ACT

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12th March,2004

Corporate Law and Governance Directorate
Department of trade and Industry
Bay 573
1 Victoria Street
London SW1H 0ET

Attention Mr James Carey

Dear Sir,

DTI CONSULTATION DOCUMENT: Director and auditor liability, December 2003

I attach a response from the Association of Corporate Treasurers.

We note that you may wish to make all responses to formal consultations available for public inspection unless the respondent requests otherwise. These comments are on the record and may be freely quoted and made available for public inspection.

We hope these responses are helpful for your deliberations and if you need any further information or clarifications please contact any of the people listed below.

Yours faithfully,

Martin O'Donovan
Technical Officer

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Comments on behalf of

The Association of Corporate Treasurers

In response to
Director and auditor liability; a consultation document
(DTI, December 2003)

The Association

The Association of Corporate Treasurers (ACT) was formed in 1979 to encourage and promote the study and practice of corporate finance and treasury management and to educate those involved in the field. Today, it is an organisation of professionals in corporate finance, risk and cash management operating internationally. A professional body and not a trade association, it has over 3,000 Fellows, Members and Associate Members. With more than 1,200 students in more than 40 countries, its education and examination syllabuses are recognised as the global standard setters for treasury education. Members of the Association work in many fields. The majority of Fellows work in large UK public companies, responsible for the treasury and corporate finance functions.

The ACT usually comments from the corporate and not the financial services sector standpoint. In the context of this consultation we should note that our members will have a general interest in maintaining the efficient functioning of the Company Law in order to promote a healthy and fair sector. Some of our members may hold directorships of listed companies or of subsidiaries of larger groups, and a small number of our members are partners or members of audit firms

Introduction

As professionals active within companies the members of the Association of Corporate Treasurers will be supporters of a system of responsibility and liability for directors and auditors which is fair and reasonable. Your consultation and consideration of the current and possible future position in this area is therefore very much supported as an important subject.

As a general point we make the observation that taxation and other commercial pressures may be encouraging companies to form divisional structures rather that having a multiplicity of companies, so that there can exist senior managers running a division who are to all intents and purposes similar in responsibility to a director of that division but under Company Law are not directors. Hence allocation of responsibility and liability to directors rather than to other key decision makers is arbitrary and potentially inappropriate.

Summary of overall position

The Association of Corporate Treasurers supports modest changes to clarify the law in respect of the giving of indemnities to directors so as to make this possibility more readily available either directly or via directors and officers insurance.

We would welcome changes to section 310 to allow auditors to limit their liability contractually.

On the question of extending the responsibility of directors and auditors to parties other than the company or giving other parties the right to sue the directors and auditors we believe there are no grounds for changing the current regime whereby it is to the company itself that the obligations are owed and hence it is only the company that has a right of recourse.

Responses to specific questions

Q1 Should investors in a company be able to claim against the directors and/or auditors? If so, on what basis and why?

We consider that the directors are the ones that are primarily responsible for the accounts and their reliability. The auditors have a secondary responsibility by virtue of their role in the audit of those accounts.

Under the law as it stands, it is the company and not the shareholders that alone can bring proceedings to enforce rights vested in the company, e.g. claims for negligence or breach of duty, against persons who owe it a duty of care or other relevant duty. This is basically because the shareholders do not own or run the business, they merely own shares in the company (which owns the business) and, via the articles, have delegated the running of the business, including the enforcement of the company's rights, to the directors. There already exist sufficient methods for the shareholders to influence the company to bring proceedings in serious cases normally through bringing new directors in or through petitioning the court in a case involving actual or likely abuse of fiduciary duties or fraud.

It follows from the above that the appropriate plaintiff in a case of negligence resulting in damage to the company (and indirectly, therefore, to the shareholders as well) is the company itself, whether the alleged wrongdoers are the directors or a third party, such as the auditors. The decision to bring proceedings is therefore a matter for the board or, if the company is in administration or liquidation, the administrator or liquidator.

The auditors do, however, owe a duty of care to the company itself, which is why proceedings against them tend to be taken by the administrator or liquidator, as the company's representative following insolvency.

The fundamental question in the DTI consultation paper is whether there is good reason for the status quo to be revised, so that shareholders (and perhaps others, such as lenders) would have a direct right of action for negligence against (a) directors and (b) auditors.

In the US where a direct right of action by shareholders is permitted the class action concept has spawned an aggressive breed of trial lawyer who actively chases business by identifying potential negligence situations where a "class" can be defined – shareholders in a particular listed company are an obvious example. We do not believe this to be a constructive approach and indeed such a system would be a retrograde step for the commercial world.

We therefore believe that investors in a company should not be able to claim against the directors and/or auditors.

Q2 Should potential investors in a company be able to claim against the directors and/or auditors? If so, on what basis and why?

Potential investors are just that, so the directors and auditors cannot be aware of the uses to which the accounts are being put. The connection is too remote for them to owe any responsibility to these potential investors. There is however an exception and that is when the accounts are included in an offering circular to potential investors as a formal part of the process of selling securities. However in such circumstance rules already exist under the Listing Rules and the Financial Services and Markets Act to define those with responsibilities and the extent of that responsibility.

Consequently we conclude that no changes should be made so that potential investors in a company are able to claim against the directors and/or auditors.

Q3 Should an ability to claim in respect of a breach of duty of care in preparing accounts be extended to any other group? If so, who and why?

In line with the position we take in respect of Q1 and Q2 we maintain that other groups should not have the ability to claim in respect of breach of duty.

Q4 Should criteria be set by statute to determine whether an auditor owes a duty of care to a particular person?

For the reasons previously stated the answer to this is also no.

Q5 Should any action seeking recompense for a loss be against the auditors, the directors, the company or some combination? Why?

We agree with the government's position that there should be no change to the current system.

Q6 (a) On what basis should any loss be assessed? For example, should liability be limited to the difference between the value of shares at the date of purchase and the value they might have had if the audit had been correct? Or should it be the loss suffered?

(b) Is this a matter for legislation, or is it for the courts to determine in any particular case?

This should be a matter for the courts to decide based on the circumstance of any losses incurred.

Q7 (a) What would be the implications of any overall limit of liability for the rights and obligations of third parties to each other? For example, would the first person who claims have to share any recompense with the last person to claim?

(b) If the company brings an action, does that rule out claims by others?

On the basis that no new right of action on the part of shareholders or others (other than the company itself) against directors or auditors is created, these questions should not arise.

Q8 If the auditors' duty of care were to be extended, should the extension apply equally to all users? Or should it depend on how much else the claimant knows (or ought to have known) about the company? For example, in addition to the annual Report & Accounts, a bank or fund manager is likely to have access to a wide range of relevant research materials that might be used in support of an investment decision. In contrast a private investor might only have access to the historical Report & Accounts.

We consider that there should be no extension to the auditors' duty of care. In addition to the fundamental objections we have to such an extension [as described above], the existence of the difficulties outlined in this question and those of sharing claims in Q7 and of potential abuses in Q9 are further reasons for not doing so.

Q9 If the auditors' duty of care were to be extended, what would be the most effective way of preventing abusive actions (for example, seeking to recover losses from bad investment decisions)?

See Q8

Q10 The directors are responsible for the contents of the company's Report & Accounts. Do you think therefore that any extension of the auditors' duty of care should be matched by an equal extension of the directors' duty of care in relation to the accounts? What would be the consequences?

We do not support an extension of the auditor's duty of care and likewise believe that it is not necessary to extend the directors duties.

Q11 Is there evidence that the cost of Directors' and Officers' (D&O) liability insurance is increasing in real terms and that coverage is becoming less comprehensive? If there is, is this a fair reflection of the market pricing in increased risk?

We are not in a position to comment on this questions save to note that if the directors duties of care were extended or if the system were to be changed to allow shareholder action against the directors it would be a certain consequence that D&O premiums would escalate significantly and availability of cover relative to demand would shrink further.

Q12 The Combined Code has been amended to refer to the need for companies to arrange appropriate insurance cover in respect of legal action against directors, and ICSA has published guidance for companies on what insurance should be provided for directors. Is there need for more to be done? If so what?

No comment

Q13 Is there evidence that suggests that issues relating to potential liability are affecting the recruitment of able non-executive directors?

No comment

Q14 Might it be appropriate to permit companies to indemnify non-executive directors even in circumstances where this is not considered appropriate in respect of executive directors? If so, in what circumstances?

Your consultation document noted that the Higgs report backed the existing position whereby the duties of executive and non-executive directors are the same, but that the CLR had recommended a statutory duty of care, skill, and diligence which it believed would impose a different standard on a non-executive director than on an executive director.

Given the possibility under section 727 of a limitation on the liability of non-executive directors it does not seem necessary to allow companies to indemnify non-executives directors in circumstances where it would not be appropriate in the case of executive directors. Furthermore if the CLR proposal to introduce a statutory duty of care, skill and diligence is enacted this will probably make clearer the circumstance when relief under section 727 will be available.

Q15 To what extent is the length of court proceedings adding to the concern of directors about their potential liabilities?

We believe that the length and personal disruption caused by court proceedings is already a potential concern to directors and that this would be enormously magnified if shareholders were allowed to sue.

Q16 Does section 727 currently allow the courts sufficient scope to grant relief at an interim stage?

We believe section 727 does allow sufficient scope to grant relief at an early stage.

Q17 Which of the three main options for reform of director's liability should the Government adopt?

Given that a statutory duty of care will be introduced you are seeking views on which of three options on directors' liability and indemnification should be followed, namely:

Option A – Retain the substance of current sections on exempting directors from liability
Option B – Implementation of the CLR's recommendations
Option C – Reforms based on the US model.

We support option B. We believe such changes are helpful and move a small way towards protecting directors but without unduly disadvantaging the company or, indirectly, the shareholders.

Q18 In relation to the CLR's ideas:
(a) are there particular aspects of the CLR's recommendations that you believe are either especially important or that should not be pursued?

With reference to paragraph 5.6 (a) you note that the CLR is proposing to amend the wording of section 310 so that the prohibition on the giving of indemnities by the company applies to liabilities under "the general duties of directors" rather than in the case of "negligence, default, breach of duty or breach of trust". The apparent intention was to eliminate the "generality" of section 310 and to create greater "clarity". We are not convinced that this wording achieves either objective. Changing the wording could suggest that a substantive change to section 310 (rather than merely "clarification") is intended, *which it is not. Section 310 was designed to prevent company funds from being used to protect a director from his own wrongdoings and should not be watered down.*

With reference to paragraph 5.6 (b) you explain that section 310 was intended to prevent the directors using undue influence to get themselves indemnities. Since the directors can use their influence over subsidiaries the prohibitions in section 310 should apply to the company and its subsidiaries but need not apply to the provision of indemnities from a parent or sister company.

With reference to paragraph 5.6 (c) it states that the CLR recommended that a company should be able to give indemnities to a director to cover the cost of defending proceedings but only if the decision was made by the disinterested directors and they had received legal advice that the prospects of success were good. In many cases a director will have his costs of proceedings covered by D&O insurance, but where this is not the case, it seems perverse to have the assessment of whether the defending director has a good chance of success being made by the directors who will have initiated the action by the company. Accordingly we support the alternative proposals from Derek Higgs that the company can indemnify the director without trying to establish in advance the prospects of success. Indeed, we think that this power would only be of real use if the indemnity could be given on a blanket, or "blind", basis in advance of there even being a suggestion of litigation against the director. This indemnification could, and if given on a blind basis no doubt would, be on a refundable basis, the refund obligation being contingent upon the defence by the director being unsuccessful.

Paragraph 5.6 (d) covers the ability of the company under section 310 to provide an indemnity for any excess payable by the director under D&O insurance. We agree with the suggestion that the company should be allowed to cover the excess.

Paragraph 5.6 (e) covers the CLR proposal that when the courts consider an application under section727 for a director to claim relief from liabilities, they should look to a fairness criterion and need not apply an "acting reasonably" test. We support the elimination of the "acting reasonably" test. (For comparison fairness, rather than fairness and reasonableness, is the criterion a court applies in deciding whether a scheme of arrangement which has the approval of the company's shareholders or creditors should be sanctioned under s.425.)

(b) do you support the recommendation by Derek Higgs that a company should be able to indemnify a director in advance against the reasonable cost of defending proceedings from the company itself without trying to establish in advance the prospects of success of the case?

Please see response above that refers to paragraph 5.6(c). We support the recommendation that a company should be able to provide an indemnity against the costs of proceedings without having first to establish the prospects of success. It would be better if this indemnification could be given on a blanket or blind basis in advance of any claim arising.

Q19 In relation to the US model:
(a) is there a case for the introduction of a statutory business judgment rule?
(b) should any other of the US provisions be considered further? If so, should they be subject to shareholder approval?
(c) should any such shareholder approval need to be renewed (for example, every year or every 5 years), and should the same requirement in respect of shareholder approval apply to all types of company?

Your consultation paper summarises how the US have a business judgment rule that means the courts will not seek to question the business judgment of directors, and have rules that allow more protection and limitation of liability for directors, but this should be seen in the context of a more litigious environment, in particular where the ***shareholders*** *of a company are able to bring action against the directors and where this is often done on a class action basis . For the reasons given in your paragraph 5.11 we do not see the need for a business judgement rule within the UK. The UK is very different from the US because of the freedom there for shareholders to sue directors, therefore we consider the elements from the US system such as the ability to limit directors' liability as unnecessary here.*

Q20 (a) Do you see substantive barriers to entry to, and expansion within, the audit market? If so, what are they?

(b) If such barriers are perceived to exist, what steps might be taken to remove them?

(c) When commissioning audits, do you feel that you have sufficient genuine choice between firms? If not, why not?

There has been a marked concentration in the business of audits with four very large firms operating in the UK having a major portion of the market. We are not in a position to comment on the extent to which this is caused by the unlimited liability position of firms or a trend towards a more litigious environment or other commercial pressures. Whatever the causes it cannot be in the interests of a competitive market to see any further concentration and therefore we believe that any measures that reduce the risk of a large firm being wiped out by liability judgements, or make it less risky for new or smaller firms to expand, must be beneficial to the overall health of the market.

If the accounts of a company are wrong and conceal a financial deterioration or material wrongdoings the fault must lie at the door of the company and directors as the originators of those accounts. The auditors have a secondary responsibility and quite rightly should share liability but given the extent of their involvement and fees earned for that work they should not be wholly responsible. Moves to allow a contractual limitation of auditor liability would address this point.

Q21 Is the only way to maintain competition to legislate (such as through reform of section 310 of the Companies Act 1985), or are there other options that can be pursued? If the latter, please describe them.

We believe competition can continue to operate and thrive without new legislation, always with the fallback of existing Competition Law.

Q22 (a) Can you provide any evidence as to whether the prohibition on limitation of liability set out in section 310 is interfering in the proper operation of the market?

No comment

(b) Would reform of section 310 improve, worsen, or leave unchanged the operation of the market?

As stated in Q28 we believe that it is appropriate for auditors to be able to limit their liability contractually and therefore consequential changes to section 310 would be needed

Q23 What evidence is there that appropriate levels of insurance cover at competitive prices are increasingly difficult to obtain?

No comment

Q24 How is the current law on liability affecting recruitment to the profession and retention of appropriately qualified individuals?

No comment

Q25 (a) Are you aware of, or do you anticipate, a trend towards defensive auditing? (b) Would defensive auditing have a detrimental impact on the quality of the audit and/or its commercial viability?

No comment

Q26 Given that no audit firm has yet collapsed as a result of a claim successfully made against it in the UK, how real is the threat to the largest firms?

No comment

Q27 Would you favour minimal law reform? Why?

No comment

Q28 Would you favour simply allowing auditors to limit their liability contractually? Why?

We favour changes to permit the auditors to limit their liability contractually (option B in paragraph 7.5). There would then be a risk that the auditors used their positions to negotiate a very low level of liability but we feel that normal competitive pressures will not permit this to happen.

Q29 Do you favour allowing auditors to limit their liability contractually, subject to rules made by the Secretary of State? Why? If so, what should be the basis of the rules made by the Secretary of State?

Although we believe that auditors should be able to limit their liability contractually we believe that the market retains sufficient competition to avoid this possibility from swinging the balance disproportionately in favour of the auditors.

Q30 Is the existing law on contributory fault and contribution adequate or is specific provision required to deal with these issues? If so, what?

The existing law is adequate.

Q31 What arrangements would you like to see for disclosure and/or shareholder consent? Why?

In the same way that audit fees are a disclosable item we would like to see any contractual limitation of liability also disclosed, but based on the principle that shareholders appoint *directors to manage their company we do not see the need for shareholder approval of the audit contract.*

Q32 Is there any further evidence on other issues which you wish to provide?

No

We note that you may wish to make all responses to formal consultations available for public inspection unless the respondent requests otherwise. These comments are on the record and may be freely quoted and made available for public inspection.

We hope these responses are helpful for your deliberations and if you need any further information or clarifications please contact any of the people listed below.

12 March 2003

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