

## DTI CONSULTS ON DIRECTOR LIABILITY

**The Department of Trade and Industry published a consultative document in December 2003 on director and auditor liability. This briefing concentrates on the background to, and proposals for, reform to director liability.**

The key principles of director and auditor liability are not set out in legislation. Instead, they have to be derived from a series of court judgments. Parliament has restricted the ways in which directors and auditors can limit their liability, and these provisions are now contained in the Companies Act 1985.

The law in some other countries provides more protection for directors, but that is often because they are more exposed to liability to start with. For example, in the case of the US, there is both greater scope for shareholders to bring actions against directors and for corporations to eliminate or limit the personal liability of directors. In recent years, common law jurisdictions such as Australia and New Zealand have introduced a statutory business judgement rule.

### For what are directors liable?

Directors' general duties to their companies are commonly divided into duties of loyalty and duties of care. The DTI consultation is mainly about the latter, both in relation to the conduct and supervision of the company's affairs and, specifically, the preparation of its accounts.

A director's duties are owed to the company rather than to individual shareholders. It therefore falls to the company to take action for breach of duty: in practice, this usually means the board of

directors (in some cases a new board of directors) or the liquidator.

The government has already said it will introduce legislation providing a statutory statement of directors' general duties, including a statutory standard of care, skill and diligence. The statutory standard will have two elements:

1. In general, the knowledge and experience that may reasonably be expected of a person in the same position as the director (this imposes a different standard on executive and non-executive directors).
2. Looking at a particular director's knowledge and experience. A qualified accountant would be expected to have a more detailed knowledge of accounting issues than a non-accountant director.

### Options

Against that background, the government has put forward three main options for reform of director liability:

1. Retain the substance of current sections on exempting directors from liability. Those favouring this option would have to believe that the 1985 act strikes a reasonable balance between the concern of directors about their personal liability and the protection of the interests of the company and its shareholders.
2. Limited reform based on some of the Company Law Review's (CLR's) recommendations. These reforms include:

- Reword section 310 so that it is clearer and applies to liabilities under the general duties of directors. Section 310 was introduced in 1929 in response to a practice for companies to include

in their articles widely-drafted exemption clauses relieving their directors, officers and auditors from liability arising from breaches of their duties, save in the case of wilful negligence or default.

- Continue the prohibition on the company giving indemnities to directors but allow indemnities negotiated with a holding company, another member or a third party.

- Allow a company to give a director an indemnity in advance against the cost of successfully defending court proceedings. Such advance indemnification could only be approved by disinterested members of the board. And if the director lost, he or she would have to reimburse the company.

- Allow the company to pay the full amount of any claim rather than expect the director to pay a limited amount.

- Broaden the scope of little-used section 727, where directors may apply to the court for relief from actual or potential liabilities. The court may grant relief if the director "acted honestly and reasonably" and that "in all circumstances he ought fairly to be excused". The CLR suggests that deleting the requirement to act reasonably may make the section more useful.

3. The litigious nature of US society means there is greater legal protection than elsewhere for honest directors. The US maintains a Model Business Corporation Act, which provides that directors must discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances. This baseline standard in the US is lower than that proposed in the CLR.

In US states, this duty is subject to the business judgement rule. This is a judge-made standard used in analysing director conduct to determine whether a board decision can be challenged

successfully or a director should be held personally liable. The court will look only to determine whether the directors – at least those making the decision – were disinterested in the matter, appropriately informed themselves before deciding, and acted with a good faith belief that the decision was in the best interest of the corporation.

The CLR ruled out the Business Model Act on the grounds that:

- British courts have shown a proper reluctance to enter into the merits of commercial decisions.
- Such a provision would be likely to add complexity, and be inflexible and unfair, being too harsh in some cases and allowing too much leeway in others.

It seems unlikely the DTI would want to go for option 3 as the CLR said no and it would amount to a radical change. But the do-nothing option 1 will not answer the worry that directors – and non-executive directors, in particular – will be scared off, as the risk seems so great. So option 2 would appear to be the DTI's favourite, but businesses will have to wait and see what the consultation produces.

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*A wide range of Briefings can be found at [www.financialdirector.co.uk/briefing](http://www.financialdirector.co.uk/briefing)*

### Useful links

- The DTI invites comments by 12 March 2004. To obtain a copy of the consultation document, go to [www.dti.gov.uk/cld/condocs.htm](http://www.dti.gov.uk/cld/condocs.htm)

- Copies can also be obtained by phone on 0870 1502 500, fax 0870 1502 333 or email at [publications@dti.gsi.gov.uk](mailto:publications@dti.gsi.gov.uk)