

# UK (England and Wales)

James Palmer and Alex Kay, Herbert Smith LLP



[www.practicallaw.com/6-213-3953](http://www.practicallaw.com/6-213-3953)

## CORPORATE ENTITIES

The main corporate entities are the private limited company (private company) and the public limited company (public company). A Societas Europaea (SE) can also be registered in the UK. Most legal requirements for directors apply equally to private and public companies. Corporate governance codes and best practice apply mainly to public companies admitted to listing by the UK Listing Authority (UKLA), which is part of the Financial Services Authority (FSA) (listed companies).

## LEGAL FRAMEWORK

### 1. What is the regulatory framework for corporate governance and directors' duties?

Corporate governance and directors' duties are regulated by:

- Case law.
- Statute, notably the Companies Act 1985.
- A company's constitution, namely the memorandum and the articles of association (articles).
- The Listing, Prospectus and Disclosure Rules published by the UKLA.

The Listing Rules apply to all companies, and their sponsors that are listed or are applying to list, on the London Stock Exchange (LSE).

The Disclosure Rules apply to all companies listed on the LSE.

The Prospectus Rules implement Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and set out when a prospectus is required. The Prospectus Rules apply to any public offer of transferable securities in the EU or for the admission of these securities to trading on an EU regulated market. In the UK this includes companies listed, or applying to list, on the LSE (but not on the Alternative Investment Market (AIM)).

- The Combined Code on Corporate Governance (Combined Code) applies to listed companies. Its provisions are not mandatory. However, companies should include a statement in their annual report indicating that they comply with the Combined Code and how they do this, or state that they do not comply and give reasons for this.

- Guidelines that supplement the Combined Code such as:
  - the Turnbull Guidance, which assists listed companies in complying with the internal control requirements of the Combined Code (see *Question 25*);
  - the Smith Guidance on audit committees and auditors (see *Question 28*); and
  - suggestions for good practice from the Higgs Report.

AIM companies are also encouraged by institutional investors to adhere to the Combined Code.

The Quoted Companies Alliance published a set of corporate governance guidelines for AIM companies. They are intended as a minimum standard and comprise some simple principles and recommendations for reporting corporate governance matters.

- Guidelines issued by bodies that represent institutional investors. These apply to listed companies and, in some respects, go further than the Combined Code. Although the guidelines are informal, institutional investors can oppose any corporate actions that contravene them. (Institutional investors, such as pension funds and insurance companies, own the vast majority of shares in UK listed companies.)
- In the context of takeovers of public companies, the City Code on Takeovers and Mergers and rules of the Takeover Panel (Takeover Code).
- The Financial Services and Markets Act 2000 (FSMA) and the FSA's Code of Market Conduct which regulates, for listed companies:
  - the disclosure and use of confidential and price sensitive information; and
  - actions that could create a false market.
- The FSA's Disclosure Rules which regulate, for listed companies, public disclosure of confidential and price sensitive information concerning the company. The Disclosure Rules also require transactions in shares or related securities in the issuer to be notified by:
  - directors;
  - persons discharging management responsibilities and connected persons.

## BOARD COMPOSITION AND REMUNERATION OF DIRECTORS

### 2. What is the management/board structure of a company? In particular:

- Is there a unitary or two-tiered board structure?
  - Who manages a company and what name is given to these managers?
  - Who sits on the board(s)?
  - Do employees have a right to board representation?
  - Is there a minimum or maximum number of directors or members of the managerial and supervisory bodies?
- 
- **Structure.** UK public and private companies typically have a unitary board structure, but this is not mandatory. A European company formed in the UK can have a one or two-tiered board structure.
  - **Management.** The company's board has ultimate responsibility for the management of the company. However, the board usually appoints a chief executive officer (CEO) (who can also be a director of the company) to be responsible for the day-to-day management of the company and its business.
  - **Board members.** The company's directors sit on its board. The directors usually consist of a mix of executive and non-executive directors (see *Question 4*).
  - **Employees' representation.** Employees are not entitled to board representation. However, the management of a European company must inform and consult with employee representatives in the European company's establishment and agree a framework for future participation.
  - **Number of directors or members.** Public companies must have at least two directors. Private companies only need to have one director. There is no maximum number of directors. Proposed reforms (see *Question 36*) will make it a mandatory requirement that at least one director of every company is an individual.

### 3. Are there any age or nationality restrictions on the identity of directors?

#### Age restrictions

There is no age limit imposed on directors of private companies (except as provided by the articles). Directors of public companies or their private subsidiaries must retire at the age of 70, unless shareholders approve their appointment or continuation in office. Under the proposed reforms (see *Question 36*) the 70 years restriction will be removed and there will be a new requirement that the minimum age of a director is 16, although there are special provisions for dispensation from this requirement.

#### Nationality restrictions

There are no nationality restrictions on directors.

### 4. In relation to non-executive, supervisory or independent directors:

- Are they recognised?
  - Does a part of the board have to consist of them? If so, what proportion?
  - Do non-executive or supervisory directors have to be independent of the company? If so, what is the test for independence or what makes a director not independent?
  - What is the scope of their duties and potential liability to the company, shareholders and third parties?
- 
- **Recognition.** Non-executive and independent directors are recognised in corporate governance regulation (particularly in the Combined Code). The term "non-executive director" usually refers to a director of the company who is not employed under a service contract. An independent director is a non-executive director who is independent of management and free from any relationships (business or otherwise) that could interfere with his independence.
  - **Board composition.** Except for smaller companies (below the FTSE 350), the Combined Code recommends that:
    - at least half of the board of a listed company be non-executive directors (for these purposes, the chairman does not count as a non-executive);
    - certain committees include independent non-executive directors; and
    - a board appoint one of the independent non-executive directors to be a "senior independent director", who should be available to shareholders if they have concerns which contact through the chairman, CEO or finance director has failed to resolve or where such contact is inappropriate.
  - **Independence.** The Combined Code recommends that non-executive directors be independent and sets out non-exhaustive criteria for determining whether a non-executive director is independent. A director is not independent if he:
    - has been an employee of the company within the last five years;
    - has, or has had within the previous three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has had such a relationship;
    - has received or receives additional remuneration from the company apart from director's fees;
    - participates in the company's share option or a performance-related pay scheme;

- is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- represents a significant shareholder; or
- has served on the board for more than nine years from the date of his first election.

The Combined Code recommends that the company identifies its independent, non-executive directors in its annual report. The chairman is not treated as an independent director.

- **Duties and liabilities.** Non-executive directors are generally subject to the same duties and liabilities as executive directors (see *Question 14*). However, in regulating these duties, the courts have recognised the more limited involvement of non-executive directors in the day-to-day conduct of the business. However the proposed reforms to Company law, broadening the scope for derivative actions against directors (see *Question 36*) applies equally to executive and non-executive directors.

---

#### 5. Are the roles of individual board members restricted? For example, can one person be the chairman and chief executive?

---

There are no legal restrictions on the combination of these roles, but for public companies it is unusual to have one individual as both chairman and CEO. It is generally prohibited to have one individual as both chairman and CEO in listed companies (*Combined Code*). There should be a clear division of responsibilities between the management of the board and the management of the company's business. The board must consult major shareholders (usually institutional investors) before making any decision to combine the posts and must justify the proposal, both to them and in the next annual report (*Combined Code*).

---

#### 6. How are directors appointed and removed? Is shareholder approval required?

---

##### Appointment of directors

The articles set out the method of appointment. Generally, these provide that the board can appoint a director, but shareholders must approve the appointment at the next annual general meeting (AGM). Generally, shareholders can also appoint new directors by a majority vote.

The Combined Code recommends the establishment of a nomination committee, consisting mainly of independent non-executive directors, to recommend all new appointments for listed companies.

On appointment, the chairman should meet the independent criteria set out in the Combined Code.

##### Removal of directors

The articles normally provide for the retirement and removal of directors in certain circumstances (for example, bankruptcy or non-attendance at board meetings).

Shareholders can remove a director (by a simple majority vote) despite anything in the articles or any agreement between the director and the company. Special notice (28 days) is required for a resolution to remove a director. This does not affect a director's right to compensation for early termination.

---

#### 7. Are there any restrictions on a director's term of appointment?

---

There is no strict legal limit on a director's term of appointment. However, a director's employment agreement (service contract) must not exceed five years without shareholder approval.

Guidelines of bodies representing institutional investors and the Combined Code recommend that directors of listed companies have service contracts with a maximum one-year notice period. In practice, directors can be removed at any time by a shareholder vote and listed company directors are almost always subject to retirement and re-election on a rotating basis every three years (*Combined Code*).

The articles typically provide that, when a director is appointed, he must submit himself for re-election at the next AGM. This is included in the Combined Code.

A non-executive director is not considered to be independent if he has served for more than nine years (*Combined Code*).

There are also age restrictions on directors (see *Question 3*).

---

#### 8. Do directors have to be employees of the company? Can shareholders view directors' service contracts?

---

##### Directors employed by the company

Directors do not have to be employees of the company.

##### Shareholders' inspection

Directors' service contracts of 12 months or longer must be open for inspection by shareholders, free of charge. For directors employed mainly outside the UK, less disclosure is required. Under the proposed reforms (see *Question 36*) for the payment of a prescribed fee, shareholders will be entitled to obtain copies of all directors' service contracts, or if the service contract is not in writing, a written memorandum of the terms of the contract.

---

#### 9. Are directors allowed or required to own shares in the company?

---

Directors can own shares in the company but must not deal in those shares in certain circumstances, or at certain times in the

company's announcements' calendar (see *Question 20*). Directors are not required to hold shares by law, but may be required to do so by the articles (this is unusual).

---

#### 10. How is directors' remuneration determined? Does it need to be disclosed? Is shareholder approval required?

---

##### Determination of directors' remuneration

The board can generally determine the remuneration of each director, subject to restrictions in the articles and common law fiduciary duties (see *Questions 14 and 19*). Delegation of remuneration decisions by the full board is difficult without express powers in the articles to do this.

The Combined Code recommends that a remuneration committee of at least three (or two for smaller companies) independent non-executive directors determines executive remuneration policy and individual packages. No director should decide his own remuneration. The remuneration committee should consult with the chairman and/or the CEO about the remuneration of other executive directors.

The Combined Code also has specific provisions relating to performance-related remuneration, including that non-executive directors should not receive share options as part of their remuneration.

##### Disclosure

There are detailed statutory provisions relating to the disclosure of directors' remuneration in the annual accounts. These include:

- Disclosure of the aggregate emoluments paid to, or receivable by, directors.
- Aggregate gains on the exercise of share options.
- The aggregate value of pension contributions made by the company.
- Details of the emoluments of the highest paid director (these are normally required, even for private companies).

The Directors' Remuneration Report Regulations 2002 (Regulations) and the Listing Rules require more detailed disclosure in the directors' remuneration report of listed companies, which must be sent to shareholders. These include full details of all elements in the remuneration package of each individual director by name.

Further disclosure is required when a director of a listed company is granted or exercises an option in a company share option scheme (*Disclosure Rules*).

##### Shareholder approval

Shareholder approval of remuneration may be required under the articles, but this is unusual. The Combined Code recommends that any new long-term incentive plan be subject to shareholder

approval. The remuneration report of a listed company (see *above, Disclosure*) must be voted on by shareholders at the AGM.

---

#### MANAGEMENT RULES AND AUTHORITY

---

#### 11. How is a company's internal management regulated? For example, what is the length of notice and quorum for board meetings, and the voting requirements to pass resolutions at them?

---

A company's internal management is mainly regulated by its articles. These typically contain provisions relating to the:

- Appointment, remuneration and removal of directors.
- Powers of directors (including delegation of powers).
- Proceedings of directors (for example, notice of meetings, director voting and quorum requirements).

The board has considerable discretion to regulate its own affairs.

---

#### 12. Can directors exercise all the powers of the company or are some powers reserved to the supervisory board (if any) or a general meeting? Can the powers of directors be restricted and are such restrictions enforceable against third parties?

---

##### Directors' powers

The articles typically provide that the board can exercise all the powers of the company. However, for listed companies there are additional requirements placed on directors when contemplating certain transactions. Under the Listing Rules, certain transactions (depending on the size of the contemplated transaction relative to the size/turnover of the company) require:

- Shareholder approval and/or notification.
- Notification to the market.

Additionally, the directors have limitations on exercising their power when entering into a related party transaction, where similar notification and approval requirements apply.

##### Restrictions

Directors' powers can be restricted by the company's memorandum and articles or shareholder resolutions, and are subject to statutory limitations. Shareholders (including through a general meeting) do not generally have any powers to interfere with management matters.

A third party acting in good faith can assume (in its favour) that the power of the board to bind the company or to authorise others to do this is free of any limitation under the company's constitution (including shareholder resolutions). This protection generally applies even if the third party knows that an act is beyond the powers of directors under the company's constitution.

**13. Can the board delegate responsibility for specific issues to individual directors or a committee of directors? Is the board required to delegate some responsibilities, for example for audit, appointment or directors' remuneration?**

The articles normally allow the board to delegate any of its powers to an individual director or committee of directors. Delegation of remuneration decisions is not usually possible (see *Question 10*).

The Combined Code provides for various committees of directors to determine, or make recommendations on, certain issues including remuneration, nomination and audit. Companies must make their terms of reference for the remuneration, nomination and audit committees available on their websites.

The Institute of Chartered Secretaries and Administrators (ICSA) suggests that companies also make the terms of reference of the executive committee (which cannot be formally appointed but is, in practice, the forum for major operational decisions) available on their websites.

## DUTIES AND LIABILITIES OF DIRECTORS

**14. What is the scope of a director's duties and personal liability to the company, shareholders and third parties? Please distinguish between civil and criminal liability under each of the following (if relevant):**

■ **General duties.**

■ **Theft and fraud.**

■ **Securities law.**

■ **Insolvency law.**

■ **Health and safety.**

■ **Environment.**

■ **Anti-trust.**

■ **Other.**

■ **General duties.** A director can be personally liable to the company (but not usually to its shareholders) for his acts or those of the company, where he has:

- not acted in good faith in what he considers to be the interests of the company;
- used his powers for an improper purpose;
- made personal profit from his position beyond his authorised remuneration;
- failed to exhibit the degree of skill, care and diligence that may reasonably be expected from a person of his knowledge and experience;

- claimed to be authorised to bind the company when the company has not given him such authority;
- purported to make a contract that fails to bind the company and which the company repudiates;
- contracted or acted without disclosing to the company his own interests in the contract or action;
- signed or authorised any cheque or bill of exchange in which the company's name is not mentioned in full;
- acted in circumstances where he has a conflict of interest not permitted under the articles; and
- failed to keep confidential information, which was obtained while acting as a director, confidential.

■ **Theft and fraud.** A director can be criminally liable under the general laws of theft and fraud (including making false statements with an intent to deceive members or creditors, and false accounting).

■ **Securities law.** A director of a listed company can be criminally liable if he is involved in misleading statements or practices, which may induce someone to buy or sell shares or other securities, contrary to the relevant provisions of the FSMA. Civil liability can arise if other securities laws are breached. Directors can be fined for breaches of the Code of Market Conduct.

■ **Insolvency law.** A director can be personally liable under the Insolvency Act 1986 for:

- fraudulent trading, if he knowingly continues to carry on business with the intention of defrauding creditors, in the knowledge that there was no reasonable prospect of the creditors being paid by the company;
- wrongful trading, if he continues to trade when he knows or ought to know that there is no reasonable prospect of the company avoiding insolvent liquidation.

■ **Health and safety.** A director can be criminally liable for breaches of health and safety regulations if he contributed to the breach through consent, connivance or neglect. The government has proposed new legislation (The Corporate Manslaughter and Corporate Homicide Bill) creating a corporate manslaughter offence, under which companies can be prosecuted for manslaughter if a person's death is caused by a gross failure by its senior managers to take reasonable care for the safety of workers or members of the public. No target date has been set for the Bill to come into force.

■ **Environment.** A director can be criminally liable for breaches of environmental regulations if he contributed to the breach through consent, connivance or neglect.

■ **Anti-trust.** It is a criminal offence for individuals to be engaged in cartels, punishable by imprisonment or an unlimited fine (*Enterprise Act 2002*). In addition, the Office of Fair Trading can apply to court to make a disqualification order against a director who has breached competition law.

- **Other.** A director can also be civilly and/or criminally liable for various other breaches, including where:
  - the director acts as a director while disqualified under the Company Directors Disqualification Act 1986 or the Insolvency Act 1986 (or both);
  - the company gives prohibited financial assistance for the acquisition of its own shares; or
  - the director destroys or falsifies company documents.

In addition, directors can incur liabilities to shareholders and third parties if they act in a way that creates a personal obligation (this is not easily implied).

In other cases, statute expressly imposes liability on directors to third parties, such as responsibility for a misleading securities offering document.

Directors' duties will be codified when the Companies Bill comes into force in 2007 (see *Question 36*).

---

#### 15. Can a director's liability be restricted or limited? Is it possible for the company to indemnify a director against liabilities?

---

It is generally not possible to restrict or limit a director's liability to the company in respect of the issues referred to in *Question 14*.

The law has recently expanded the potential subject matter of directors' indemnities. A company can generally indemnify a director against liabilities to third parties (a qualifying third party indemnity provision), but cannot indemnify a director against:

- Costs of criminal proceedings if found guilty.
- Penalties payable to regulatory authorities.
- Costs incurred in connection with certain other proceedings.
- Liabilities owed to the company (for example, where the company is suing the director for breach of duty).

---

#### 16. Can a director obtain insurance against personal liability? If so, can the company pay the insurance premium?

---

Directors can (and directors of public companies commonly do) obtain insurance against certain civil liabilities (including for negligence, breach of duty and breach of trust in relation to the company), but not losses due to fraud, dishonesty or criminal behaviour. Companies can purchase this insurance on behalf of their directors and officers.

---

#### 17. Can a third party (such as a parent company or controlling shareholder) be liable as a director (even though such person has not been formally appointed as a director)?

---

Company legislation recognises the concept of a shadow director (a person in accordance with whose instructions the directors of

the company are accustomed to acting). Liability can attach in certain cases (such as wrongful trading) to shadow directors in the same way as for directors. However, a shadow director is not merely someone acting as a director; the test requires a greater degree of influence and control. A parent company is not treated as a shadow director just because the subsidiary's directors are accustomed to act in accordance with the parent company's directions.

However, recent case law has not ruled out the possibility that a director of a company which is itself a director of a company may be viewed as a de facto director (*Secretary of State for Trade and Industry v Hall & Another [2006]*).

---

### TRANSACTIONS WITH DIRECTORS AND CONFLICTS

---

#### 18. Are there general rules relating to conflicts of interest between a director and the company?

---

Directors are subject to common law fiduciary duties. A director must not put himself in a position where his personal interests (or duties to other parties) may conflict with the company's interests. A director can be liable to his company if he allows an actual or potential conflict between his personal interests and the company's interests to prejudice his ability to make decisions objectively, to the best advantage of the company. The articles can permit certain conflicts (for example, a private company's articles usually allow directors to have an interest in a transaction which the company has an interest in, and a director to be a director of another company which also has an interest in a transaction, provided the nature and extent of the interest is disclosed to the board).

Under the proposed reforms (see *Question 36*) the duty of a director to avoid conflicts of interest will become an absolute duty; it will therefore be essential for a company's articles to allow for exceptions and board approvals.

---

#### 19. Are there restrictions on particular transactions between a company and its directors?

---

The Companies Act contains provisions on fair dealing by directors (which may be supplemented by the articles) including:

- A duty to disclose an interest in any contract or proposed contract with the company.
- A prohibition on loans to directors (excluding loans of a small amount).
- A requirement for shareholder approval if the company proposes to make certain substantial transactions with a director.
- Controls on payments to directors on loss of office or a takeover.

Listed companies must also obtain shareholder approval for certain transactions with directors and other related parties under the Listing Rules (including shareholders holding more than 10%

of a listed company's shares). There are also statutory limitations relating to conflicts of interest (see *Question 18*).

---

**20. Are there restrictions on the purchase or sale by a director of the shares and other securities of the company he is a director of?**

---

It is a criminal offence for directors (and others) to buy or sell publicly-traded securities if they are in possession of unpublished, price sensitive information. The Code of Market Conduct also limits dealings with shares while in possession of confidential information. Breach of the Code of Market Conduct is punishable by fines.

In addition, the Listing Rules, including the Model Code (*appendix, Chapter 9, Listing Rules*), prevent directors of listed companies from dealing in their company's shares during certain periods (for example, before the announcement of results). The Takeover Code also prohibits dealing in shares in the company if it is the subject of a takeover bid.

## DISCLOSURE OF INFORMATION

---

**21. Do directors have to disclose information about the company to shareholders, the public or regulatory bodies?**

---

Disclosure obligations relating to public companies include:

- Detailed disclosure requirements when offering shares or other securities to the public. The FSA's Prospectus Rules contain detailed rules that apply in these circumstances.
- An obligation on listed companies to inform the market as soon as possible when there is an event that, if known, would be likely to have a substantial effect on the company's share price. There is an exemption available where disclosure would prejudice the legitimate interests of the company (for example, where negotiations for a major transaction are incomplete) and the information remains confidential. The Disclosure Rules contain detailed rules that apply in these circumstances.

## COMPANY MEETINGS

---

**22. Does a company have to hold an annual shareholders' meeting? If so, when? What issues must be discussed and approved?**

---

All public companies must hold an AGM. Private companies can dispense with this obligation by unanimous vote of the shareholders, although under the proposed reforms (see *Question 36*) there will be no statutory requirement for private companies to hold an AGM.

There are no specific issues that have to be dealt with at an AGM, but some standard issues should be addressed. These include:

- The adoption of audited accounts. Directors of public companies (and most private companies) must present the

annual accounts to the company in a general meeting each year, together with:

- a directors' report;
- an auditors' report; and
- for listed companies, a directors' remuneration report.

There is no formal legal requirement for a resolution to adopt the accounts, but this is recommended by the Combined Code and the bodies representing institutional pension funds insist on the resolution being put to the meeting. Shareholders usually raise any general issues about the management of the company when discussing this resolution.

- Election of directors.
- Appointment of auditors.
- Approval of dividends.
- For listed companies, approval of the remuneration report.

If shareholder approval is required for certain directors' remuneration schemes (see *Question 10*), this is commonly done at the AGM.

---

**23. Can shareholders call a meeting or propose a specific resolution for a meeting? If so, what level of shareholding is required to do this?**

---

Holders of 10% of a company's issued voting share capital can require a company meeting. Holders of 5% of a company's issued voting share capital (or at least 100 members) can require a resolution to be put to an AGM.

## MINORITY SHAREHOLDER ACTION

---

**24. What action, if any, can a minority shareholder take if it believes the company is being mismanaged and what level of shareholding is required to do this?**

---

If a minority shareholder believes that the company is being mismanaged, it can:

- Start an action against the directors for breach of their duties, although this is very difficult to do unless the shareholder can demonstrate that the directors owe personal duties to shareholders (see *Question 14*). A shareholder may have more success obtaining an order to prevent a breach of fiduciary duties.
- Require a meeting to make a complaint (see *Question 23*). This may be of little value.
- Apply to court for an order declaring that the company is being run in a way that is unfairly prejudicial to the interests of all or some of its members. Courts have wide discretion in

deciding remedies, but are reluctant to interfere in a company's management unless there is clear prejudice. This is more likely to be available for an unlisted company.

- Apply for the company to be wound up on just and equitable grounds. This remedy is usually only used for private companies, where the company is owned and managed by substantially the same people and, for example, there is deadlock.
- Seek shareholder support for changes to the board and encourage the new board to pursue previous directors for breaches of duty to the company.

The articles or a shareholders' agreement can provide further remedies. The Companies Bill introduces a new statutory procedure to enable shareholders of a company to bring a derivative action. (see *Question 36*).

## INTERNAL CONTROLS, ACCOUNTS AND AUDIT

### 25. Are there any formal requirements or guidelines relating to the internal control of business risks?

The Combined Code requires the board of listed companies to maintain a sound system of internal control and ensure it effectively manages risks in the way the board has approved. It also requires that the board should, at least once a year, review the effectiveness of the company's internal controls and report to shareholders that it has done this.

Some of a company's statutory accounting and record keeping obligations require effective financial and accounting controls to be in place.

### 26. What are the responsibilities and potential liabilities of directors in relation to the company's accounts?

Directors must approve the company's annual accounts and are primarily responsible for their accuracy. If accounts are not reasonably accurate, every director who is in default is potentially criminally liable (for a fine and/or imprisonment), unless he can show that he acted honestly and the default was excusable. Similarly, if annual accounts are approved which do not conform to statutory requirements, every director who is a party to their approval and who knows that they do not comply (or is reckless as to whether they comply) is guilty of a criminal offence and liable for a fine. It is a criminal offence to make false statements to auditors.

Directors can also be liable under civil law for breach of a statutory duty or for failing to exhibit the requisite degree of skill that may reasonably be expected (see *Question 14*).

Directors must also prepare an annual report, giving a fair review of the business, and are potentially criminally liable if they fail to do this. The business review must describe the principal risks and uncertainties facing the company and include:

- An analysis of the company's position at year end and the development and performance of its business in the previous financial year.

- An analysis of the business using financial key performance indicators (KPIs) and, where appropriate, other KPIs (including information relating to environmental matters and employee matters).
- A statement that as far as the directors are aware, there is no relevant audit information that the directors have not disclosed to the auditors.

The Combined Code recommends that directors explain, in the annual report, their responsibilities for preparing accounts and present a balanced and understandable assessment of the company's position and prospects.

### 27. Do a company's accounts have to be audited?

Annual accounts of all public companies and some private companies must be audited. There are exceptions to the audit requirement for certain small private companies.

### 28. How are the company's auditors appointed? Is there a limit on the length of their appointment?

Every company must appoint an auditor. The appointment (and re-election) must take place at each general meeting when the accounts are presented, usually the AGM (see *Question 22*). Shareholder approval is required by simple majority. Private companies can dispense with the obligation to appoint auditors annually.

There is currently no limit on the duration of auditors' appointments (subject to annual shareholder approval), although the ethical standards issued by the Institute of Chartered Accountants of England and Wales (ICAEW) require internal rotation of the audit engagement partner every five years for listed companies and every ten years for non-listed companies.

The Combined Code recommends that:

- An audit committee of at least three (two for small companies) independent non-executives is set up to review the scope and results of the audit and the independence and objectivity of the auditor.
- At least one member of the audit committee has recent and relevant financial experience.
- The audit committee annually reviews the need for an internal audit, if it does not have one.

### 29. Are there restrictions on who can be the company's auditors?

Auditors must be appropriately qualified and a member of a recognised supervisory body. An insufficiently independent auditor is ineligible for appointment. The grounds for ineligibility are narrow (for example, a director or employee of a company cannot be its auditor) but they can be extended by statutory instrument.

---

**30. Are there restrictions on non-audit work that auditors can do for the company that they audit accounts for?**

---

There is no statutory ban on non-audit work by a company's auditors, however auditors must comply with the Auditing Practice Board Ethical Standards and failure to comply can result in a practitioner having their licence to practice revoked.

The Companies (Disclosure of Auditor Remuneration) Regulations 2005 require detailed disclosure in the annual reports of large and listed companies of the fees paid by the company to auditors for audit and non-audit work and the Institute of Chartered Accountants has recently issued guidance on this issue.

In addition, the National Association of Pension Funds (NAPF) insists on disclosure of non-audit work in the annual report of listed companies.

---

**31. What is the potential liability of auditors to the company, its shareholders and third parties if the audited accounts are inaccurate? Can their liability be limited or excluded?**

---

Auditors are potentially liable to a company and its shareholders if the accounts and directors' report are materially inaccurate or misleading and they have been negligent in performing their duties. Auditors are not generally liable to third parties, unless it can be shown that a special relationship exists between the auditor and the third party. An auditor's duties to the shareholders vary, depending on the circumstances of shareholder reliance and loss.

Auditors are prevented by statute from limiting their liability in relation to the company for audit work.

---

## CORPORATE SOCIAL RESPONSIBILITY

---

**32. Is it common for companies to report on social, environmental and ethical issues? Please highlight, where relevant, any legal requirements or non-binding guidance/best practice on corporate social responsibility.**

---

Most companies must prepare an annual business review (as part of the annual report) which provides an analysis of its business performance using (where appropriate) non-financial KPIs, such as information relating to environmental matters (see *Question 26*).

The Association of British Insurers (ABI) has separately published reporting guidelines on corporate social responsibility issues.

Proposed reforms (see *Question 36*) will impose additional duties on directors relating to the community and the environment.

---

## ROLE OF GENERAL COUNSEL

---

**33. Is it common for the general counsel to be on the company's board or to have a formal role in corporate governance?**

---

In some companies, the general counsel is a member of the board or may be present at board meetings as company secretary (the

role of company secretary and general counsel is sometimes combined). It is less common for the general counsel to be a director.

It is not common for the general counsel to have a formal role in corporate governance, unless he is also company secretary. All directors should have access to the company secretary for advice (*Combined Code*); he is responsible to the board for compliance with procedures, rules and regulation. In addition, non-executive directors of a listed company should have access to independent professional advice (*Combined Code*).

---

## ROLE OF INSTITUTIONAL INVESTORS AND SHAREHOLDER GROUPS

---

**34. How influential are institutional investors and other shareholder groups in monitoring and enforcing good corporate governance? Please list any such groups with significant influence in this area.**

---

Investment Committees (including those of the AIB and the NAPF) provide guidelines and recommendations to institutional shareholders. Compliance with the guidelines is not mandatory. However, listed companies that consistently fail to comply with the guidelines may lose the confidence and support of their institutional shareholders.

The ABI and the NAPF are both members of the Institutional Shareholders' Committee which advises institutional shareholders.

Additionally, institutional shareholders can requisition a meeting and propose resolutions if they have the required shareholding (see *Question 23*).

---

## WHISTLEBLOWING

---

**35. Is there statutory protection for whistleblowers (persons who disclose criminal activity or other serious malpractice within a company)?**

---

Employees who raise legitimate concerns about malpractice and who, as a result, find themselves subject to detriment from their employer, can claim compensation for unfair dismissal and bring an action for victimisation.

---

## REFORM

---

**36. Please summarise any impending developments or proposals for reform.**

---

The Companies Act received Royal Assent in November 2006 and all parts of the Act are expected to be brought into force by October 2008 (although some will take effect before). Key corporate governance proposals include:

- The inclusion of a statutory statement of directors' duties. This expands the scope of existing duties, by, for example, imposing a duty to consider the interests of employees, the

environment and suppliers and customers (a director's duty to act in the best interests of shareholders will, however, remain paramount).

- A new statutory derivative action procedure. Under the current law an individual can bring a derivative action but only when those who control the company have permitted the wrong and, generally, there has been fraud on the minority. The new procedure allows a shareholder to bring proceedings on behalf of the company against a director for negligence, default, breach of duty or breach of trust. This, together with the revised court process, could lead to increased shareholder activism or derivative actions.
  - For private companies, simplifying existing requirements for shareholder meetings, resolutions, company formation and the articles.
  - Allowing companies to use electronic communication as its default method of communicating with shareholders.
- Quoted companies must ensure that their reports and accounts are published on their website.
  - Providing for proportionate liability for auditors. This will allow auditors to contractually limit their liability to amounts that are fair and reasonable.
  - Directive 2004/109/EC on transparency requirements for securities admitted to trading on a regulated market and amending Directive 2001/34/EC will be implemented with effect from 20 January 2007. The FSA will introduce new transparency rules as part of the renamed Disclosure and Transparency Rules. These measures will significantly change the existing regime for the disclosure of financial information by listed companies (including a new quarterly reporting requirement) and to the requirements for the disclosure of voting interests in listed, AIM and OFEX (the UK's independent public market specialising in small- to medium-sized European businesses, regulated by the FSA) companies.

**PLC Corporate**   
Essential know-how

PRACTICAL LAW COMPANY

“We find the standard documents and drafting notes to be of a very high quality - practical and focused on the needs of front-line fee earners.”

Larry Nathan, Partner, Corporate/Commercial Department, Mishcon de Reya.

**PLC Corporate** is a revolutionary online professional support service that keeps corporate lawyers up to date and provides them with transaction support through legal updates, practical guidance notes and standard documents. [www.practicallaw.com/corporate](http://www.practicallaw.com/corporate)

## Herbert Smith

“An extremely high-quality service across all disciplines provided by a deep team of creative lateral thinkers.”

*Chambers UK 2006*

Your company  
is our concern

### **Contacts**

Michael Walter  
T +44 20 7466 2841  
[michael.walter@herbertsmith.com](mailto:michael.walter@herbertsmith.com)

Caroline Goodall  
T +44 20 7466 2147  
[caroline.goodall@herbertsmith.com](mailto:caroline.goodall@herbertsmith.com)

Herbert Smith LLP  
Exchange House  
Primrose Street  
London EC2A 2HS  
[www.herbertsmith.com](http://www.herbertsmith.com)



Herbert Smith in association with  
Gleiss Lutz and Stibbe