1, which requires that the remuneration committee has at least three independent non-executive directors, and Code Provision C.3.1, which has the same requirement for the audit committee The number of non-executives will however be more than three if a larger number is required to ensure compliance with Provision B.1.2 noted in the last sub-paragraph;
- at least one member of the audit committee would have "recent and relevant financial experience" (Code Provision C.3.1), as discussed below in para.7–008 and in more detail in Ch.15 (External Audit, Internal Audit and the Audit Committee);
- a senior independent director from among the independent non-executive directors (Code Provision A.4.1), whose role is discussed below in para.7–005.

The term "independence" in relation to the status of a director is not a term of art. Code Provision B.1.1 of the UK Corporate Governance Code Provision does however require the board to state in the annual report each director it considers to be independent and in particular why it considers that directors are independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination. A broader discussion of the meaning of "independence" is contained in para.12–007 of Ch.12 (Non-Executive Directors).

Size

7–004 The UK Corporate Governance Code contains no particular stipulations as to the size of a board, but a company seeking to fulfil the requirements noted above in para. 7–003 is likely to have at least seven directors. Larger and more complex

[22] I.e. a company that is below the FTSE 350 throughout the year immediately prior to the reporting year: fn.6 to the UK Corporate Governance Code.
[23] See fn.22 above.

companies may have more[24]: e.g. Unilever has 14 directors, Barclays has 13, Aviva 11 and British Airways 10, although each of these boards has only two executive directors, the chief executive and chief financial officer (or finance director). It generally becomes difficult for a board with too many directors to operate effectively and efficiently.

A supporting principle to Main Principle B.1 (composition of the board) of the UK Corporate Governance Code states that the board:

> "should be of sufficient size that the requirements of the business can be met and that changes to the board's composition and that of its committees can be managed without undue disruption, and should be not so large as to be unwieldy".

Other constraints may also exist. The Walker review[25] suggested[26] that boards of banks and other financial institutions were being constrained from appointing from within the organisation non-executives of financial experience on the grounds that they were not "independent" within the meaning of the Code. Thus, boards might need to be specially enlarged in order to accommodate additional (external) "independent" directors. Walker felt that this was an undesirable side effect of the "independent" director rules.

Balance may be as important as size: see further in Ch.9 (The Effective Board).

The chief executive (and other executive directors)

As noted and further discussed in para.11–007 of Ch.11 (The Chairman), the chairman and chief executive should be separate individuals.[27] It may be advisable to set down in writing their different roles, and for the board to approve this.[28] 7–005

The chief executive (traditionally referred to in the UK as the managing director) is the senior executive in the company, working on a full-time basis and responsible for proposing strategy to the board and the company's implementation of the overall strategy agreed with the board.[29] The chief executive will report to the chairman, who will act as the chief executive's principal channel of communication with the board as a whole. The chief executive will have the key role in managing the company's executive, setting its tone and values, and in

[24] In practice, the need for sufficient directors of appropriate skills and experience to provide effective oversight of all its activities, and to people its board committees, is likely to increase the number of directors on the board of a larger company. But note what is said below in this paragraph on the conclusions of the Walker Review on the size of boards in the financial sector.
[25] The Walker review of corporate governance in the UK banking and other financial industry entities (2009), available at *http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf* [Accessed April 30, 2014]. See particularly para.4–004 of Ch.4 (The Governance of Banks and other Financial Institutions).
[26] Paras 3.2, 3.6 and 3.7 of the review.
[27] See Code Provision A.2.1, noted in para.7–003 above. The separation of these two roles has been a particular issue at ITV over the period from 2006–2009, and at Marks & Spencer over the period from 2004–2009.
[28] Para.1.13 of the FRC Guidance on Board Effectiveness.
[29] Para.1.13 of the FRC's Guidance on Board Effectiveness.

relations with shareholders[30]; he or she "is responsible for supporting the chairman to make certain that appropriate standards of governance permeate through all parts of the organisation".[31] The chief executive should ensure that the board knows the executive directors' views on business issues, to improve board discussion and to make known any divergent views before final decisions are taken.[32]

Paragraphs 1.12 to 1.17 of The FRC Guidance on Board Effectiveness address the roles of all executive directors. In larger companies, the executive directors of the board may comprise only the chief executive and the chief financial officer (or finance director)[33]; in medium size and smaller companies, a larger number of board members, and a greater proportion, will be executives. Among the points made by the FRC Guidance just referred to are:

- executive directors have the same duties as other directors on a unitary board, and thus have wider responsibilities than those attaching to their purely executive roles. They may develop their understanding of the wider board role by taking up a non-executive position with another board (although there are obvious constraints on the time they may devote to another role, and potential conflict issues: the board should have a clear understanding, perhaps in writing, on the "external" roles its members may take on);
- executive directors have the most intimate knowledge of the company and its capabilities: they should appreciate that constructive challenge from non-executives is an essential aspect of good governance, and executives should encourage their non-executive colleagues to test their proposals in the light of the non-executives' wider experience outside the company.[34]

The senior independent director

7–006 The role which a senior non-executive director might have as "the senior independent director" (or "SID")[35] was first identified in the Hampel Report,[36] and then emphasised by Higgs.[37] It will generally be helpful for a company to set out in writing the particular role expected of the SID.[38] Code Provision A.4.1 of the UK Corporate Governance Code states that:

[30] See the Supporting Principles in Section E.1 of the UK Corporate Governance Code. See para.20–013 of Ch.20 (Communicating with Shareholders: the Legal and Regulatory Framework), and note also para.25–003 of Ch.25 (Companies and Their Owners—How They Engage: A Historical and Personal Perspective).

[31] Para.1.14 of the FRC Guidance on Board Effectiveness.

[32] Para.1.15 of the FRC Guidance on Board Effectiveness.

[33] Para.1.16 of the FRC Guidance on Board Effectiveness states that the chief financial officer has a "particular responsibility to deliver high quality information to the board on the financial position of the company". Enough said!

[34] See further para.9–008 of Ch.9 (The Effective Board) and para.12–008 of Ch.12 (Non-Executive Directors). See also para.7–002 above.

[35] For a discussion of "independence", see para.12–007 of Ch.12 (Non-Executive Directors).

[36] See paras 1–014 to 1–016 and 1–021 to 1–022 of Ch.1 (Definition, Background and Purpose of Corporate Governance).

[37] See fn.36 above. The Higgs review is available at *http://www.ecgi.org/codes/documents/higgsreport.pdf* [Accessed April 30, 2014].

[38] Para.1.11 of the FRC Guidance on Board Effectiveness.

> "The board should appoint one of the independent non-executive directors to be the senior independent director to provide a sounding board for the chairman and to serve as an intermediary for the other directors when necessary. The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or other executive directors has failed to resolve or for which such contact is inappropriate."

The Provision thus outlines the two primary functions of the SID:

- to act as an intermediary between the chairman and the rest of the board. In this role, the SID should provide: "support for the chairman in the delivery of his or her objectives" and "work with the chairman and other directors[, and/or shareholders,] to resolve significant issues".[39] The FRC Guidance on Board Effectiveness, from which these quotes are taken goes on to say that: "Boards should ensure that they have a clear understanding [i.e. this is a two way process] of when the senior independent director might intervene in order to maintain board and company stability", and gives some examples of occasions when intervention may be necessary or desirable, including disputes between chairman and CEO and when shareholders or non-executives have expressed concerns that are not being addressed by the chairman or CEO.
  In interacting with the other non-executives, the SID will meet with them "at least annually to appraise the chairman's performance and on such other occasions as are deemed appropriate"[40]—per Code Provision A.4.2 of the UK Corporate Governance Code:
- to act as liaison with shareholders. Walker[41] noted that "the SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate". Code Provision E.1.1 of the UK Corporate Governance Code states in this connection that: "The senior independent director should attend sufficient meetings with a range of a major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders".[42]
  In addition to these functions, the SID may be expected to take a lead in succession planning, particularly if this is being ignored, and in taking "responsibility for an orderly succession process for the chairman".[43]

In some companies, the SID may also act as Deputy Chairman.

[39] Para.1.10 of the FRC Guidance on Board Effectiveness.

[40] See further para.9–005 of Ch.9 (The Effective Board).

[41] See fn.25 above.

[42] See further in this connection paras 12–017 and 12–018 of Chapter 12 (Non-Executive Directors), and note the Supporting Principle to Main Principle E.1 (Dialogue with shareholders) of the UK Corporate Governance Code, which states that: "Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman should ensure that all directors understand their major shareholders issues and concerns".

[43] Para.1.9 of the FRC Guidance on Board Effectiveness.

COMMITTEES OF THE BOARD

7–007 A board's authority to establish any committee to which it delegates powers will be set out in the company's articles of association, to which reference should be made at the outset to ensure compliance with their provisions. The Model Articles for Public Companies[44] give the board very wide ranging discretions to delegate any of its powers to a committee. The FRC Guidance on Board Effectiveness stresses[45]:

- the ultimate responsibility of the board itself for making final decisions on the matters considered by board committees;
- the importance of communication between the board and its key committees and of the committees' reporting on the content of their discussions and their recommendations on any actions to be taken. Further, "the processes of interaction between committees and between each committee and the board should be reviewed regularly".

It will be desirable when any committee of the board is established for the relevant board resolution to specify:

- how membership of the committee is to be constituted, including the qualifications or criteria by which any person will be entitled to be appointed a member of the committee and the number of people who will serve on the committee;
- the committee's terms of reference: the matters on which it will be expected or required to deliberate, and the nature and scope of the decisions which it will be entitled to make; and
- any special rules of procedure which the committee should follow.

Some committees will be set up for a special purpose, e.g. to oversee the company's participation in a particular transaction in which the continuous involvement of the whole board will be impractical. Other committees, of particular importance in the governance field, will be "standing committees", of essentially unlimited duration to carry out the board's functions in relation to certain of its key functions.[46]

Compliance with the UK Corporate Governance Code will require that a company establishes at least three standing committees:

- the audit committee;
- the remuneration committee (or "Remco"); and
- the nomination committee.

[44] See Articles 5 and 6 of the Model Articles for Public Companies, set out in The Companies (Model Articles) Regulations 2008 (SI 2008/3229), as amended by the Mental Health (Discrimination) Act 2013.

[45] Paras 6.1 and 6.2 of the FRC Guidance.

[46] See also para.7–002 above concerning executive committees. They will in any event have a reporting line through to a board member (probably the CEO), but will not necessarily be constituted as a board committee.

These may frequently be supplemented by a Risk Committee (whose functions, or some of whose functions may frequently be supplemented by the Audit Committee)[47] and sometimes by a Corporate Governance Committee (which may, amongst other things take the lead in preparing the corporate governance statement referred to in para.7–001 above).

Code Provision B.5.1 of the UK Corporate Governance Code states that "[all] committees should be provided with sufficient resources to undertake their duties".

The audit committee

7–008 A full discussion of the composition and role of the audit committee is set out in Ch.15 (External Audit, Internal Audit and the Audit Committee).

Code Provision C.3.1 of the UK Corporate Governance Code requires that the board should establish an audit committee of at least three or, in the case of smaller companies,[48] two members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has "recent and relevant" financial experience.[49]

Code Provision C.3.3 requires that the terms of reference of the audit committee,[50] including its role and the authority delegated to it by the board, should be "made available", which the Code indicates[51] can be satisfied by publication on the company's website.

The remuneration committee

7–009 A full discussion of the composition and role of the remuneration committee is set out in Ch.16 (Directors' Remuneration).

Code Provision D.2.1 of the UK Corporate Governance Code requires that the board should establish a remuneration committee of at least three or, in the case of smaller companies,[52] two members, who should all be independent non-executive directors, but may now include the chairman provided that (s)he was independent at the time of appointment and provided that (s)he does not chair the committee.[53]

[47] The establishment of a Risk Committee (separate from Audit) was recommended by the Walker Review (for which see fn.23 above). For more on this, see para.17–005 of Ch.17 (Practical Risk Management).

[48] I.e. a company that is below the FTSE 350 throughout the year immediately prior to the reporting year.

[49] This provision overlaps with FSA Disclosure and Transparency Rule 7.1.1. See further para.15–021 of Ch.15 (External Audit, Internal Audit and the Audit Committee).

[50] See *http://www.icsa.org.uk* [Accessed April 30, 2014] for suggested terms of reference for an audit committee.

[51] See fnn.7 and 19 to the UK Corporate Governance Code.

[52] See fn.48 above.

[53] Under Code Provision D.2.1 the chairman of the board may also be a member of, but not chair, the remuneration committee if (s)he was considered independent at the time of appointment as chairman.

As with the audit and nomination committees, the terms of reference of the remuneration committee must be "made available", and publication on the company's website will satisfy that requirement.[54]

The nomination committee

7–010 Code Provision B.2.1 requires that there should be a nomination committee which should "lead the process for board appointments and make recommendations to the board". A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee, but the chairman should not be chair of the nomination committee when dealing with the appointment of a successor to the chairmanship.

Code Provision B.2.2 requires that the nomination committee should evaluate the balance of skills, experience, independence and knowledge on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.[55]

For the appointment of the chairman, the nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crisis.[56] Other significant commitments should be disclosed both before appointment and included in the annual report. Changes to such commitment should be reported to the board, and included in the next annual report.

The nomination committee should ensure that the terms and conditions of appointment of non-executive directors are made available for inspection at the company's registered office during normal business hours and can be inspected at the AGM (for 15 minutes prior to the meeting and during the meeting).[57]

Code Provision B.2.4 requires that a separate section of the annual report should describe the work of the nomination committee,[58] including the process it has used in relation to board appointments. This section should include a description of the board's policy on diversity, including gender,[59] any measurable objectives that it has set for implementing the policy, and progress on achieving the objectives. An explanation should be given if neither an external research consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director.

Paragraph 4.7 of the FRC Guide on Board Effectiveness[60] suggests that good board appointments should "not depend solely on the nomination committee" and that prospective directors should carry out their own due diligence to ensure the appropriateness of their appointment.[61]

[54] See fn.51 above, and see *http://www.icsa.org.uk* [Accessed April 30, 2014] for suggested terms of reference for a remuneration committee.
[55] For more on the balance of a board, see para.9–002 of Ch.9 (The Effective Board).
[56] See Code Provision B.3.1.
[57] Footnote 9 in the UK Corporate Governance Code.
[58] This Provision overlaps with FSA Rule DTR 7.2.7 R (see Sch.B to the Code reproduced in App.8 of this book).
[59] For more on diversity, see para.7–011 below and Ch.10 (Gender Diversity in the Boardroom).
[60] See fn.4 above.
[61] See also para.12–012 of Ch.12 (Non-Executive Directors).

As with the audit and remuneration committees, the terms of reference of the nomination committee must be "made available", and publication on the company's website will satisfy that requirement.[62]

RECRUITMENT, APPOINTMENT AND DIVERSITY

7–011 Main Principle B.2 to the UK Corporate Governance Code (Appointments to the board) states: "There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board". Care should be taken that appointees have the time available to devote to the job.[63]

The Supporting Principles in Section B.2 of the Code make clear that it is for the board to:

> "satisfy itself that plans are in place for the orderly succession for appointments to the board and senior management, so as to maintain an appropriate balance of skills and experience within the company and on the board and to ensure progressive refreshing of the board."

But in practice it will be largely for the nomination committee (discussed in para.7–010 above) to make and implement plans to achieve this objective.

The "progressive refreshing" of the board may not always be easy to achieve. There may be good reasons for some directors to stay on for longer than others, and unforeseen and unforeseeable events may disrupt a carefully planned schedule of retirements and new appointments. But some order, if it can be achieved, is desirable: it will be difficult for a chairman to manage a board where several directors are being inducted[64] at more or less the same time, and a board full of well-seasoned directors is unlikely to provide the requisite degree of "challenge"[65] in the board's activities.

The UK Corporate Governance Code in Supporting Principle B.2. speaks of the benefits of diversity, including gender: the gender reference was introduced following the 2009 consultation process on the Code and reflected the growing impatience with the lack of progress in including more women on listed company boards. Progress on diversity, whether of gender or in other respects, seems disappointingly slow,[66] and seems to be impeded by a growing feeling that relevant professional expertise is a pre-requisite to a board appointment.[67] Higgs[68] was quite clear about this: referring to the assumption that business experience is important for a non-executive director, he said:

[62] See fn.29 above, and see *http://www.icsa.org.uk* [Accessed April 30, 2014] for suggested terms of reference for a nomination committee.
[63] See Main Principle B.3 of the UK Corporate Governance Code and the discussion on time commitment in para.12–009 of Ch.12 (Non-Executive Directors).
[64] See para.9–004 of Ch.9 (The Effective Board) and para.12–013 of Ch.12 (Non-Executive Directors).
[65] See para.9–008 of Ch.9 (The Effective Board).
[66] See further on gender diversity, Ch.10 (Gender Diversity in the Boardroom)
[67] Note, in this connection, para.4.4 of the FRC Guidance on Board Effectiveness, referenced in fn.4 above.
[68] See fn.37 above.

CHAPTER 18

D&O Insurance and Indemnification

Edward Smerdon[1]

WHAT IS D&O INSURANCE?

18–001 Attention on the subject of directors' and officers' liability ("D&O") insurance has increased in the UK in the last ten years, beginning with its discussion in the Higgs Review and the subsequent inclusion of provision for it (first) in the Combined Code and (then) in the 2010 UK Corporate Governance Code and ICSA Guidance, which have been followed by new laws on indemnification and heightened interest in executive protection arising out of some notorious extradition cases. It is an insurance policy bought by companies for the benefit of their directors and officers, insuring them in respect of their potential liabilities as directors and officers. Some policies also reimburse the companies themselves to the extent they have lawfully indemnified the directors and officers, and may provide separate cover to the company in respect of securities claims that are also brought against their directors.

In London, D&O insurance is provided by commercial insurance companies and the Lloyd's market, usually via insurance brokers, either as a bespoke product or as part of a wider insurance programme. Its availability, scope and price is ultimately dictated by supply and demand. This has led to periods when the cover has been cheap to buy and broad in coverage: for instance, the insurance market was soft between 1996 and 2002. In 2003/04, following heavy losses suffered by insurers during that soft market, when claims exceeded premiums particularly as a result of D&O claims in the US, the market for D&O hardened, which meant there were fewer insurance companies providing the cover and at increased cost. Since 2007 the market has been soft with high levels of competition and the D&O product had become relatively inexpensive to buy and broader in scope than ever before. On top of this, the change in the law on

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companies' indemnification of their directors focused attention on complementary insurance products that fitted around the indemnification, or which step in should it fail for some reason.

Whilst D&O cover is not generally compulsory, the UK Corporate Governance Code[2] states that all Premium listed companies should buy and provide it for their directors in order to persuade them to take up positions which involve more responsibility and potential exposure than in the past.

A BRIEF HISTORY OF D&O INSURANCE

18–002 D&O insurance has been available in the UK for over 25 years. However, it was rarely offered or bought until s.310 of the Companies Act 1985 was amended by the Companies Act 1989, now s.233 of the Companies Act 2006 (CA 2006), expressly so as to allow companies to purchase D&O insurance for their directors. Even then, take up was slow and the products available extremely restrictive in their scope of coverage, with low limits of the amount of indemnity available.

This was partly because they were based upon the US D&O product, by then mature, which suited the US risks well but did not necessarily address UK liabilities. It was also because in the early 1990s the long-established law governing directors' duties was such that they were to be judged according to very subjective criteria: this meant that liability to the company would be extremely rare. This relatively benign climate changed following the spectacular corporate collapses of the early/mid 1990s with the introduction of codes of best practice and various cases in which courts began to take a tougher view of directors' duties. By the end of the 1990s the accepted test for a director's standard of care was that contained in s.214(4) of the Insolvency Act 1986[3] which effectively provides there is a minimum standard of care required to be met, and the Companies Act 2006 codified directors' duties for the first time.

With the soft insurance market and increased demand, D&O insurance has become more popular and, with increasing amounts of regulation and its position in the UK Corporate Governance Code, it is now fully established.

TYPES OF COVER AVAILABLE—WHO IS COVERED?

18–003 Standard form D&O policies all follow a similar format in the basic cover provided. There are two heads of cover routinely provided and a third which is provided in addition to public companies. A number of further options exist. A brief description of each is set out below.

[2] Code Provision A.1.3 states: "The company should arrange appropriate insurance cover in respect of legal action against its directors." See also paras 8–050 to 8–054 of Ch.8 (Directors: their Duties and other Legal Issues) for a discussion on directors' personal risk strategies.

[3] That of: "A reasonably diligent person having both—(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that Director in relation to the company and (b) the general knowledge, skill and experience that that Director has."

Side A Cover—the directors and officers

18–004 All policies provide cover to the directors and officers in respect of their personal liabilities (this head is often referred to as "Side A cover"). In the UK this is the most widely used cover.

"Directors and officers" are normally defined in the policy by reference to their statutory definitions which rely primarily on their de facto roles. The definition of director will therefore embrace not only those registered as directors at Companies House, but also any individual who in fact performs the role of director.[4] As regards officers, these will typically include the company secretary and senior managers but again the emphasis is upon the role actually performed. In both cases the cover is for "natural persons" and therefore "corporate directors" are not covered.

The cover provided for the directors and officers is typically broad so long as four basic elements are in place: there must be a "*Loss*" suffered as a result of "*Claims*" made against the directors and officers in respect of a "*Wrongful Act*" committed "*in their capacity as Directors & Officers*".

The Side A cover of the policy will be triggered only where all four elements exist. Some examples as to how this works in practice, by reference to different types of problem, appear later in the chapter at para.18–010 below ("What is covered?").

The D&O policy is what is known as a "claims made" policy and so the final requirement for cover in all cases is that the claims are made during the policy's period (typically one year from the inception date). Frequently a situation arises where a claim is anticipated in the policy's period but not made until afterwards. In this event, if the directors have notified the insurer of the potential claim during the policy's period any subsequent claim will be deemed to have been made within the policy's period.

Importantly, the policy covers present and past directors and anyone who becomes a director during the policy's period. There is no requirement for the director to have been a director during the policy's period—only that the claim is made or deemed to be made in that period (as stated above). In this way, directors are covered under policies taken out after their retirement. They are potentially vulnerable if the company stops buying the insurance within six years (the most likely applicable limitation period) of their retirement.

Side A only products have become more prevalent with the changed laws on indemnification, as they are tailored to fit around the indemnification provided by the company and step in should it fail. This topic is addressed later in this chapter.

Side B Cover—company reimbursement

18–005 Claims that are made against the company are not covered under a D&O policy unless additional "entity" coverage has been provided by the insurers (see below for instance "Side C Cover"). However, the company may be covered if and to the extent it has lawfully indemnified the directors and officers in respect of their liability. This head of cover is often referred to as "Side B cover".

[4] See further Appendix 4 (Glossary of Terms concerning Directors) at the back of this book.

Company reimbursement cover used to be more commonly triggered in the US, where companies have routinely indemnified their directors, but was less frequent in the UK, due primarily to the provisions of Companies Act 1985 s.310, which in relation to directors were replaced by CA 2006 s.232 and s.234. Section 310 was a much criticised section, both for its ambiguity and for its effectively prohibiting companies from indemnifying their directors in circumstances where they are now exposed to much greater threats from, for instance, US shareholders. The provisions in CA 2006 s.232 and s.234 are examined in more detail later in this chapter but the basic position is that UK companies are now permitted to indemnify their directors in certain situations. Where they do so, for example by advancing defence costs, Side B cover is potentially available, although it is often subject to an excess.

Side C Cover—securities entity cover

18–006 This head of cover, only needed by public companies, covers the company in respect of claims made against it under s.90 of the Financial Services and Markets Act 2000 (FSMA 2000) or otherwise, for misleading particulars in any public offering of shares where the directors are also sued. Such claims are rare but in principle can be brought against both the directors and the company at the same time, for the same losses.[5] In addition, UK companies with US listings will be exposed to lawsuits from ADR holders under US securities laws, for which this cover is also provided. Whilst under Side A the directors may be covered under the D&O policy, the company would not, and so this cover is given to enable the directors and company to share the responsibility for defending the claims, using the same defence team. Whilst this is convenient, it may not ultimately be in the directors' best interests as costs incurred by the company in respect of its exposures may reduce the amount of cover available to the directors personally.

Investigation costs cover

18–007 Under the FSMA 2000, the Financial Conduct Authority (FCA) has sweeping powers to investigate the affairs of public companies. There have been numerous other pieces of legislation within the last decade that have produced enhanced powers for regulators, the Office of Fair Trading and the Data Protection Commissioner being other examples. Investigations by regulators are therefore part of the day-to-day life of any company, particularly public and financial services companies, and are costly where legal representation is necessary.

An investigation by a regulator will usually start out as an investigation of the company, not of the directors, and without any allegation of wrongdoing on the part of the directors. The costs of attending an investigation would therefore not be covered elsewhere in the policy because the investigation, or at least its preliminary stages, is unlikely to meet the four elements identified above that are

[5] In 2013 group actions were commenced in London against Royal Bank of Scotland Plc and its directors in respect of alleged misleading particulars in the prospectus for the 2008 rights issue which followed the purchase of Dutch bank ABN AMRO. This is the highest profile case of its kind since FSMA 2000 became law.

required for Side A (and Side B) to be triggered (because for instance there is no "claim"). However, insurers recognise the benefit of directors (either personally or more commonly on behalf of the company) being legally represented in such proceedings as a claim may follow later. Cover is therefore now given for such legal representation costs, sometimes without regard to whether the costs are being incurred on behalf of the company or the directors. As an example of the difference a soft market can make to the product, this head of cover used to be subject to a lower limit (a "sub-limit") than the other heads because it would be more likely to be used; it is currently being given without any lower limit.

Outside board cover

18–008 This used to be an optional or very restricted cover but is now standard. It covers employees of the company who, at the direction of the company, sit on the boards of other companies, in respect of their potential liability as directors of those companies. Such cover is popular with venture capital companies who routinely place nominee directors on the boards of companies in which they have invested. It is a more risky cover for the insurers to give because they cannot easily assess these risks. Rather than insist on the details of every such company, insurers usually impose restrictions so that it is not automatically given for certain types of company (such as those with listings or US domicile), and that the cover only operates over and above (a) any D&O insurance bought by the outside company, and (b) any indemnification available from the outside company.

Additional covers

18–009 The fundamental heads of cover have now been dealt with but it is possible to secure additional cover via extensions to the basic policy wording. This is commonly done either by extensions offered within the policy document or by way of "endorsements" to the policy, which are added on. In 2014 there are numerous other extensions offered, too many to set out in this chapter. Below are some examples of extensions of cover:

Employment Practices Liability ("EPL") Insurance covers a company in respect of employment claims made against it that arise out of working practices adopted by the company or its employees. Examples might include unfair dismissal, discriminatory conduct or sexual harassment. Such claims would seldom otherwise be covered under a D&O policy as they are generally against the company as employer (although see para.18–010 ("What is covered?"), below). The insurance provides defence costs cover for the company in defending such claims. There is an argument that as an entity coverage it can erode the amount of cover available for the directors personally and should therefore be bought separately.

Prosecution Costs Cover covers the costs of a director taking *new* proceedings to appeal or overturn or challenge a judicial or governmental order against the director. Side A cover will include the costs of bringing/defending appeals of claims but in certain exceptional circumstances the only right of appeal lies in taking a new and different type of proceeding to the one in which the claim against them was brought. An example is in the context of extradition where,

once the magistrates' court has decided in favour of extradition, it is the Home Secretary who decides to allow the extradition and signs the order for extradition. The only appeal of that lies by taking a new proceeding in the High Court, against the Government. This does not fit happily within the traditional policy structure; but conceptually it should be covered as part of the protection afforded to directors, and so today has become relatively routinely provided.

Non-executive Directors' Additional Limit[6] is a special additional amount of cover (sometimes expressed as a percentage of the policy limit of indemnity) provided on top of the usual limit of cover which is available to the non-executive directors only, once the policy limit has been fully exhausted by claims (involving executive and/or non-executive directors and/or the company). The theory behind this is that the policy is more likely to become exhausted by attritional claims against the executive directors, leaving less cover available for the non-executives to defend themselves on the less frequent occasion of their being sued. Also, it is in recognition of the heightened interest of non-executives in D&O insurance given the fact the liability risks for non-executives outweigh the salary rewards.

Retired Directors' Run-off Cover is frequently provided for no extra premium. This provides six or more years' cover to any director who retired voluntarily before expiry of the policy's period, where the policy is subsequently neither renewed nor replaced by an equivalent policy. The purpose behind the extension is to address legitimate concerns of retired directors that D&O insurance will not be maintained after they have left, leaving them unprotected against future claims that relate to their conduct whilst directors of the company.

Reinstated Limits of Liability and Per Claim Limits are a recent phenomenon. D&O policies are subject to a single aggregate limit for all claims brought, which is eroded by every payment made by the insurer regardless of when made and on whose behalf. Sometimes this limit is not sufficient to satisfy losses claimed under the policy due to there being multiple claims. Where this happens, and depending on the precise terms, the policy may reinstate itself again for every new claim brought within the policy's period that is not connected to the others.

WHAT IS COVERED?

18–010 The nature of the liability risks facing directors has changed over the last 20 years and so has the cover provided by the D&O policy. In practice claims have been brought against directors in the UK relatively infrequently. This may have been for a variety of reasons, including, as mentioned above, the more relaxed standards of conduct that for so long existed, the limited groups of people that under English law could bring claims with any prospects of success, and the relatively benign claims culture in the UK by comparison with the US. Whilst the UK legal regime has some considerable way to go before it exposes directors to

[6] A typical example of this clause states: "In the event of payments in respect of LOSS arising from all CLAIMS on behalf of any INSUREDS exhausting the Limit of Liability … then the Limit of Liability of this Policy Shall be increased by the sum set forth in the [Schedule] in the aggregate in respect of [Side A and Side B coverage] for the benefit only of NON-EXECUTIVE DIRECTORS at the date of the WRONGFUL ACT" (Source: Axis Specialty D&O Policy 2006).

the liability risks imposed on their US counterparts, a gradual increase in potential exposure has heightened interest in the D&O policy, and what it in practice covers.

As mentioned above, the amount of cover provided may change with time, according to insurance market conditions. If in doubt about the amount of cover provided under a policy, it is advisable to ask the company's insurance brokers to comment.

The policy—general

18–011 When a problem that needs to be notified to the insurers arises it is for the directors to show that it falls within the cover in the first instance. This is done by reference to the heads of cover available (see above). The reader is reminded that Side A cover, which is provided for the directors and officers in respect of their potential liabilities, requires four basic elements to be in place: there must be a "*Loss*" suffered as a result of "*Claims*" made against the directors and officers in respect of a "*Wrongful Act*" committed "*in their capacity as Directors & Officers*".

The definition of "*Directors & Officers*" has already been discussed above. The policy definition of "*Loss*" will usually be sufficient to embrace compensatory damages awarded against the directors, settlement payments, defence costs, and the claimant's costs where the claim has been successful. Defence costs are usually expressed to be payable "as incurred" which means they are paid by the insurers as they fall due, rather than reimbursed at the end via an "advancement of costs" provision (relevant to the conduct exclusions, below). The policy definition of "*Claims*" will usually include pre-action protocol or other letters threatening proceedings, civil proceedings, regulatory proceedings and criminal prosecutions. Finally, the policy definition of "*Wrongful Act*" will typically be broad, embracing all types of actual and alleged misfeasance; the crucial element is that there be allegations of wrongdoing.

Importantly, there is no coverage limitation on where claims can be brought, unless claims in certain territories are expressly excluded. Directors of companies with US listings, parent companies or subsidiaries stand a higher chance of being sued and so a "US exclusion" would be unacceptable to them.

Below, we look at the most common areas of exposure for directors in the UK and comment upon how Side A of a typical policy might respond.

Civil claims brought by the company

18–012 Claims by the company are in theory the main source of liability claims for directors as it is to the company that directors primarily owe their duties, although in practice such claims are infrequently brought. The situation most commonly occurs after the constitution of the board changes significantly and the new board recommends to the company that it brings proceedings against the retired directors for mismanagement.

Such claims are for, inter alia, civil damages and will usually make allegations concerning the management of the company. In this event, the four elements needed for there to be cover will usually be present. Where the claim contains a

restitutionary element, for instance where the directors are required to repay sums they allegedly should never have received, this aspect will not usually be included within the cover.

Derivative claims

18–013 Generally the principle of "majority rule" applies to companies. However, minority shareholders have always had a theoretical common law right to bring an action against the directors in the name of and on behalf of the company where the directors have also been majority shareholders and have allegedly been guilty of egregious conduct that is manifestly against the company's interests (known as committing a "fraud on the minority"). Practically speaking, however, this right is very rarely exercised given uncertainty over its application and the perceived legal hurdles to overcome. Sections 260 to 264 of CA 2006 contain provisions designed to make the circumstances in which such claims may be brought, and the machinery for bringing them, clearer. Such claims will otherwise closely resemble claims by the company as described above and for that reason are likely to be included within the cover.

Since the law changed there have been a number of "low profile" derivative actions commenced under the new machinery, but few have proceeded past the court's filtering system.

Claims by shareholders

18–014 It is established law that directors do not generally owe a duty to individual shareholders. This has not prevented minority shareholders from trying to bring claims against directors from time to time. Such claims ought to fail, but the directors will need to incur costs defending the proceedings, at least to the point where they may be struck out. The four necessary elements for the cover to be triggered are likely to be present, except for example where a director, who is also a shareholder, is sued in his or her capacity as a shareholder (such as in a shareholder dispute). Claims under CA 2006 s.994 for unfair prejudice may fall into this category, depending upon the particular allegations.

Claims by third parties

18–015 Generally in their dealings with third parties, the directors act as representatives of the company, and therefore it is the company that ought to be liable where the directors have caused others loss and damage. However, where the company has subsequently ceased to exist, particularly where the director in question was also the main shareholder and driving force behind the company, a third party may allege that the director is liable on the basis that the director assumed a personal responsibility for his or her actions beyond that assumed by the company.

The four necessary elements for cover may be present, as it is likely there would be a civil claim for damages alleging a wrongful act. However, it is arguable that if the claimant succeeds in establishing that the director assumed personal responsibility, (s)he could not have been acting in their capacity as a director. On the other hand, the crucial factor may be that the director could not

have been in a position to assume personal responsibility had he or she not been a director at that time. Coverage may ultimately depend on the precise language used in the policy.

Claims arising out of public offerings

18–016 As mentioned above, claims may be brought against the directors (and the company) for misleading particulars following a public offering of shares. The liability imposed by FSMA 2000 s.90 is at first sight strict, but the effect of the statutory defence contained in FSMA 2000 Sch.10 means that the directors are only likely to be liable where they did not act reasonably, thus introducing the requirement of fault. In practice few claims under this provision have been brought, reflecting a benign claims culture and lack of recent significant corporate failures, but depending on how some high profile cases[7] currently proceeding through the courts are determined, FSMA 2000 s.90 could be used more frequently in future. UK companies with level 2 and 3 ADR programmes are much more likely to face equivalent claims under US securities laws. The claims are civil in nature and for compensatory damages, therefore are again likely to trigger the cover because all four necessary elements are present.

Employment practice (EPL) claims

18–017 Usually employees with a complaint bring proceedings against the company employer, which is not covered under the D&O policy. In cases of discrimination or harassment, a claimant may also join the employee most directly responsible for the matter complained of. This employee may coincidentally also be a director, however, the position of director is unlikely to be crucial to the establishment of the wrongful act alleged, and therefore it could not be said to have been committed in the capacity as a director. Companies with specific concerns as to their exposure to employment claims should seek to address them through EPL insurance.

Insolvency Act claims

18–018 A major source of potential claims against directors is after the company has entered insolvent liquidation, under the Insolvency Act 1986. Liquidators have broad powers to bring claims against directors for misfeasance on behalf of the company (under s.212), for fraudulent trading (under s.213) and for wrongful trading (under s.214).

Coverage of misfeasance claims is likely to be subject to similar considerations as for claims by the company (see above). Claims for fraudulent trading are likely to present additional considerations for the cover (see para.18–023 ("What is excluded?") below). In respect of wrongful trading, the directors may have to contribute to the assets of a company if they continued trading in circumstances where they knew or ought to have known there was no reasonable prospect that the company would avoid going into insolvent liquidation. The claim is civil in nature and involves an actual or alleged wrongful act. A possible doubt is over

[7] See fn.5.

whether a "loss" has been suffered: a requirement "to contribute to the assets of the company" sounds restitutionary in nature; however, the remedy is likely in effect to be compensatory.

Disqualification claims

18–019 Under s.6 of the Company Directors Disqualification Act 1986, directors of a company which has become insolvent will be disqualified if their conduct makes them unfit to manage a company.

Liquidators file a confidential "D Report" with the Government's Department for Business Innovation & Skills on the directors' conduct, and thereafter the Department may bring proceedings for disqualification. There is no other recourse available under the Act. This procedure has been used against directors in increasing numbers in recent years.

In practice the directors incur substantial costs defending these proceedings, and so there is a "loss" notwithstanding the absence of any award of damages. Similarly, disqualification proceedings usually fall within the definition of "claim" even though this is not a civil claim for damages. An allegation of a "wrongful act in the capacity of a director" is obviously involved as the right to disqualify is based upon the director's conduct.

Criminal proceedings

18–020 There are many criminal offences for which directors may be charged. They could then incur potentially substantial costs defending themselves in a criminal trial, so a "loss" is thereby suffered. Any criminal fine imposed cannot be covered due to public policy, and in any event would fall outside the normal definitions of "loss". Criminal proceedings will normally constitute a "claim" and obviously involve an allegation of a "wrongful act in the capacity of a director" and so the cover is likely to be triggered. Due to uncertainty whether extradition proceedings, and in particular, the appeal of an order of the Home Secretary, are covered as a "claim", policies are generally giving express cover for the process to ensure the protection is there.

FSMA 2000 proceedings, fines and restitution orders

18–021 Directors incurring costs in co-operating with the FCA in an investigation of the directors' conduct will be covered for such costs if the circumstances amount to a claim (i.e. where there are allegations of a wrongful act). In the absence of a claim the Investigation Costs cover (above) is likely to apply. Once the FCA issues its findings and makes an order, the directors can appeal by taking a new proceeding to a Financial Services and Markets Tribunal. The taking of such an appeal proceeding may be subject to the same coverage doubts as the extradition appeal process and therefore some policies are giving broader "prosecution costs" cover than simply for extradition.

However, whether the remedies are covered by the D&O policy is more open to question. Under FSMA 2000 s.91, the directors may be fined by the FCA for breaches of FSMA 2000 for "such amount as it considers appropriate". The fines

are not "criminal" in nature and therefore in theory are capable of coverage under insurance. However, the FCA outlawed the possible coverage of such fines under insurance policies from January 1, 2004 on the basis that insurance removes the incentive for compliance. In any event, it is doubtful whether a "loss" has been incurred: typical definitions do not embrace fines of any nature.

Under FSMA 2000 s.382, the FCA may impose restitution orders upon the directors. Another new area of exposure for directors, a restitution order may attract cover depending on which type of restitution order it is. An order for repayment of any profits that have been earned by the directors as a result of, for example, a breach of the Listing Rules, is unlikely to be embraced by "loss". However, an order requiring payment by the directors of a sum equivalent to the loss or other adverse effect of the breach that has been caused to others, such as shareholders, could be a "loss" because it is essentially compensatory in nature.

Conclusions

18–022 From the above it can be seen that in respect of the major areas of potential claims that can be brought against directors in the UK, the losses incurred by those directors are likely to be within the cover under the D&O policy. This is not, however, the only consideration, as coverage is also subject to the other terms, conditions and exclusions of the policy (see below).

WHAT IS EXCLUDED?

18–023 Assuming the problem notified to the insurers by the directors has engaged the cover outlined above, the losses will be presumed covered under the policy unless otherwise excluded. At this point if the insurers assert the loss is excluded, then it is their responsibility in law to demonstrate that a relevant exclusion applies, not the directors' responsibility to demonstrate that an exclusion does not apply.

When the D&O policy was in its infancy, mainly because the nature of the exposures was not fully understood and insurance capacity was scarce, it contained a long list of exclusions. Now, the product has matured and insurers are using more targeted exclusions for specific matters not intended to be covered. This has effectively reduced the number and breadth of the standard exclusions used. However additional exclusions may be added on a bespoke basis by way of endorsement.

In this section, there is brief consideration of the standard exclusions.

Dishonesty, unlawful gain, deliberate breach of rules

18–024 These are known as "conduct" exclusions as they relate to the directors' behaviour. Losses arising from dishonest acts are always excluded; indeed the policy is unable to cover those guilty of dishonest acts as a matter of public policy. Losses arising from unlawful gain, such as the receipt of remuneration to which the director was not entitled, and losses as a result of a deliberate breach of rules are also excluded. However, importantly, the exclusion is usually severable, which means that it should be considered separately for each director and applied

only to a director guilty of the relevant misconduct. The effect of this, for example, is that directors who may be the subject of a claim which involves the dishonesty of another director will be covered so long as they were not dishonest themselves.

As to how the exclusion is applied, the usual requirement is that conduct be "actual" and, practically speaking, that means the exclusion only bites if a court finds that a director was guilty of the relevant excluded conduct. For instance, an allegation of dishonesty will be insufficient to trigger the exclusion. The effect of this is that the exclusion will not actually apply unless or until there is a finding of dishonesty at the conclusion of the claim (or an admission, but this is rare). Because the directors' defence costs are normally covered "as incurred", the insurers would normally pay them regardless of whether there is a question mark over the directors' behaviour, particularly if there is an express advancement of costs provision in the policy.

In the event of an ultimate finding of excluded conduct, any damages awarded against the guilty directors would be excluded and the insurers may be entitled to claim reimbursement of their outlay for defence costs from them.

Civil claims brought by the company

18–025 As mentioned above, claims by the company are generally covered within the terms of Side A cover. However, the way the cover has been structured in theory left insurers vulnerable to attempts by directors to recover first party losses of the companies they managed from insurers under the policy when there had in reality been no claim against them at all.

This concern gave rise to what is known in the industry as the "Assured v Assured" exclusion. In the early days in its most basic form (now relatively rare), the exclusion prevented there being coverage of any claims brought by the company.

Despite the insurers' legitimate concern, the clause was seen as a blunt tool in circumstances where the company, under English law, is the primary source of claims against directors. Consequently, over the years, the clause has been refined in an attempt to allow "arm's length" claims that are brought by the company. Common examples of arm's length claims that are now commonly covered are claims brought by an administrator or liquidator of a company, claims brought by the company at the recommendation of a new board of directors against former directors (*Equitable Life* being an example), derivative actions and claims sanctioned by the shareholders in a vote.

In a further dilution of the detrimental effect of the clause for directors, the exclusion frequently does not now affect the coverage of the directors' defence costs, therefore, even if the claim itself falls foul of the exclusion, the directors would have their defence costs paid. This removes the incentive for the artificial formulation of a claim.

In many recent policies the exclusion has been removed altogether for non-US claims but with the insurers retaining the right to take over and control the defence of such claims rather than leave the directors to do so (the latter being the usual position—see below). This seems to be the most effective way to remove the risk of "abusive" claims and ensure the cover is given for legitimate claims.

Personal injuries, physical damage, pollution, professional liability and other insurance

18–026 Claims brought directly for personal injury, physical damage, pollution and the provision of professional services are routinely excluded as they are considered to be more appropriately covered under other types of insurance purchased by the company. This dovetails with another routine exclusion/limitation, for losses that are covered by other insurance policies taken out by the company (the norm is to state that the D&O policy is to sit in excess of more specifically relevant insurance). In practice this does not mean any significant gap in cover for the directors because such claims should be covered by EL/PL, property and professional liability insurance also purchased by the company.

However, claims against directors that arise *indirectly* from personal injury, physical damage, pollution and professional liability are normally covered. Consequently, for example, a claim for losses based on mismanagement brought by the company because its business was adversely affected by environmental proceedings, or for loss of business as a result of a high profile class action of personal injury claims, will usually be covered.

Pre-existing claims

18–027 It is routine for claims arising from (1) matters notified under a previous D&O policy and (2) litigation that existed before the policy period to be excluded. The reason for this is that previous D&O policies should be applicable to such matters, and so the current policy should not also apply.

Pension trustee liability

18–028 Directors may also be trustees of the company's pension fund. The D&O policy will exclude liabilities incurred in their capacity as pension trustees. This is because it is essentially a different kind of risk to directors' liability, to be assessed separately, and a bespoke policy purchased for it (a "pension trustee liability policy").

EVENTS THAT AFFECT THE COVER

18–029 There are some important additional clauses in the policy which dictate how it reacts to certain events that take place during and at the end of the policy period.

Acquisitions/new subsidiaries

18–030 Directors of companies acquired by the insured company during the policy period may be covered automatically under the insured company's D&O policy for claims arising from matters post-dating the acquisition, so long as the acquired company is not listed, nor domiciled in the US, and does not have total assets exceeding a certain percentage of the newly consolidated assets of the insured company. If any of these provisos are not met then there will be no automatic

coverage and the insurers will have to be approached to agree to cover the acquired company's directors on terms to be negotiated. Importantly, and in any event, the cover only applies to claims arising from facts and matters occurring after the date of acquisition.

Takeovers/mergers

18–031 Where the insured company is itself taken over or merges into another entity where the other entity is the survivor then the policy will cease providing ongoing cover, and from the transaction date until policy expiry will only cover claims in respect of facts and matters occurring prior to that date (this situation is usually referred to as the policy going into "run-off"). The company should be included within the acquirer's D&O policy for claims arising out of post-transaction facts and matters. It would also be advisable for the company to buy a six year "run-off" policy to incept when the company's existing policy expires, in respect of pre-transaction facts and matters, as claims in respect of these will not be covered under the acquirer's D&O policy.

Some policies automatically go into "run-off" in the event the company goes into administration or liquidation, on the basis that the risk changes fundamentally once insolvency practitioners are appointed. Such policies would still cover claims in respect of pre-insolvency facts and matters, until expiry. For the directors, the real issue arising from insolvency is the likelihood the appointed insolvency practitioner will not renew the premium when the policy expires and so the policy is not renewed.

NON-RENEWAL OF THE POLICY

18–032 It is unlikely the D&O policy would not be renewed without being replaced by another equivalent one, other than when the company becomes insolvent. However, upon payment of an additional premium, an "extended reporting period" will be provided by the insurer. This allows the directors to report, up to 12 months after the policy has expired, claims which arise out of facts and matters which occurred prior to policy expiry, and coverage will be provided subject to the policy's terms and conditions. As mentioned earlier in this chapter (para. 18–009 above (Additional Covers)), any director who retired voluntarily before the expiry of the policy may be able to take advantage of six years' free run-off cover via one of the extensions in the Policy.

In the event of insolvency, the company (via the relevant insolvency practitioner) is unlikely to renew the policy, and so the directors will be left to either approach the insurer for "run-off" cover, or notify "circumstances likely to give rise to a claim" before the existing policy expires (see para. 18–004 above (Side A Cover), and para.18–040 below (Notification of claims and/or circumstances)).

BUYING A POLICY

Finding the right cover

18–033 A D&O policy can be purchased through the company's insurance brokers either as a bespoke cover or as part of the company's wider insurance programme. If the latter it may be possible to achieve savings in overall premium paid but there may be sacrifices made in terms of the policy's "fit" with the directors' precise needs.

It is usually the risk management department of the company which handles the purchasing of D&O insurance, along with the other insurances the company needs to buy. Often directors do not have any involvement in the purchasing process, but it is advisable that they take an interest given it is for their benefit.

Given the relatively complex nature of the cover, and the potential expense involved, it is also important to seek advice from the brokers on the most suitable product for the directors' particular circumstances. There is arguably a conflict of interest between what the directors want cover for, and what the company is prepared to buy, but as the company pays the premium this issue is rarely explored. This is another reason why the directors would be well advised to ask questions about the cover available during the purchasing process.

The brokers will then need the directors to provide accurate information about the company's business in order to obtain quotations from the various insurers approached by them. It is possible the insurers' underwriters will invite the directors to meet with them to answer any additional questions they may have. Where there are legitimate concerns over disclosure of sensitive information the underwriters are usually prepared to sign a confidentiality undertaking. This also provides an opportunity for the directors to ask the underwriters any questions they have about the policy they may be buying.

Ultimately, the main buying criteria for the directors will be price, the amount of coverage provided, and the quality of the security.

Policy limits

18–034 An important issue to consider with the insurance brokers is the amount of cover to purchase. A standard level of cover for small/medium sized companies is up to £10 million but for large public companies limits of say, £200 million or more can be bought. Such limits are usually expressed to be "in the aggregate", which means that once payments by the insurers in respect of claims notified in that policy period have reached that sum, the cover is exhausted. Put another way, the policy limit will be eroded by every payment made under the policy, regardless of on whose behalf it has been paid. This can mean that the cover is severely depleted by one claim against a director, leaving the others exposed. This may be of particular concern to non-executive directors who are less exposed to claims than their executive counterparts but will be concerned about their position in the event of corporate collapse, by which time the limit of cover might have been considerably eroded by costs incurred by the executives in respect of other matters (hence the possible provision of extra non-executive director cover as mentioned above).