Company Law Reform in the UK: A Progress Report

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This paper was revised for publication during a period of academic leave spent, at the invitation of Professor Campbell McLachlan (Deputy Dean), at the Law Faculty, Victoria University, Wellington, New Zealand, and made possible through the generosity of the partners of Chapman Tripp. I benefited greatly from discussions with Jack Hodder, who was closely involved in New Zealand's successful company law modernisation project that culminated in the Companies Act 1993. New Zealand's achievements cast a harsh light on the UK's struggles to bring an ambitious company law reform project to fruition but some aspects of the New Zealand experience (such as the fairly substantial time lag between the first discussion paper (in 1987) and the new Act) suggest that there is room for optimism about the UK's chances of eventually overcoming the obstacles to change. In writing this paper, I have also drawn upon stimulating discussions on company law reform with my Cambridge colleague, Richard Nolan. The paper seeks to report on the UK position as at early November 2004

Abstract

The UK has been taking its time on major company law reform. Comprehensive company law reform has been under discussion for more than six years but a full set of legislative proposals to achieve this goal has not yet been published. The leisurely pace can be interpreted positively: since high-quality law reform in such a complex field takes time, it could be a good sign that the UK is proceeding slowly. This benign interpretation of events has some accuracy but it does not tell the full story of a project that appears to have lost its way. Yet company law in the UK has not stood still in recent years. This paper reports several notable recent amendments to the legislative framework, including new requirements on disclosure of directors' remuneration, statutory strengthening of the arrangements for the institutional oversight of auditors and relaxation of the ban on companies giving indemnities to their directors. A new reporting obligation, in the form of a mandatory annual operating and financial review by directors of quoted companies, is also in prospect. Such developments prompt questions about why the UK Government has made certain changes ahead of the intended general overhaul of the corporate framework and whether that general review is a project that is in danger of being left behind as Government policy adapts to changing events. This paper considers these questions and assesses what the responses to them tell us about the substantive merits of conducting a general review of company law and about the usefulness of the reform process employed in the UK as a possible model for other countries.

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A: INTRODUCTION

If company law 'matters', it would be a logical policy choice for Governments to invest resources in bringing the rules governing the availability and operation of the corporate form, and the accompanying administrative and judicial infrastructure, up to or ahead of prevailing international standards. A successful upgrading exercise could offer a range of potential benefits depending on exactly how company law matters.[1] These benefits might include more entrepreneurs wanting to locate their business within the jurisdiction, more investors wanting to invest in the corporate sector, and more business for accountants, lawyers, bankers and other professionals in advising the growing band of entrepreneurs and investors on how to operate within the system and use it to their advantage.

There has been an explosion of recent scholarship exploring the links between law and the breadth and depth of capital markets, corporate ownership structures, dividend policies and other elements of countries' financial systems.[2] However,

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[1] E. Ferran, 'Company Law Reform in the UK' (2001) 5 *Singapore Journal of International and Comparative Law* 516 (discussing UK company law reform as a strategy to foster enterprise and boost competitiveness).

[2] Research in this field has been spearheaded by a series of papers published by a group of distinguished economists. Their key papers on corporate and securities law include: R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R.W. Vishny, 'Legal Determinants of External Finance' (1997) 52 *Journal of Finance* 1131; R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R.W. Vishny, 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113; R. La Porta, F. Lopez-de-Silanes and A. Shleifer, 'Corporate Ownership Around the World' (1999) 54 *Journal of Finance* 471; R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R.W. Vishny, 'Agency Problems and Dividend Policies Around the World' (2000) 55 *Journal of Finance* 1; R. La Porta, F. Lopez-de-Silanes, A. Shleifer, A and R.W. Vishny, 'Investor Protection and Corporate Governance' (2000) 58 *Journal of Financial Economics* 3; R. La Porta, F. Lopez-de-Silanes and A. Shleifer, 'Investor Protection and Corporate Valuation' (2002) 57 *Journal of Finance* 1147; R. La Porta, F. Lopez-de-Silanes and A. Shleifer,

whilst this work deserves attention from regulatory policymakers, there are several considerations that should curb enthusiasm for building policy agenda on the basis of it. Causation remains contestable.[3] Even if it is assumed that law does matter in some way to financial development, the question 'which laws matters most?' still remains to be answered.[4] It is unlikely, moreover, that research will eventually yield a single, universally applicable answer because legal rules that are superficially similar may operate quite differently from country to country as a result of variations in the broader commercial, economic, cultural regulatory and legal environments. Since the effectiveness of substantive rules is crucially dependent on the quality of the accompanying administrative and judicial infrastructure through which they are implemented and enforced, the notion that the key to fostering financial development and economic growth could lie simply in adopting some ready-made package of legal rules can be quickly dismissed. Such considerations suggest that policymakers should proceed with caution in using law reform as an instrument for the promotion of economic change and should be sceptical about the likely success of a strategy based on the transplantation of rules that have been successful in other countries.

The UK has certainly been taking its time on major company law reform. Despite the fact that there has been extensive debate in the UK on comprehensive company law reform for at least[5] six years, a full set of specific legislative proposals

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'What Works in Securities Laws?' *National Bureau of Economic Research* Working Paper 9882 (July 2003).

[3] J.C. Coffee, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control' (2001) 111 *Yale Law Journal* 3; B.R. Cheffins, 'Does Law Matter? The Separation of Ownership and Control in the United Kingdom' (2001) 30 *Journal of Legal Studies* 459.

[4] B.S. Black, 'The Legal and Institutional Preconditions for Strong Securities Markets' (2001) 48 *UCLA Law Review* 781 presents an analysis of the fundamental laws and supporting institutions that, the author suggests, are needed to support the development of strong securities markets. Black acknowledges (at 834) that research on the empirical correlation between investor protection and the strength of a country's securities markets or its economy is still in its infancy.

[5] 1998 marked the start of the general company law review but the origins of this can be traced back to the work done by the Law Commission for England and Wales on

has not yet been published. The leisurely pace can be interpreted positively: since high-quality law reform in such a complex field takes time, it could be a good sign that the UK is proceeding slowly. This benign interpretation of events has some accuracy, yet it does not tell the full story.

Despite the sluggishness of the general company law reform programme, company law in the UK has not stood still and there have been several notable recent amendments to the legislative framework. This prompts questions about why the UK Government has made certain changes ahead of the intended general overhaul of the corporate framework and whether that general review is a project that is in danger of being left behind as Government policy adapts to changing events. This paper considers these questions and assesses what the responses to them tell us about the substantive merits of conducting a general review of company law and about the usefulness of the reform process employed in the UK as a possible model for other countries.

The paper is organised as follows. Section B identifies key stages in the general review and considers an important factor that appears to have slowed the pace of the reform process, namely the difficulty of combining reform of some of the law and restatement of all of it in a single exercise. This section welcomes a recent initiative by the Department of Trade and Industry (DTI) to separate substantive reform and restatement. Although this decoupling may mean that restatement will slip down the list of policy priorities, it argues that this is a price that is worth paying in order not further to delay substantive change in certain areas. Section C notes that the recent re-awakening of enthusiasm for company law reform at EU level, particularly in relation to legal capital rules, presents a further difficulty for the domestic reform agenda because it makes it pertinent to ask whether the UK should refrain from making changes domestically until the picture at EU level becomes clearer. This section argues that delay could undermine the perceived credibility of the British Government's commitment to company law reform. It therefore welcomes the recent DTI proposals to effect company law reform in stages and to amend the

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shareholder remedies (Consultation Paper No. 142, (1995) and Report No. 246 (1997)) and the joint work of the English/Welsh and Scottish Law Commissions on directors' duties (Consultation Paper No. 153 (1998) and Report No. 261(1999)).

legislative process to facilitate this arrangement. Section D examines legislative developments and proposals relating to corporate governance. In this area there can be no doubt that the existence of the general company law reform exercise has not acted as a inhibiting factor constraining the Government from intervening significantly where it has considered it appropriate to do so. Section E concludes on the merits of a general review of company law. It recognises that ambitious projects of that sort are liable to become sidetracked as changing events create new political priorities and that there is little that can be done to prevent this. It argues that this has occurred in the UK but that other factors, including certain problems with the reform process, have also contributed to the slow progress towards fulfilling the aspiration for a fully modernised framework for corporate law. It concludes, however, that there is room for optimism in the current position, which is evolving towards limited substantive change now but with the prospect of further reform and restatement thereafter, because the general review has equipped policy-makers with a good understanding of current issues and the decoupling strategy that has emerged should enable them to act on key areas before the debate engendered by the review becomes too stale to be useful.

B: THE GENERAL COMPANY LAW REVIEW

In May 1998 the recently-elected Labour Government announced a root and branch review of company law. The aspiration was to allow company law to break free of its outdated nineteenth Century roots and to provide a modern framework.[6]

The Government set up an independent body – the Company Law Review Steering Group (the 'Steering Group') – to manage the review. The Steering Group published a series of consultation documents between 1999 and 2001,[7] and a *Final*

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[6] DTI, *Modern Company Law for a Competitive Economy* (London, March 1998), foreword.

[7] The three main consultation documents were: *Modern Company Law for a Competitive Economy: The Strategic Framework* (London, DTI, URN 99/654, 1999) (*Strategic Framework*); *Modern Company Law for a Competitive Economy: Developing the Framework* (London, DTI, URN 00/656, 2000) (*Developing the Framework*); and *Modern Company Law for a Competitive Economy: Completing the*

Report in July 2001.[8] The Government then published a White Paper response to the *Final Report* in July 2002 outlining some of its intentions.[9] However, on close reading, this White Paper was revealed to be a very unsatisfactory document that left considerable doubt about the Government's plans. Examination and reflection suggested that it was little more than a stopgap measure designed to signal to the world that company law reform had not been forgotten about, that work was continuing but that perhaps it was proving to be more challenging than had been originally anticipated.

Later events tend to confirm this view of the White Paper. In July 2003[10] the Government publicly reaffirmed its ongoing commitment to general company law reform but announced that, while work continued on that, it would publish a Companies Bill to make certain Enron-related changes on audit and accounting,[11] and also that it would introduce a new legal rule requiring large companies to publish annual operating and financial reviews (OFR). It had been one of the central recommendations of the Steering Group in the general company law review that companies of significant economic size should be required to prepare and publish an OFR as part of their annual report and accounts, so the Government was in effect 'cherry-picking' that item and bringing it forward ahead of the general project.

Structure (London, DTI, URN 00/1335, 2000) (*Completing the Structure*). There were also several, often more technical, consultation papers on specific topics such as company formation and capital maintenance, and company charges.

[8] *Modern Company Law for a Competitive Economy: The Final Report* (London, DTI, URN 01/942 and URN 01/943, 2001). The *Final Report* included a summary of the working methods adopted by the Steering Group and an acknowledgement by the Steering Group of 'the need for a legislative project of this scale and significance to command the support of a substantial consensus of qualified opinion on the overwhelming majority of its proposals': para. 1.45.

[9] *Modernising Company Law* (Cm 5553, July 2002).

[10] The announcement is noted at Hhttp://www.dti.gov.uk/companiesbill/index.htmH (accessed July 2004).

[11] Companies (Audit, Investigations and Community Enterprise) Bill 2003, which completed its passage through Parliament and became law in Autumn 2004.

This did not augur well for the general project, not least because one of the key reasons why that project had been thought necessary in the first place was that past indulgence in piecemeal law reform had produced laws that were complex, lengthy and often obscure.

Thereafter there were further signs that the general project was in some difficulty. Of the various problems with which the Bill team at the DTI may have been struggling, one in particular appears to stand out.

A Central Problem for the Government – Limited Substantive Change and a General Rewrite Make Uneasy Bedfellows

As originally conceived, the UK company law reform project tried simultaneously to embrace two distinct goals: to change some of the rules; and to rewrite all of the rules in more modern and more easily accessible language. The Steering Group regarded it as one of their guiding principles that, so far as possible, the rules should be stated in accessible language so as to minimise the legal costs involved in running an incorporated business.[12] This goal complemented another central objective: to structure the legislation around the needs of small companies (‘think small first’).[13]

However, the hydra-headed character of the project was always liable to be problematic: how would someone reading the new legislation know how to distinguish between changes in wording that were meant to have substantive effect (and therefore to which existing cases interpreting the old rules would no longer be relevant) and those that were meant simply to recast existing requirements in more modern language without affecting the substance? The DTI officials appear to have struggled to find an answer to this question within the confines of an exercise that was conceived of as leading to a single piece of reforming legislation. In the end, 2004 saw a change of direction with an announcement by the DTI that it intended to separate out the process of substantive reform from the rewrite of the legislation to

[12] *Completing the Structure*, ch. 2; *Final Report* paras.1.18-1.22.

[13] *Completing the Structure*, ch. 2.

reduce the risk that rewriting might have an unwanted effect on case law and the substantive particular provisions.[14]

The details of what this separation would involve were subsequently filled in by a DTI consultation paper.[15] This paper suggested that a new Companies Bill should include a specific power to 'restate' the law, which the paper defined as 'rewording and/or rearranging the law in order to simplify it, in the sense of making it easier for modern users to find the provision that affects them and to understand it'.[16] This proposed restatement power would allow the DTI to restate the primary legislation through a special form of secondary legislation. Alongside this, another new power, also to be included in the new Companies Bill, would allow the DTI to 'reform' the law, which the paper defined as meaning any kind of amendment to the existing law which changes its effect, again by means of a special form of secondary legislation.[17] The DTI suggested that there is a need for the second power because changing developments, particularly in relation to European law, mean that it may not be possible at this stage to reach definitive, long-term term conclusions on what the final regime in domestic law should be.[18]

If the DTI's proposals are adopted, what was originally envisaged as a single, comprehensive overhaul of outdated legislation will be transformed essentially into a three-stage process: (i) a new Companies Bill, which will make certain substantive changes directly; (ii) a restatement exercise effected under a new secondary law-making process for which power is taken in the new Companies Bill; and (iii) further reform, again effected under a new delegated law-making power conferred by the Companies Bill. The DTI's paper acknowledged that the restatement and reform powers may be used at the same time because simplification of the law in any real sense will often require both changes to its effect and changes to the way the law is

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[14] This announcement is available via Hhttp://www.dti.gov.uk/cld/review.htmH (accessed July 2004).

[15] DTI, *Company Law. Flexibility and Accessibility: A consultative document* (London, May 2004).

[16] Ibid, p. 9.

[17] Ibid, p. 9.

[18] Ibid, p. 10. See further, sec. C of this paper.

set out. Nonetheless, it emphasised the need for a clear conceptual and formal distinction between them so as to avoid uncertainty.[19]

There is a precedent in the UK legal system for the establishment of a separate project to rewrite law so as to make it clearer and easier to use without changing its substance in the area of tax legislation.[20] An obvious risk with separating substantive reform from rewriting is that the latter may lack any sense of urgency – certainly the tax law rewrite is proceeding very slowly.[21] The DTI consultation paper, which suggests adoption of the new restatement power, tried to assuage concerns on this front by emphasising that the proposals should not be seen as an attempt to avoid the challenge of making company law more accessible.[22] However, reassuring words of this sort are only to be expected; until events prove them true they can reasonably be regarded with some degree of scepticism. Thus it is possible that some old style rules could limp on indefinitely, the overall corporate law package could become a curious mixture of old and new (assuming the intention is still to use modern, accessible language in areas of substantive change), and the goals of making company law more accessible and orientated towards the needs of small companies could remain unfulfilled to a significant degree for a fairly lengthy period. The question is whether incurring this risk is a price that is worth paying.

There are some good indications to suggest that it is. It is evident that the attempt to combine both reform and restatement in one single exercise had become a serious burden for the public officials charged with the task of transforming the

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[19] Ibid, p. 9.

[20] The main features of the tax rewrite project are outlined in *Tax Law Rewrite: Plans for 2003/4*, available at Hhttp://www.inlandrevenue.gov.uk/rewrite/plans0304/menu.htmH (accessed July 2004).

[21] *Hansard*, 31 Jan 2002 : Column 511W records a statement by a Treasury Minister (Dawn Primarolo MP) that: 'The original estimate was that it would take about five years to rewrite the main primary legislation on direct tax. However, as the work of the project progressed, it became clear that it would take longer to do the job to the necessary standard, and there is general agreement that it is more important for the work to be done properly rather than quickly'.

[22] DTI, *Company Law. Flexibility and Accessibility*, p. 8.

general principles established by the Steering Group into detailed rules, and that it was hindering progress. Furthermore, commentary on the limited number of draft clauses that the Government had published indicated that there was substance to the fears that efforts to reproduce existing rules in more modern and accessible language could introduce new doubts and problems.[23] In the longer term, it would be a matter for some regret if the rewriting of the companies legislation in more modern, accessible language and in a form that puts the needs of small companies first were to become a project that simmers gently on the back burner without ever attracting much serious or sustained attention from its political masters. Yet it is unrealistic to suppose that a subject as technical as company law can ever be fully distilled into statutory language that lay business people can read and understand without professional guidance and advice, or to imagine that, even if such legislation were to exist, all of those to whom it is addressed would have the time or inclination to read it and to search out the accompanying body of interpretative case law.[24] Such considerations suggest that the benefits likely to be secured by having companies legislation that is fully recast in modern language would be limited anyway. Therefore, if something had to give, it looks like the right policy choice to favour substantive reform, which should, in any event, include some deregulatory change

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[23] See e.g., Law Society Company Law Committee, *Response to Modernising Company Law Cm 5553* (Paper No 451, November 2002), available at Hhttp://www.lawsociety.org.uk/dcs/pdf/companylaw_451.pdfH (accessed July 2004).

[24] D. Goddard, 'Company Law Reform – Lessons from the New Zealand Experience' in A. Borrowdale, D. Rowe and L. Taylor (eds.), *Company Law Writings A New Zealand Collection* (Christchurch, The Centre for Commercial and Corporate Law Inc, 2002) p. 145, 153 notes the failure of the New Zealand Companies Act 1993 to meet reformers' aspirations for a simple, readable Bill and comments that: 'The accessibility goal was always rather optimistic. There are few (if any) examples around the world of clear, simple company law that could be read and understood and acted on without further advice in most circumstances by the average business-person'.

likely to favour smaller companies, at the possible expense of language simplification.[25]

Furthermore, one feature of the new approach looks likely to promote accessibility more effectively that what was previously envisaged. The DTI's new proposals will allow for changes to the primary legislation to be effected by means of secondary legislation. Thus, the primary legislation will remain the main source of the law (although presumably there will be some situations where it deemed more appropriate to put the changes into secondary legislation rather than to incorporate them into the main Companies Act); this should mean that people will not have to search through a potentially large and confusing number of secondary legal instruments in order to be sure that they have a comprehensive picture of the legislative position as, arguably, could have occurred had the model favoured by the Steering Group, whereby the primary legislation would have been reserved for certain fundamental aspects and much of the detail would have been contained in secondary legislation, been pursued.[26]

One obvious concern about giving more rule-making power directly to the DTI is how to ensure that there effective accountability mechanisms. The DTI's proposals on process broadly follow contemporary canons of good regulatory practice, involving wide consultation and publication of formal feedback statements and assessments of the proposed benefits of the regulatory intervention, as well as Parliamentary scrutiny.[27] It is clearly important to get the process right from the outset in order to shield the actual exercise of the power from controversy and criticism rooted in concern about the legitimacy of the DTI as a law-making authority.

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[25] Justice Kirby, 'Rethinking Company Law and Practice' (1995) 5 *Australian Journal of Corporate Law* 176, 180 welcoming moves towards simplification of Australian corporate law but noting that it would be 'all too easy' to overlook the abiding need for fundamental reform of the substance.

[26] DTI, *Company Law. Flexibility and Accessibility*, p. 7.

[27] DTI, *Company Law. Flexibility and Accessibility*, p. 19 (Annex A).

C: SUBSTANTIVE REFORM PROPOSALS – THINK SMALL FIRST, WITH PARTICULAR REFERENCE TO LEGAL CAPITAL AND THE SHIFTING EU AGENDA

At the same time as it announced its intention to separate substantive reform from the rewriting exercise, the Government produced a helpful summary of key substantive reforms that it intended to make directly in the new Companies Bill. This summary is reproduced as Annex C to the DTI's consultation paper.[28] (As a aside on process, the lack of a comprehensive list of proposals in the Steering Group's *Final Report* was unfortunate; whilst the Group's various Reports contained much excellent material that deserved to be read in full, having to trawl through the entirety of that voluminous body of work to establish exactly what was being proposed was hardly conducive to establishing a sense of the project having definite and manageable boundaries.)

There is much in the list of substantive proposals that promotes the goal of thinking small first and which if implemented would reduce the regulatory burden involved in setting up and running a private company. Yet it is hopefully a fair assessment to say that many of the proposed deregulatory changes are ones that excite little comment because in some form or another they have been on regulatory reform agenda for many years, and many of them already represent the law in other Commonwealth countries that historically followed English company law but have moved ahead of (or at least away from) it in recent years.[29]

The deregulatory changes aimed particularly at smaller companies include some reform of legal capital. There is no doubt that the existing rules on legal capital are defective and contain curiosities only understandable by reference to their

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[28] Ibid, pp. 21 – 22.

[29] The Canadian Business Corporations Act 1985 marked the first decisive break with the English model by a major Commonwealth jurisdiction. This Act was the model chosen by the New Zealand Law Commission for new comprehensive companies legislation that resulted in the New Zealand Companies Act 1993: R. Grantham and C. Rickett, *Company and Securities Law: Commentary and Materials* (Wellington, Brookers, 2002) pp. 38 – 44.

historical origins. Yet views have differed amongst British company law specialists on the appropriate regulatory response, with proposals ranging from technical fixes to remedy known, specific problems though to fundamental redesign to move away from the concept of a fund of undistributable capital maintained for the benefit of creditors in favour of more modern techniques based on solvency tests and personal liability attaching to directors. This is an area where the review process helpfully provided a good opportunity to explore the options although some policy choices – such as complete abolition of the ban on financial assistance – were not fully explored because of the constraints resulting from the UK's obligation to give effect to the Second EC Company Law Directive in relation to public companies.[30]

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[30] Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, [1977] OJ L23/1.

Another area where the Second Company Law Directive powerfully shaped the debate is in relation to no par value shares. The case in principle against par values is overwhelming (E. Ferran, *Company Law and Corporate Finance* (Oxford, OUP, 1999) pp. 282 – 6) but they are regarded as a mandatory requirement for public companies by reason of the Second Directive, art. 8 (for interpretation of this and the 'accountable par' alternative: J. Rickford (ed.), 'Reforming Capital' (2004) 15 (4) *European Business Law Review* 919.

The Steering Group floated the possibility of a no par value regime for private companies (*Company Formation and Capital Maintenance*, URN99/1145), para. 3.8) but this was dropped after consultation indicated that having distinct regimes for private and public companies might create more problems than it resolved (e.g., for companies seeking to convert from private to public).

Par value requirements have disappeared from the companies legislation of other leading Commonwealth countries: Corporations Act, s. 254C (Australia); Companies Act 1993, s. 38 (1) (New Zealand); Canadian Business Corporations Act 1975, s. 24 (1).

The outcome, as reflected in the Government proposals, is for quite significant change within the boundaries established by the Second Directive. Capital maintenance is to be reformed, including repeal of the restrictions on financial assistance by private companies and the abolition of the requirement for companies to have an authorised share capital. All well and good, yet it is hard to avoid the conclusion that the debate has already moved on to a more radical level.

At the time when the British Steering Group was formulating its proposals on legal capital, the European position was represented by the SLIM (Simpler Legislation for the Internal Market) proposals for simplification of the Second Directive.[31] There were few indications that the SLIM proposals were an urgent policy priority at the EU level. Since then, however, the issues have moved to the foreground of EU policy debate, thanks largely to the Winter Group, which was appointed by the European Commission in September 2001 to make recommendations on a modern regulatory framework in the EU for company law, and which put its weight behind 'SLIM-Plus' moves to improve the legal capital regime (including limiting the scope of the ban on financial assistance, permitting no-par value shares, and relaxing the rules on expert valuations of contributions in kind, pre-emption rights and share buybacks).[32] The 'SLIM-Plus' proposals are not a paradigm shift away from legal capital as a creditor protection mechanism within the EU and towards reliance upon solvency tests instead; and thus the Commission's decision formally to propose changes to the Second Directive that are based on SLIM-Plus is only a modest step forward.[33] But it is a step; and seen in the context of the Winter

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[31] The SLIM Report is summarised in European Commission, *Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward* (COM (2003) 284) para. 3.2.

[32] *Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe* (Brussels, European Commission, November 2002) ('Winter Report'), pp. 79 – 93.

[33] As anticipated in *Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*, para. 3.2, in Autumn 2004 the Commission published a proposal for a Directive to amend the Second Directive

Group's support for the further investigation of alternative options and its call for an European framework rule on wrongful trading and for the introduction of the concept of subordination of insiders' claims, it is at least plausible to suggest that it could prove eventually to have been the start of a new, fundamentally different approach.[34]

This paper eschews the temptation to speculate on what may lie ahead generally for legal capital rules at the EU level. From the UK perspective the most significant point is simply that a credible, active EU reform agenda in relation to the Second Directive now exists. This creates a dilemma: should the UK press on with its own reform agenda for legal capital within the confines of existing EU law or wait to see what happens at the EU level? There are obvious competing considerations.[35] On the one hand, it is possible that the costs of adjustment and adaptation would be lower if EU-inspired reforms plus any additional purely domestic changes were brought in simultaneously rather than sequentially. On the other hand, for the UK to limp on with laws that its own review process and also recent case law[36] have shown to be

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Hhttp://europa.eu.int/comm/internal_market/company/capital/index_en.htmH (accessed November 2004).

[34] In *Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*, para. 3.3 the Commission indicated its intention in the medium term to launch a study into the feasibility of an alternative to the capital maintenance regime.

[35] This paragraph draws upon E. Ferran, 'Corporate Transactions and Financial Assistance: Shifting Policy Perceptions but Static Law' [2004] *Cambridge Law Journal* 225.

[36] The recent decision of the Court of Appeal in *Chaston v SWP Group plc* [2002] EWCA Civ 1999, [2003] 1 BCLC 675 (leading judgment by Arden L.J.) has highlighted problems with financial assistance law. In this case personal liability was imposed on a director of a subsidiary company who had authorised the payment by the company of the accountants' fees incurred in the preparation of short and long form reports used in the sale of the group, on the grounds that this amounted to unlawful financial assistance and that the director in question was therefore in breach of his fiduciary duty. Arden L.J.'s wide-ranging judgment raised concerns about the legality of a range of common corporate finance structures, used in venture capital

defective with no certainty about the likely timeframe for change at EU level is also a costly option.

The strategy now proposed by the DTI to deal with this dilemma – to make certain changes in the short term in a new Companies Bill and to take power in that Bill to make further changes by a new form of secondary legislation once the European position is clearer[37] – seems well-judged. There is a palpable sense of frustration in many quarters that things are moving so slowly in areas, such as financial assistance law, where it has been clear for many years that change is needed.[38] Against this background, delaying the process indefinitely to 'wait and see' the EU's plans for the Second Directive would simply risk fuelling growing scepticism about the credibility of the Government's commitment to company law reform. Admittedly, as with the decoupling of restatement from substantive reform, this could mean that longer-term reform of company law will slip down the policy agenda.[39] However, it is open to question whether the prospect of the grand design of comprehensive company law reform, which seemed to be what was intended back in the late 1990s when the UK review process began, giving way to a more modest project in which substantive changes are made from time to time in response to changing events is really that disturbing.[40]

D: SUBSTANTIVE REFORM PROPOSALS – CORPORATE GOVERNANCE

UK Law on Corporate Governance Has Not Been Standing Still

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financing and other contexts, and transactions, including share buybacks. See further Ferran, 'Corporate Transactions'.

[37] DTI, *Company Law. Flexibility and Accessibility*.

[38] C. Shutkever, 'Financial Assistance' (2004) 25 *Company Lawyer* 34.

[39] As discussed in the previous section, there are public law concerns to be addressed to ensure effective accountability in respect of the exercise of the reforming power. The DTI's proposals on process in respect of the exercise of the reform power are set out in DTI, *Company Law. Flexibility and Accessibility*, p. 20.

[40] This point is developed further in sec. E of this article.

An outsider surveying the British scene might be surprised to discover that there is any sense of frustration about the slow pace of change in company law reform if the starting point for her inquiries is the field of corporate governance rather than the needs of smaller companies and the potential for simplification of legal capital and other rules. There are proposals within the comprehensive company law reform programme that will have certain implications for corporate governance, such as the proposed codification of directors' duties and the enactment of a statutory derivative action. But, given the tenor of the debate on legal capital, it is worthwhile to note that the existence of these proposals has not acted as an albatross, impeding change. Instead there has been significant recent incremental change in the regulation of corporate governance in the UK, and the regulatory agenda continues to develop.

Relevant new laws and Government proposals for further statutory intervention that are currently under active consideration in the UK are as follows.

- Directors' Remuneration Report Regulations 2002.[41]

These regulations amended the Companies Act 1985 to add a new requirement for quoted[42] companies to publish a report on directors' remuneration as part of their annual report. The contents of directors' remuneration reports are prescribed in considerable detail: a report must include a statement on the company's remuneration policy, details of the membership and role of the remuneration committee, and for each director the total amount of their remuneration package in the relevant financial year.[43] The sections of remuneration reports that give details of individual directors' pay packages must be audited.[44]

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[41] S.I. 2002/1986.

[42] Defined as having equity share capital officially listed in the UK or an EEA Member State or admitted to dealings on the NYSE or NASDAQ: Companies Act 1985, s. 262(1).

[43] Companies Act 1985, ss. 234B – C, 241A and sch. 7A. The contents of the disclosure requirements are discussed by L. Roach, 'The Directors' Remuneration Report Regulations 2002 and The Disclosure of Executive Remuneration' (2004) 25 *Company Lawyer* 141.

[44] Companies Act 1985, s. 235 and sch. 7A, Pt 3.

The changes made by these regulations also gave shareholders an entitlement to vote on a yearly basis on an ordinary resolution to approve the directors' remuneration report.[45] The resolution relates to the report as a whole, not to individual directors' entitlements, and it is advisory only, which means that it is not binding on the Board and it is not formally obliged to act on it in any way.

- Responding to 'Enron': Companies (Audit, Investigations and Community Enterprise) Act 2004.[46]

The first part of this Act is a 'post-Enron' initiative that, according to the DTI: 'forms part of the Government's strategy to help restore investor confidence in companies and financial markets following recent major corporate failures'.[47] The Act strengthens the arrangements for the institutional oversight of auditors (including providing legal underpinning for the UK's Professional Oversight Board for Accountancy (POBA)) and the supervision and enforcement of accounting and reporting requirements. It also amends the company investigation regime, including providing specific protection for 'whistleblowers' from breach of confidence claims. One provision in the first part of the Act[48] will impose a new obligation on directors to certify that so far as each director is aware (a) there is no relevant audit information of which the company's auditors are unaware, and (b) he has taken all the steps that he ought to have taken as a director in order to make himself aware of any relevant audit information and to establish that the company's auditors are aware of that information. Considerations that are relevant to the determination whether a director has complied with this obligation include in particular (a) the knowledge, skill and experience that may reasonably be expected of a person carrying out the same

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[45] Companies Act 1985, s. 241A.

[46] The text of the Act is available via Hhttp://www.legislation.hmso.gov.uk/acts/acts2004/20040027.htmH (accessed November 2004).

[47] Explanatory Notes prepared by the DTI, para. 4. These notes are available via http://www.legislation.hmso.gov.uk/acts/en2004/2004en27.htm (accessed November 2004).

[48] Section 9.

functions as are carried out by the director in relation to the company, and (b) any superior knowledge, skill and experience that the director has. Non-compliance will be a criminal offence.

The second part of the Act provides a new form of corporate vehicle for social enterprise. This specialised initiative is a little removed from mainstream developments in UK company law and corporate governance.

- The Companies Act 1985 (Operating and Financial Review and Directors' Report) Regulations 2004 (draft).[49]

In May 2004 the DTI published draft regulations that are intended to amend the Companies Act 1985 so as to impose an obligation on directors of quoted companies[50] to prepare an operating and financial review (OFR) for each financial year. The draft regulations describe the objective of the OFR as being to enable the members of the company to assess the strategies adopted by the company and its subsidiary undertakings and the potential for those strategies to succeed by giving:

> 'a balanced and comprehensive analysis of (a) the development and performance of the business of the company and its subsidiary undertakings during the financial year, (b) the position of the company and its subsidiary undertakings at the end of the year, (c) the main trends and factors underlying the development, performance and position of the business of the company and its subsidiary undertakings during the financial year, and (d) the main trends and factors which are likely to affect their future development, performance and position'.

The OFR is thus intended to be a narrative statement covering past developments in key areas and also future prospects. The terminology is meant to be consistent with

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[49] DTI, *Draft Regulations on the Operating and Financial Review and Directors' Report: A Consultative Document* (London, 2004).

[50] It is proposed to use the same definition of 'quoted' as in relation to directors' remuneration reports (see n. 42, supra).

the Accounts Modernisation Directive[51] (which is also to be implemented by these regulations) but the OFR requirements are more detailed and precise than those in the Directive.

A range of matters that an OFR must cover is specified. The list includes information on business objectives and strategies, available resources, principal risks and uncertainties facing the business, capital structure, liquidity and treasury policies. To the extent necessary to comply with these disclosure requirements, an OFR must also contain information on certain additional matters, including employees, environmental matters, social and community issues and essential commercial relationships.

Enforcement against directors in respect of their obligation to produce an annual OFR will be by way of criminal and administrative sanctions.

Auditors are to play a quality assurance role in relation to OFRs. The draft regulations propose an obligation on a company's auditors to state (a) whether in their opinion the directors have prepared the OFR after due and careful enquiry, (b) whether in their opinion the information given in the OFR is consistent with those accounts, and (c) whether any matters have come to their attention, in the course of the performance of their functions as auditors of the company, which in their opinion are inconsistent with the information given in the OFR. However, this part of the draft regulations has proved to be especially controversial and there has been extensive lobbying from business quarters to the effect that it goes too far, both in the standard that it expects of directors ('due and careful enquiry') and in requiring auditors to form a view on matters other than simply financial information.[52]

Such lobbying appears to have had an effect: the Government is reported to be looking again at some of the substantive aspects of the proposed reporting obligation

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[51] Directive 2003/51/EC amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings, [2003] OJ L178/16.

[52] For an early example see 'CBI Warns DTI of 'Excessive' Reporting Requirements', CBI Press Release, 5 May 2004, available via Hhttp://www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/1d21e6e077ba2fcb80256e8a0046f269?OpenDocumentH (accessed May 2004).

and also at delaying its implementation date so as to give companies more time to prepare for the extended disclosure burden.[53] However, the process of refining the details of the OFR obligation does not detract from the core position, which is that the imposition of some disclosure obligation of this sort is now settled Government policy.

- ‘Rewards for failure’ – no statutory intervention for now, but ‘Big Brother’ is watching.

In June 2003 the DTI published a consultative document entitled *‘Rewards for Failure: Directors’ Remuneration – Contracts, Performance and Severance*.[54] The purpose of this paper was to explore options for curbing excessive payments to departing directors of ailing companies. The consultative document did not suggest strong Government enthusiasm for aggressive intervention in this sensitive area so it was not a complete surprise when, after the close of the consultation period, it ruled out new law as being ‘not necessary at this stage’.[55] However, the Secretary of State added that Government monitoring of pay-offs to directors would continue and that she would ‘not hesitate to take appropriate action’ if necessary.[56] Soon afterwards a £15 million payment to Michael Green, the departing Chairman of the television company, ITV, attracted much criticism from shareholders and the media. Even the Chairman of the remuneration committee publicly admitted that the pay-off was ‘too

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[53] S. Tucker, ‘Ministers Retreat on Company Reporting’, *Financial Times*, 17 November 2004.

[54] This document is available via Hhttp://www.dti.gov.uk/cld/4864rewards.pdfH (accessed July 2004).

[55] Statement by Patricia Hewitt, Secretary of State for Trade and Industry, quoted in J. Finch and D Teather, ‘Hewitt Will Not Act on Top Pay: US Watchdog Warns on Executive Wages, But Trade Secretary Says Britain Does Not Need New Laws’, *Guardian*, 26 February 2004, p. 19. This response has attracted some sharp criticism. For example, PIRC (Pensions Investment Research Consultants), a corporate governance monitoring group, has described it as ‘totally inadequate’ (Hhttp://www.pirc.co.uk/hewitt.pdfH (accessed May 2004).

[56] ‘Hewitt Will Not Act’.

large' but claimed that there had been no room for manoeuvre because of Mr Green's contractual entitlements.[57] Controversies such as this are likely to ensure that the issue remains on the Government's policy agenda. Press coverage has suggested that further measures to enhance scrutiny and accountability in this area are likely to feature in the Labour Party Manifesto for the next election,[58] which is expected to be held in Spring 2005.

- Relaxing the Law so as to Allow Directors (but not Auditors) to Limit Their Liability.

A common thread linking all of the developments considered thus far in this section is that they increase the regulatory burden on directors and auditors. Swimming against the tide, to some extent, was a consultative document from the DTI, published in December 2003, on *Director and Auditor Liability*, which raised the possibility of relaxing the law so as to put directors and auditors into a more favourable position.[59] The current position under the Companies Act 1985 is that provisions that attempt to exempt directors and auditors from civil liabilities attaching in respect of breach of obligations in relation to their company are void.[60]

So far as directors were concerned, the DTI raised three reform options which, in broad terms amounted to (a) doing nothing and simply preserving the status quo, (b) retaining the basic idea that exclusion from liability is not possible, but clarifying its scope through improved drafting and qualifying it in certain limited respects, or (c) radically relaxing the current prohibition and moving to a model based on US law, whereby limitation of liability, indemnification and advances for expenses in defending claims would be widely permitted.

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[57] D. Litterick, ''We Had No Choice on Green's £15m' ITV Bosses Tell Stormy Shareholder Meeting that Law Dictated the Size of Ousted Director's Pay-off', *Daily Telegraph*, 20 April 2004, p. 29.

[58] O. Morgan, 'Labour Fosters Investor Revolt: Manifesto Pledge to Encourage Shareholder Activism', *Observer*, 4 April 2004, Business, p. 1.

[59] This consultative document is available via Hhttp://www.dti.gov.uk/cld/auditors_directors.pdfH (accessed July 2004).

[60] Companies Act 1985, s. 310.

The reform options for auditors outlined by the DTI were (a) no change (save to the extent that this may be required to comply with future EU directives), (b) removing the ban so as to allow auditors to limit their liability contractually and relying on market forces to curb abuse, or (c) removing the ban so as to allow auditors to limit their liability but within limits set by legislation.

The consultative document was written in quite neutral language that made it hard to detect a firm Government preference in any particular direction. However, references to the different legal culture in the USA and to switching to the US model in relation to directors as being a 'very radical step in the context of British company law'[61] gave a hint that this option did not have strong political backing.

The consultation period on this issue closed in March 2004. In September 2004 the Government announced that it had decided to rule out changes in the law on auditors' liability.[62] Confirming the intuition that it was not inclined to favour radical reform with regard to directors' liability either, the Government also stated that it would relax the law on indemnification of directors but only to the extent of permitting companies to indemnify directors in respect of proceedings brought by third parties and to pay directors' defence costs as they were incurred. Provisions to this effect were then added to the Companies (Audit, Investigations and Community Enterprise) Act 2004 and these will take effect by way of amendment to the Companies Act 1985.[63]

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[61] At para. 5.13 of the consultative document.

[62] *Hansard*, 7 September 2004, Col 107 - 109 WS, Written Statement by the Secretary of State for Trade and Industry on Director and Auditor Liability.

[63] Section 19 and 20 of the 2004 Act, which insert sections 309A (Provisions protecting directors from liability), 309B (Qualifying third party indemnity provisions), 309C (Disclosure of qualifying third party indemnity provisions), 337A (Funding of director's expenditure on defending proceedings) in the 1985 Act.

Why Has the Pace of Change Been Accelerated in These Areas?

- Companies (Audit, Investigations and Community Enterprise) Act 2004.

In common with many other countries, the fallout from Enron and the US response to it in the Sarbanes-Oxley Act has been felt in the UK.[64] The controversial outreach of the Sarbanes-Oxley auditor oversight provisions to foreign auditors of SEC-registered foreign issuers[65] certainly acted as a catalyst for the establishment of the new auditor oversight body (POBA), which is to be legally underpinned by the Companies (Audit, Investigations and Community Enterprise) Act 2004.

- Executive Pay.

Corporate scandals and the bursting of the bubble in technology stocks in the early 2000s have also fuelled an international backlash by shareholders against excessive executive pay.[66] Such events have propelled the control of directors' remuneration to

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[64] Generally on the impact of Enron/Sarbanes Oxley in Europe, L. Enriques, 'Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms' (2003) 38 *Wake Forest Law Review* 911, 918 – 9.

[65] Sarbanes-Oxley Act, § 106.

[66] 'We're Still in the Money', *Economist*, 17 April 2003, noting, amongst others, GlaxoSmithKline's troubles in the UK over a proposed pay package of almost $30m for its CEO, Jean-Pierre Garnier, which was withdrawn after protests from major shareholders) and French controversy over amounts paid to the former Chairman of Viviendi, Jean-Marie Messier.

More recently, 'Fun and Games', *Economist*, 29 April 2004, notes the start of litigation in Spain arising out of payments made to Emilio Botín, Chairman of Santander Central Hispano, and comments that the action is 'unlikely to be the last launched by shareholders disgruntled by the scale of executive pay'.

the foreground of the EU company law policy agenda,[67] and it is also a major theme is broader international debate on corporate governance.[68] Yet, though the UK was thus acting in a manner consistent with broad international trends in making this a policy priority, the decision to accelerate regulatory intervention in this area can be viewed as also having been strongly influenced by local circumstances.

Helped by enthusiastic media coverage of 'fat cat pay' excesses, executive pay was a controversial issue in the UK throughout the 1990s.[69] Attempts to control executive pay were developed initially through private sector initiatives on corporate governance.[70] These resulted in certain specific provisions being added to the London Stock Exchange's (later UKLA's) *Listing Rules* for officially-listed issuers and the

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[67] European Commission, *Fostering an Appropriate Regime for the Remuneration of Directors* (MARKT/ 23.02.2004), which outlines options for giving effect to the Winter Group's suggestion that the Commission should issue a Recommendation to Member States so as to foster the development of at an appropriate regulatory regime for directors' remuneration that would apply to all listed companies across the EU. This consultation paved the way for a proposed Commission Recommendation on fostering an appropriate regime for the remuneration of directors of listed companies, which was published in October 2004 and the text of which is available via Hhttp://europa.eu.int/comm/internal_market/company/directors-remun/index_en.htmH (accessed November 2004).

[68] Major recent writings on executive remuneration include: M.C. Jensen, K.J. Murphy and E.G. Wruck, 'Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them', *Harvard NOM* Working Paper No. 4-28, *ECGI* Finance Working Paper No. 44/2004, ssrn abstract id=561305; L.A. Bebchuk and J.M. Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Boston, Harvard University Press, 2004).

[69] B.R. Cheffins and R.S. Thomas, 'Should Shareholders Have a Greater Say Over Executive Pay? Learning from the Us Experience' [2001] *Journal of Corporate Law Studies* 277, 278 – 284 outlines the British scene. B.R. Cheffins, *Company Law Theory, Structure and Operation* (Oxford, OUP, 1997) ch. 14 traces the recent history in more depth.

[70] Particularly, *Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury* (London, Gee Publishing, 1995).

establishment of accompanying best practice guidelines. However, these changes did not suffice to quieten the debate.

The Labour Government's interest in executive pay was signalled by the decision to keep it outside the general review of company law launched in 1998. Instead, the Government gave this politically contentious issue special treatment by conducting its own consultation exercise on the topic in 1999.[71] This document laid the groundwork for the statutory framework that is now in place. The Government's case for upgrading the disclosure requirements from regulatory requirement under *Listing Rules* to full-blown statutory obligation was that some quoted companies had failed to comply in full with the spirit of the existing requirements and guidelines.[72] This case was supported by a monitoring report that the Government had commissioned from PricewaterhouseCoopers which identified a number of problems.[73]

Initially there was some uncertainty about what difference an 'advisory' vote (which had no obvious precedent in UK company law) would make to corporate governance practice.[74] Despite being non-binding, it was recognised that a negative vote on an advisory resolution would be commercially significant because in ordinary circumstances the market would view it as a signal that the shareholders lacked confidence in the existing managerial team.[75] Yet some commentators doubted whether shareholders would actually make much use of their new power to hold

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[71] *Directors' Remuneration: A Consultative Document* (URN 99/923).

[72] Ibid.

[73] Ibid, Annex A.

[74] E.g., Law Society Company Law Committee, Memorandum No. 435 expressing concerns about the status of an advisory resolution. This memorandum is available via Hhttp://www.lawsoc.org.uk/dcs/newsubject.asp?category_id=75H (accessed July 2004).

The technique is employed already in some other common law jurisdictions: for example, the New Zealand Companies Act 1993, s. 109 gives shareholders the power to pass resolutions relating to the management of the company but, unless otherwise provided by the company's constitution, such resolutions are not binding on the board.

[75] Law Society Company Law Committee, Memorandum No. 435.

directors accountable via the advisory resolution on the remuneration report, broadly on the basis that retail shareholders would have little incentive to involve themselves in internal corporate affairs in this way whilst institutional shareholders would hesitate to engage in public confrontation with boards.[76] One study concluded that it was difficult to predict the impact of the reform because available evidence did not provide much guidance on how investors in the UK used their existing powers but, based on US empirical studies, that it could not be expected that shareholders would take a leading role in the setting of executive pay. [77]

We are now in the second year of remuneration reports being put to shareholders for an advisory resolution. The 2003 AGM season was stormy and directors' pay was commonly at the epicentre of the storm. Outright rejection of reports was rare but levels of abstentions and 'no' votes were sufficiently large to cause embarrassment in some cases.[78] This pattern of events led one commentator to conclude that: 'the advisory vote seems to have galvanised shareholders into positively considering directors' remuneration packages rather than somewhat passively accepting them as a fait accompli'.[79] Yet, despite quite significant vocal opposition to pay levels in this year's round of AGMs, many companies are still managing to record over 90% shareholder support for their directors' remuneration packages,[80] a result that suggests that the shareholder vote may have quite a limited role to play in addressing the accountability problems inherent in executive pay.

It is too early to come to a definitive judgment on the value of the shareholder advisory vote on remuneration reports: this must surely await systematic study of its operation over a number of years, including consideration of ways in which the threat of a negative vote may have strengthened the hand of shareholders in informal discussions as well as examination of the direct data on voting levels and patterns. Yet it is notable that lack of empirical data has not inhibited the British Government from trumpeting its success in changing corporate governance practice by changing the law. In launching the consultation on 'rewards for failure', the Secretary of State for

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[76] Roach, 'Directors' Remuneration'.

[77] Cheffins and Thomas, 'Executive Pay'.

[78] B. Hannigan, *Company Law* (London, Butterworths, 2003), pp. 160 – 161.

[79] Ibid.

[80] A. Senior, 'Banks Face Anger on Top Pay', *Times*, 30 April 2004, p. 32.

Trade and Industry wrote of ‘a welcome increase in the level of shareholder activism on the issue of directors’ remuneration’ and claimed the credit for it: ‘this is very much a result of the new requirements on disclosure and a shareholder vote which the Government has introduced, and which came into effect this year’.[81] This theme continued in the introduction to the OFR draft regulations where the Secretary of State stated: ‘The Government’s recent legislation on directors’ remuneration reports has demonstrated how increased transparency can lead to greater shareholder engagement. Our intention is that the OFR will enhance this trend’.[82] Statements such as these give a good indication of the Government’s current policy orientation, which is clearly in favour of relying on disclosure and associated mechanisms as the first choice regulatory policy tools.

- Operating and Financial Review.

The OFR overlaps to some extent with the Accounts Modernisation Directive and, in embracing employees, environmental matters, social and community issues and essential commercial relationships, it chimes with international debate about policy choices concerning the wider social responsibilities that should be imposed on the corporate sector. Thus the UK has not gone out on a limb in proposing legislation in this area. That said, the timing of the change seems likely to have been influenced by local factors. Before it was elected to power in 1997 the Labour Party had made the creation of ‘stakeholding society’ a key element of its policy agenda.[83] One way in which this policy was given effect after the election was in the review of company

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[81] DTI, *Rewards for Failure*, p. 5 (foreword by the Secretary of State). O. Morgan, ‘Gunning For The Board’, *Observer*, 18 April 2004, Business p. 9, largely repeats this claim and notes that the Secretary of State’s supporters argue that the remuneration reports vote initiative did much to fire up the 2003 AGM season.

[82] DTI, *Draft Regulations on the Operating and Financial Review and Directors’ Report*, p. 6.

[83] A major pre-election speech by Tony Blair, delivered in Singapore in 1996, outlined his vision of a ‘stakeholder society’. This speech is quoted at length in Plender, J, *A Stake in the Future* (London, Nicholas Brealey, 1997), pp. 11 – 13.

law where questions about ‘scope’ – in whose interests should companies be run? – dominated the early stages. The issues touched upon fundamental sensitivities about the centrality of shareholders within the Anglo-American corporate structure and raised difficult legal concerns about the loss of accountability and control that could result from a departure from the shareholder primacy model in favour of a more pluralist view. The OFR in effect emerged from the general company law review as the favoured compromise solution: it is consistent with the traditional model of shareholder primacy (which has associated accountability advantages) because its legal purpose is to make shareholders better informed but it is framed in terms that make it harder for companies to ignore social, environmental and other broad concerns because their failure to pay attention to them will be more openly exposed to public scrutiny. The late John Parkinson made the point that although disclosure obligations of the type represented by the OFR do not necessarily seek to achieve particular social outcomes, they are likely nevertheless to have ‘socially progressive’ effects by virtue of increasing the responsiveness of corporate decision-making to public concerns. He commented: ‘Businesses need to take account of the perspectives of third parties, such as consumers or campaign groups, who are able to inflict commercial damage on them if they consider that their social or environmental performance is unacceptable. With greater transparency, share prices should also more accurately discriminate between the future prospects of good and bad performers, providing corresponding inducements to management to improve performance where necessary.’[84]

The existence of longstanding and high-level Labour party political interest in shifting the emphasis ‘from the company being a mere vehicle for the capital market to be traded, bought and sold as a commodity, towards a vision of the company as a community or partnership in which each employee has a stake, and where a company’s responsibilities are more clearly delineated’,[85] provides an explanation for why, once the Government felt that it had a workable way of moving towards achievement of this objective, it put the OFR reform proposals on a legislative fast-

[84] J. Parkinson, ‘Disclosure and Corporate Social and Environmental Performance: Competitiveness and Enterprise in a Broader Social Frame’ [2003] *Journal of Corporate Law Studies* 3, 6.

[85] Blair Singapore speech, noted in n. 81.

track. The timing may also have been influenced by a number of Bills that were introduced into the UK Parliament in the past few years, which sought to require companies and Government departments to report on the impact of their social and environmental policies and performance and to expand directors' duties to include a duty of care with regard to the social and environmental impact of their company's activities.[86] These were private Members Bills, introduced by groups of MPs and, as such, they had negligible chance of becoming law because they lacked Government backing. Yet they could have served some purpose by maintaining the pressure on the Government to take action in this area.

- Directors' and Auditors' Liability

The accountancy profession has kept debate about the capping of auditors' liability alive in the UK over many years but the decision to bring liability to the foreground of current policy debate appears to have been driven more by concerns relating to the liability position of directors, particularly non-executive directors. Whilst it is a standard response from opponents to any proposal to increase the burden on directors that this will unbalance the benefits and burdens associated with directorships and could undermine efforts to attract highly-qualified individuals to fill such positions, two recent developments gave the British Government particular cause to treat such arguments seriously at this time and not discount them simply as lobbyists' overstatements designed to attract attention.

The first was the review by Sir Derek Higgs of the role and effectiveness of non-executive directors,[87] which resulted in revision to the *Combined Code on Corporate Governance* (effective for financial years beginning on or after 1 November 2003). The Higgs Review described non-executive directors as the

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[86]Corporate Responsibility Bill 2002; Performance of Companies and Government Departments (Reporting) Bill 2004.

[87] D. Higgs, *Review of the Role and Effectiveness of Non-executive Directors* (London, 2003). The Higgs Review is available via Hhttp://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdfH (accessed July 2004).

'custodians of the governance process'[88] and made a range of specific and general suggestions on their role, which have now been reflected in the *Combined Code* itself or in accompanying guidance. Higgs briefly considered concerns about growing litigation risks. His conclusion was that it did not appear that concerns about potential liability were yet having a significant effect in deterring people from putting themselves forward for non-executiveships at least in larger companies, but he acknowledged that there was a risk that such perceptions could reduce the willingness of able people to take on such roles.[89] He therefore called on the Government to clarify some of the rules on directors' liability and, in particular, to look again at the strictness of the ban on indemnification.[90]

The second factor, which was taken into account by Higgs himself, is the ongoing litigation against the non-executive directors of the Equitable Life Society. This case is part of the fallout from *Equitable Life Assurance Society v Hyman*,[91] where the House of Lords ruled against Equitable in its interpretation of certain life assurance policies. Equitable is now suing its former non-executive directors for breach of fiduciary duty and negligence relating to bonus declarations in favour of policyholders over a number of years. The company is seeking up to £3 billion by way of damages. The litigation is at an early stage but the fact that there has been a preliminary decision to the effect that there is indeed a case for the non-executives to answer at trial has itself been enough to send shock waves through the corporate sector and to bring issues about directors' enhanced exposure to litigation risks to the forefront of Government attention.

E : THE VALUE OF A GENERAL REVIEW OF COMPANY LAW AND THE MERITS OF INCREMENTAL CHANGE

It would have been unrealistic to suppose that company law was on hold indefinitely pending production of a completely revised statutory framework. Governments need

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[88] Ibid, para. 1.6.

[89] Ibid, para. 14.3.

[90] Ibid, para. 14.6 (particularly as regarding funding/reimbursing litigation expenses).

[91] [2002] 1 A.C. 408, HL.

to have the flexibility to respond to events as they arise and that includes being able to pass new laws if need be. Yet if we examine the current position through the lens of the prevailing sentiment at the start of the general review of company law in 1998, when the then Secretary of State (at that time the title President of Board of Trade was used) wrote critically of the 'numerous additions, amendments and consolidations' that have 'created a patchwork of regulation that is immensely complex and seriously out of date',[92] we find a surprisingly large number of additions to the patchwork made by the self-same Government. There is no one single explanation for this, as the previous section demonstrated – the UK was not immune to international aftershocks of corporate collapses and market falls; and there was always a chance that politically favoured issues would somehow jump the queue, especially if comprehensive reform proposals showed no signs of coming quickly. Indeed, as the discussion of directors' remuneration revealed, appearances were a little deceptive because the review never was truly 'comprehensive' in any event.

Part of the explanation may also lie in a degree of political disillusionment about the merits of the general review of company law. Despite the British Government's 'official' continuing commitment to a general overhaul of company law, the familiar and much-used qualification that implementation of reform proposals will take place only 'as soon as Parliamentary time allows'[93], does not instil confidence that the project continues to enjoy strong support. This disillusionment, if it is right to suggest that it does in fact exist, could be related to the way in which the review process has evolved. No-one wants half-baked laws that are enacted as a knee-jerk reaction to scandal or collapse but there comes a point when lack of progress on law reform proposals begins to look like a problem rather than a sign of proper care and attention. UK company law reform has passed this point. In terms of public pronouncements, there has been nothing of substance since the White Paper in 2002. This has simply been too long.

The first stage of the process – the independent review of company law conducted by the Steering Group – generally attracted a favourable reaction. For example, Klaus Hopt has written of it in very positive terms, saying that it could serve

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[92] *Modern Company Law for A Competitive Economy* (1998) foreword.

[93] See, e.g., the statement on implementation intentions at Hhttp://www.dti.gov.uk/cld/review.htmH (accessed July 2004).

as an example for other EU Member States.[94] One of its strongest features was that it was structured as an inclusive exercise that was heavily orientated towards consultation and collaboration. There is always a risk that a process that is built on consultation and consensus-building will follow the path of least resistance and produce reform proposals that are undistinguished, fuzzy and unimaginative because they represent the lowest common denominator among all of the interest groups that have had a say in the process. The Canadian experience with its Business Corporations Act, a widely admired statute that was the brainchild of a three-person committee, illustrates the success of an alternative model in achieving clear and radical reform.[95] However, modern theories of good governance emphasise the consultation and collaboration as techniques that can enhance the legitimacy of rules and the accountability of the rule-makers.[96] Experience in the UK company law review is certainly supportive of the legitimacy-enhancing function performed by consultation. Consultation effectively took the heat out of the debate on contentious issues such as the 'scope' question. The process allowed those who advocated a more pluralistic view of the directors' role to have their say and then for a 'settled', and now effectively unchallengeable, view to emerge – still shareholder-orientated but with a pluralistic aspect explicitly built in.

However, whilst the general level of the Steering Group's inquiry was very helpful in establishing objectives and in settling policy in contentious areas, it is evident that it has not proved easy to translate its recommendations into legal rules. It is difficult to pinpoint exactly what the problem may have been but there seem to

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[94] K. Hopt, 'Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron' [2003] *Journal of Corporate Law Studies* 221, 223.

[95] C. Jordan, *International Survey of Corporate Law in Asia, Europe, North America and the Commonwealth* (Melbourne, Centre for Corporate Law and Securities Regulation, University of Melbourne, 1997) Pt. 3 traces the legacy of Canada's Dickerson Report (R.W.V. Dickerson, J.L. Howard and L. Getz, *Proposals for a New Business Corporations Law for Canada* (Ottawa, Information Canada, 1971) in New Zealand and, latterly, Australian law.

[96] On these considerations in the context of securities law-making within the EU see E.Ferran, *Building an EU Securities Market* (Cambridge, CUP, 2004), ch. 3.

have been gaps in the process somewhere between the Steering Group, the officials within the Department of Trade and the Parliamentary draftsmen. Perhaps the Steering Group could have done more to close the gaps by making more of its proposals in the form of draft legislation[97] but that suggestion needs immediately to be qualified by the recognition that the Steering Group did remarkable work within the constraints of very thin and overstretched resources.[98]

Yet it could be that hindsight will eventually suggest that it was no bad thing that UK company law in fact took longer than was envisaged at the outset[99] because the delay allowed a fundamental underlying error to be exposed and corrected. Until recently, the UK debate on company law reform seems largely to have proceeded on the basis that a general review would necessarily lead to comprehensive, reforming legislation or would otherwise fail to achieve its purpose. We can now see the flaw that is inherent in the assumption that general review and general reform are somehow inevitably entwined. A general review is valuable in itself because it keeps the focus on the primary aims of company law and requires the various constituencies that have an interest in the development of company law to think in the round and not have tunnel vision about their own particular concerns. However, we can emphasise the need to engage in comprehensive thinking about the conceptual foundations of company law so as to avoid messy, piecemeal legislation whilst at the same time accepting that the legislative response that eventually emerges from such thinking may be selective and more narrowly focused or may, as has now occurred in the UK, lead to the conclusion that reform (and restatement) are best done in stages. An incremental rather than a radical one-shot approach to legal change can be thought of as being consistent with the traditional British approach to the regulation of the

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[97]The Steering Group's *Final Report* did include (as vol. II) some illustrative draft clauses and a model constitution for private companies limited by shares.

[98] This statement is supported by informal anecdotal evidence about the resources available to the Steering Group. It is hard to find any formal published data on the budget that was devoted to the company law review.

[99] The broad indicative timetable that was outlined at the launch of the review suggested that there would be a White Paper in 2001 with legislation to follow thereafter: DTI, *Modern Company Law for a Competitive Economy* (1998), para. 8.

corporate sector, a tradition that, as Len Sealy has noted, has actually delivered a company law 'of truly remarkable flexibility'.[100]

There is room for disagreement on the urgency of the need for comprehensive reform of existing British company law. Despite longstanding criticism by specialists, British company law ranks well in international surveys.[101] Practitioners know their way around the old, obscure rules and, as *Centros*[102] so famously demonstrated, the existence of certain peculiarities in the law, which can only properly be understood against a complex historical background, do not seem to put the UK at a competitive disadvantage, as least as regards other European countries, in attracting incorporations. Fine-tuning rather than radical overhaul has been shown to be an effective response to corporate governance problems arising in larger companies with dispersed shareholders - at least to the extent of satisfying political goals, though the long term value of recent changes cannot yet be properly assessed. Furthermore, for companies at this end of spectrum securities law and regulations that are imposed on issuers for reasons of ensuring capital market efficiency and investor protection are increasingly eclipsing company law as the most important source of additional obligations. Admittedly securities laws traditionally tended to be orientated towards disclosure rather than substantive requirements; but as disclosure is increasingly the first-choice policy option in company law too, this rather undermines the argument that it is necessary to pay attention to the entire range of company law in order to deliver policy outcomes that cannot somehow be achieved through securities law. The validity of the traditional distinction is also eroded by recent developments in international securities law, most notably the US Sarbanes Oxley Act, which go

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[100] L. Sealy, 'Perception and Policy in Company Law Reform' in D. Feldman and F. Meisel (eds.), *Corporate and Commercial Law: Modern Developments* (1996), ch. 2.

[101] See, e.g, the various studies conducted by La Porta *et al*, which are reported in the material cited in n. 2.

[102] *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459, [1999] 2 CMLR 551, [2000] 2 BCLC 68. This case involved a Danish couple incorporating a private company in England in order to conduct business in Denmark. England was the incorporation location of choice because its company law does not (unlike Denmark) have minimum capital requirements for private companies.

beyond disclosure and interfere significantly in the substantive organisation of internal corporate governance structures, areas that were, historically, regarded as being core elements of company law.

Thus it is legitimate for the Government to suggest that urgent reforms, as identified by the Company Law Review, be dealt with first, with further reform and restatement being left to a later stage. The real challenge now is not to lose further time on bringing forward a new Companies Bill to make these changes. Selective intervention in certain areas derives legitimacy from being based on the findings of a thorough, wide-ranging review and can thus be defended against charges that, in effect, there is a reversion to the piecemeal habits of old. However, this defence will become less and less credible as time passes and as changing events (such as the revival of interest in the EU-wide company law reform agenda that, as this article has noted, has already moved forward the debate on legal capital) render the Steering Group's assessment of priorities increasingly outdated.

For the future, the argument that selective intervention is fine so long as it is rooted in a careful and wide-ranging assessment of its implications for the general system of corporate regulation suggests that there is a case for returning to the question whether there is a role for some kind of official corporate law 'think tank' to assist the DTI in its deliberations on reform choices. Although the idea of an advisory body of this sort did not attract Governmental support in its response to the Company Law Review,[103] this could have been because it had become subsumed within a much more elaborate, and potentially costly to implement, proposal for a companies commission with certain regulatory and supervisory powers.[104] Admittedly, the pre-legislative consultation mechanisms attaching to the proposed restatement and reform powers to be included in the new Companies Bill may do much of the job of providing the Department with appropriately wide-ranging views and advice that might be envisaged for such a body. However, whether these consultative processes

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[103] *Modernising Company Law* (Cm 5553), sec. 5.

[104] E. Ferran, 'Corporate Law, Codes and Social Norms—Finding the Right Regulatory Combination and Institutional Structure' [2001] *Journal of Corporate Law Studies* 381 (discussing concerns about the institutional structure that was proposed by the Steering Group).

will be a functionally adequate alternative to a standing advisory body will depend significantly on the timing of consultation exercises: if consultation takes place only after the policy-formation stage it is unlikely to have the same sort of influence as could be enjoyed by an appropriately constructed body that is involved in the earliest deliberations.

There can be no doubt that many difficult challenges still lie ahead for those involved in the reform of company law in the UK. However, it is pleasing to be able to close this report on a broadly optimistic note regarding the recent constructive developments towards moving that project forward and bringing it to a successful outcome.[105]

[105] However, this optimism is not universally shared: L. Sealy, 'The Reform of Company Law: Selling British Business Short' (2004) 16 *Sweet 7 Maxwell Company Law Newsletter* 1, which describes the DTI's *Flexibility and Accessibility* consultation paper as a 'rubbishy document to which the Secretary of State should have been ashamed to put her signature, a 'cop-out' and a 'slap in the face' for the Company Law Review Steering Group and others who worked for the success of the project.

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