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Victoria Masterson, *Scottish Business Insider*
Carrying the Corporate Can

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More than ever before, company directors are being held to account for damaging business mistakes – understanding the duties involved is imperative discovers **Victoria Masterson**

WITH so many corporate scalps littering Wall Street and the City, being a company director has arguably never been less appealing. Public scrutiny on boardrooms was already intense and now promises to get much, much worse.

The good news is it may take regulators a while to work out exactly what action they can take next to purge apparent corporate incompetence.

The bad news is that the UK has already introduced a new statutory code of conduct for company directors that many fear makes it easier for them to be sued if they are found to have breached their legal duties.

"There's a greater focus on [directors' duties], directors are more conscious of it and they're just a little bit more worried about it," says **Pinsent Masons** corporate partner Martin Webster. "The example I always quote to people is Northern Rock.

"In July the chairman, Ron Sandler, announced that he was appointing lawyers on behalf of Northern Rock to investigate the conduct of the former directors with a view to finding out whether they had been in breach of their duties. This hadn't happened in the past and it made quite a few people sit up.

"To have all your decisions trawled over and papers looked at with the benefit of hindsight is quite a sobering thought."

Sandler subsequently announced in October that 'insufficient grounds' had been found to proceed with a negligence claim against the directors, led by deposed chief executive Adam Applegarth, and the bank's auditor, PricewaterhouseCoopers.

But had the action proceeded, the nationalised lender would have been one of the first companies in the UK to run a claim against its former directors for breach of duty under the overhauled Companies Act 2006.

The law – which came into force in two stages on October 1, 2007 and October 1, 2008 – sets out a new statutory code of directors' duties, including a 'duty to promote the ▶ success of the company' - not just for its members as a whole, but also with regard to employees, suppliers, customers, the environment, the community and the likely future impact of any decision.

The flipside of this so-called 'enlightened shareholder value', is that, where the company itself won't sue errant directors, members – such as shareholders – can now apply to the courts to sue the directors for acts, or proposed acts, that are found to involve negligence, default, breach of duty or breach of trust.

Although the government has tweaked the original wording to prevent a flood of frivolous claims, lawyers agree that previous 'significant hurdles' to shareholder suits under the common law have now been removed.

Scott Kerr, head corporate partner at **Semple Fraser**, says: "Given the current increase in shareholder activism, the combined effect of the new code of directors' duties, the business review – under the Companies Act 2006, all companies not classified as small businesses (those with turnover above £5.6m, assets over £2.8m and more than 50 staff) must include a report on the company's performance and principal risks in the annual directors' report – and the new statutory derivative action, may well be to expose directors to increased risk of litigation."

The penalties for breaching these duties include the award of damages or compensation against the director where the company has suffered loss, the reclamation of any property due to the company, an account of profits made by the director, rescission of a contract where the director has failed to disclose an interest and ultimately, being disqualified from holding office as a director.

There are six other statutory directors' duties.

Directors must act within pow-

ers – for example, properly and in accordance with the company's constitution.

Directors have a duty to exercise independent judgement and are free to confer and take advice, but must take responsibility for the final judgement.

Directors must exercise reasonable skill, care and diligence, including applying particular skills they may have in areas like accounting, finance and health and safety.

There is a duty to avoid conflicts of interest, particularly in relation to property, information or opportunity.

Directors have a duty not to accept benefits from third parties, codifying the common law rule prohibiting a director exploiting his position for personal benefit.

And directors have a duty to declare interest in a proposed transaction or arrangement including any transaction which may indirectly benefit them.

Advisers point out that these responsibilities are not exclusive. Directors must also comply with their legal obligations under The Health and Safety at Work Act 1974, The Insolvency Act 1986, The Employment Act 2002, The Corporate Manslaughter and Corporate Homicide Act 2007 and others.

Directors of companies listed on the stock exchange also have obligations under UK Listing Rules and the Combined Code on Corporate Governance. The most recent version of this (2003) combines the Cadbury and Greenbury reports on corporate governance, the Turnbull Report on Internal Control, the Smith Guidance on Audit Committees and elements of the Higgs Report.

Companies quoted on the Alternative Investment Market are not formally required to comply with the Combined Code, although some choose to do so voluntarily. If in doubt, the Quoted Companies Alliance – a not-for-profit organisation set up to represent the interests of the smaller quoted company sector – has published the Corporate ▶ Governance Guidelines for AIM companies, which are based on the Combined Code and are voluntary.

With so much material to get through, the quip that you now need a degree to be a company director is not far from the truth.

The Institute of Directors has offered its own professionally recognised certificate and diploma in company direction, leading to the professional qualification of Chartered Director, for about eight years and is seeing increasing demand.

"You certainly need to be a pretty rounded individual to handle all the different responsibilities you have as a company director these days," says **Institute of Directors (IoD) Scotland** director David Watt.

"You need to have a knowledge of areas like health and safety, human resources and the whole gamut of things, as well as your fiduciary and legal duties, so it's really quite demanding.

"Particularly at times like this, people become more aware of the need to have training in the roles and responsibilities of being a director, as well as in their own areas of specialism."

Watt explains the IoD is very keen on professionalising the role of director so that people take it seriously. But the Institute is equally worried that the role is becoming so onerous and "scary". This makes it particularly hard to attract directors to organisations like charities and voluntary groups, who rely on voluntary support to help them run as businesses. Negative press also takes its toll.

"It's partly the increased threat of litigation [that scares potential directors], but also the sense that directors don't seem to be properly appreciated. I think there's a misconception that directors are all overpaid, under-worked fat cats on big pensions and it's simply not true. The money you see mentioned in the papers is by far in the minority.

"The other misconception is that non-executive directors are massively highly paid. The truth is in most companies, it's not so.

"We did some research on companies outside the FTSE listings in Scotland and we're talking about [an average of] £15,000 a year.

"There's also the misconception that this sort of duty is only for a couple of days a month. In real terms, you're called upon almost 24/7."

With companies focused on day-to-day firefighting as the economy slips into recession, commentators believe there is an increased risk of directors breaching their statutory duties, accidentally or otherwise.

"As companies look to finance themselves and find ways to survive, it's more likely that they could breach the rules by finding themselves in conflict situations," warns Jeff Meek, Edinburgh managing partner of accountancy firm **French Duncan**.

"The classic scenario is when two companies are run together, and one lends the other money. In doing so they can then breach their responsibility to their creditors."

Meek mentions Farepak, the Christmas hamper savings company that went bust in 2006 owing an estimated 300,000 customers savings of more than £40m. Critics at the time said savers' money had been used to repay loans to the parent company from Halifax Bank of Scotland instead of being ringfenced to provide

Christmas spending.

Companies can also open a hornets' nest when employee contributions in the pension scheme start getting moved around to finance other parts of the business. In this scenario, directors can find themselves personally liable to repay every penny found to be misplaced.

Meek believes it is too easy to start companies in the UK and argues that directors should sit the equivalent of a driving test before starting a business. "In Sweden and other countries, you need £20,000 minimum to start a company and a certificate from the local trade body saying you're certified," he explains.

"In the UK the minimum capital is £1, or you can get an off-the-shelf company for £100. It's very cheap and easy for someone to set up, but there are no steps to make sure they are fit to be a director or that they fully understand their responsibilities.

"It's easier than passing your driving test but the consequences can be as bad as crashing your car.

"I'm not saying it should be the responsibility of company formation agents to do this, but something needs to be done to make people more aware of the responsibilities they're taking." ■