

COMPANIES BILL DEALS WITH DIRECTOR/AUDITOR LIABILITY

The UK government has been reviewing what changes – if any – should be made to UK company law to prevent further corporate scandals.

The government's response has been two-fold: to increase transparency for shareholders with regards to company financial information they can access while clarifying the responsibilities of auditors and directors, and cutting red tape so smaller companies can flourish.

On 7 September 2004, Secretary of State for Trade & Industry Patricia Hewitt announced the government's thinking with regards to director and auditor liability as set out under the Companies (audit, investigations and community enterprise) Bill presently going through Parliament.

The government's consultation on the role and responsibilities of directors identified two particular concerns from UK business:

(1) Exposure to liabilities that arise from legal action against directors by third parties.

The sharp rise in the number of class actions by groups of shareholders in the US has made this a particular concern for directors of UK companies with a US listing.

(2) The cost of lengthy court proceedings.

Companies can indemnify a director against the cost of defending legal proceedings, but only when judgment has been given in the director's favour or he/she has been acquitted. For many directors, indemnification comes too late.

The government's proposals will:

- Permit, but not require, companies to indemnify directors in respect of proceedings brought by

third parties (covering both legal costs and the financial costs of any adverse judgment, except for the legal costs of unsuccessful defence of criminal proceedings, fines imposed in criminal proceedings and penalties imposed by regulatory bodies such as the FSA).

- Permit, but not require, companies to pay directors' defence costs as they are incurred, even if the action is brought by the company itself. The director would still be liable to pay any damages awarded to the company and to repay the defence costs to the company if his/her defence is unsuccessful (except where the company chooses to indemnify the director in respect of legal costs in civil proceedings brought by third parties).

The government amendments will also remove a loophole under which a company in the same group may currently provide an indemnity to a director that would be unlawful if it were provided directly by the company of which the individual was a director.

The amendments will require disclosure in the directors' report by companies that indemnify directors. Shareholders will have the right to inspect indemnification agreements. Companies that do not indemnify directors will not have to make any disclosure.

Comment

The Confederation of British Industry has welcomed the government's plan to indemnify directors, but complains that "it has not addressed capping liability or indemnifying against civil damages as opposed to costs and third-party actions".

"Put simply, people aren't going to want directorships if they have to put their house on the line for a relatively small return. If the risks outweigh the benefits, we will never see real diversity in the boardroom," says Digby Jones, the CBI's director general.

Patricia Peter, head of corporate governance at the Institute of Directors, says the government's reluctance to set a cap on liability "is a missed opportunity" and that "directors still face ruin for innocent mistakes".

The government also believes "there must be an appropriate degree of transparency and accountability for the audit process" and so has extended the investigative powers of external auditors to ensure that boards and stakeholders have accurate information on which to judge the company's financial status and risk profile. The Bill extends the powers of auditors to obtain information and contains new provisions for each director to confirm there is no relevant audit information of which he is aware but the company's auditors are unaware.

There are a number of initiatives to improve the quality of the audit and other information provided to shareholders. These include the setting up of an audit inspection unit to carry out independent reviews of the effectiveness of the audit procedures of the four largest audit firms, as well as setting up a new accountancy investigation and discipline board to investigate cases of alleged breaches of professional standards by auditors.

Crucially, the government will not extend an auditor's duty of care or introduce a cap on auditor liability.

Instead, it is considering introducing limited liability on a proportionate basis by contract. This would allow parties to determine what damages and costs each party would be liable for if there were a governance failure.

But Prem Sikka, professor of accounting at the University of Essex, is unconvinced. "How can such agreements settling potential liabilities be carried out? If a number of organisations are involved, but not all agree to pay whatever costs they have been lumbered with, where does that leave investors and creditors if not all liabilities – and we could be talking tens of millions of pounds – are settled?"

Freedom of information

Mike Davis, senior research analyst at the Butler Group, says that, like Sarbanes-Oxley in the US aimed at improving corporate governance and accountability, the UK's Companies Bill will require major IT investment to properly comply.

"If this Bill becomes law, companies will have to ensure their auditors and shareholders have access to even more company information. It is also the duty of directors to ensure that that information is accurate. As the government has not set a cap on either director or auditor liability, there is a greater emphasis on companies having the right mix of IT systems and skills to find any discrepancies that could affect the company's books," says Davis.

Neil Hodge

A wide range of Briefings can be found at www.financialdirector.co.uk/briefing

Useful links

- The consultation on director and auditor liability is at www.dti.gov.uk