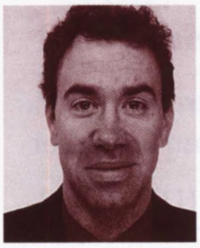
Shaping the duties of directors: 'No' to stakeholder approach, 'Yes' to transparency?

by Giles Proctor and Lilian Miles



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The Company Law Review must continue to facilitate the change from a closed to a more open culture.

The Secretary of State for Trade and Industry, Stephen Byers, recently gave a speech at the TUC/IPPR Seminar on Corporate Governance. In it, he referred to the ongoing Company Law Review, and stressed the importance of reshaping company law in order that it may reflect the needs of the modern economy and provide a clear framework within which companies may operate. On the subject of directors' duties, Mr Byers recognised that companies today do not operate in a vacuum. Indeed, the way companies are run affects a whole range of interests beyond those of the immediate shareholders, including customers, creditors, the environment and the wider community. He pointed out that companies need to be flexible so that they may consider the wider interests of the company alongside those of their investors, and not merely focus on short-term profits, as they currently do:

> '...*the way companies are governed also affects those who work for them. Decisions taken by companies affect customers, creditors, the environment and the wider community in which the companies concerned operate...that is why good corporate governance is about how companies treat their workforce, how they have an impact on the environment, how they help the wider community, how they impact on the developing world ... we must ensure that the framework of company law allows and encourages directors to take wider responsibilities into account ... we need an approach which actually recognises the needs of stakeholders, which enables companies to look at the interests of stakeholders*'

THE ROLE OF DISCLOSURE

This idea of the 'stakeholder' and its involvement in the company/society is a familiar theme of this government, having featured in its pre-election literature and been pursued since in various policy areas. But given the content of the speech, how can we ensure that directors take their wider responsibilities seriously? In an apparent shift in policy emphasis away from their pre-election position, further recognition of the corporate stakeholder did not gain favour with Mr Byers. Instead, he indicated that the way forward was to look at disclosure of relevant issues by companies. He thought disclosure would need to cover important issues such as 'relations with suppliers, customer complaints, employment policies, corporate governance, environmental, social and ethical policies where these are material to the business.' He further stressed the importance of 'quality rather than quantity of information so that shareholders, customers and other stakeholders can make informed decisions.' Indeed, Mr Byers made a valid point about the stakeholder approach, in that it will be difficult for directors to take into account all interests (if such a duty is indeed imposed), as there will always be conflicts of interests which may be difficult, if not impossible, to resolve.

At first sight, it is difficult to disagree with Mr Byers. Disclosure is a just and fair obligation for companies to shoulder. If their activities affect the livelihood of consumers, employees and suppliers as well as the environment, then these affected parties or their representatives should be able to enquire into company affairs where it affects them, in order that they can make decisions about their affairs and dealings with the company. In conjunction with this, they should also be able to represent their interests before the company in order to influence the way the company makes decisions where it concerns them. Despite the much-heralded reality of globalisation, it is still very much the fact that many communities are tied directly to the economic good fortune (or otherwise) of a few large companies in their locality who provide direct and indirect employment as well as funding the social infrastructure.

This article will look at how third parties can currently obtain information about the way companies are run by directors and ask if this is adequate. We will also question if this flow of information from directors to affected/interested parties can be improved. If information is the key to proper corporate governance, then the law must ensure that these parties can gain access to information they need without undue hindrance.

DISCLOSURE TO NON-EXECUTIVE DIRECTORS

The last decade has seen the rise of the non-executive director as monitor of company activities. In simple terms, the non-executive director can be identified as an individual who serves on the board of directors of a public limited company but does not work for that business enterprise on a full-time basis. Corporate governance literature ascribes to the non-executive (as distinct from the full-time executive director) a pivotal role in reforming the practices, standards and performance of the board of directors within UK companies. The effectiveness of that role depends on the quality of information received by those individuals. They usually come into these positions having substantial experience of the sector: as board members they should receive all board papers for the meetings they attend as well as both formal and informal briefings from their colleagues.

However such disclosure is neither guaranteed nor fully effective. There is no means of vetting the consistency of supply and quality of information passed to the non-executives. There may or may not be provision for the non-executive to have access to outside paid advice. Furthermore the utility of the information provided may be negated by the contractual arrangements with the company. If the non-executive's contract provides for a fixed number of hours per year, will this give the individual enough time to get to grips with the issues underpinning the company's strategy and policy so as to give advice that is timely, relevant and of value? If non-executives are to be effective as 'independent' monitors and indeed act as links between shareholders and the board, the informational aspects of their roles need to be addressed, if necessary, by regulation.

DISCLOSURE TO SHAREHOLDERS

Shareholders are a strange breed of people in the UK. They invest in their companies mainly for financial gain. There is little loyalty to the company on the part of the majority of shareholders. On the contrary, they often sell up and leave the company in the event that they are unhappy with the performance of the company. They also seldom involve themselves in the decision-making process of the company, but are happy to leave the management of the company in the hands of their directors. This attitude, although very slowly changing with regard to institutional shareholders, is still true of private individual shareholders.[1]

Rightly or wrongly, directors take advantage of this apathy. The law does not, as a general principle, obligate directors to inform shareholders of how the company is run, how the board makes decisions or which particular director has breached his duty to the company. Indeed, shareholders cannot (unless they are also directors) generally attend board meetings, nor are they permitted to see the board minutes or papers. Vital information which shareholders may need to know is often concealed as a result. Further, directors choose what kind of information to reveal to shareholders, and when. Information passed on to shareholders often takes the form of glossy circulars telling shareholders about a particular acquisition, disposal or share issue. Such circulars, together with any other publicity material do not always inform shareholders in plain terms how well 'their' company is performing nor provide an accurate depiction of the state of the company at all. Thus information which is given may be somewhat complex for the ordinary shareholder to absorb easily. If shareholders do not understand what is being presented, it is little wonder that they may be reluctant to question policies and decisions, however strongly they may feel about particular decisions taken by the company.[2]

What about the use of general meetings as a forum for disclosure? The general meeting is billed as an important event where management gives an account to shareholders of how they have run the company. Directors can be placed under the spotlight and can be asked to explain certain policy decisions, justify controversial measures and generally be available to provide/disclose information about the company to interested shareholders. The reality however, is somewhat different, and several flaws can be detected in our current system.

For one, before convening the meeting, directors are required by law to send certain information to all shareholders entitled to attend and vote (*Companies Act* 1985 s. 370(2)). Shareholders must be sent a notice convening the meeting, as well as other relevant information such as reports, accounts and a summary of resolutions to be passed at the general meeting. The information sent is very brief indeed. The law does not require that full information be made available to shareholders, although certain resolutions may need to be set out in full. The more diligent shareholder, who may want to view any texts in their entirety, such as proposed changes to articles, will have to visit the registered office of the company. In addition, current practice only dictates that relevant documents (such as articles) be made available for inspection 15 minutes before the meeting (Stock Exchange Rules). This hardly leaves any time for detailed consideration, and the situation is exacerbated if other shareholders also want to inspect the same documents, or where the documents contain controversial matter. The shareholder may of course then choose to question the directors directly on a specific matter at the meeting, but even then, under the law, he is not entitled to an answer. Indeed, if the item which he wishes to consider is not on the agenda, there is no obligation on the chairman to allow any questions on it. Not only is all this frustrating for the diligent shareholder, it also detracts from the principles of transparency and disclosure.[3]

INFORMATION IS THE KEY

If information is the key to proper corporate governance, then the law must ensure that these parties can gain access to information they need without undue hindrance.

It is important to point out however, that the law does impose a duty on directors to disclose certain information about the company elsewhere. Indeed, there are different levels of disclosure. Some kinds of information about the company are available to the general public at Companies House where anyone can obtain information regarding the incorporation of the company, the allotment of shares, registration of charges, annual accounts etc. (*Companies Act* 1985 s. 18, s. 88, s. 242, s. 401). Information about the company is also available to the general public at the company's registered office. This includes the register of debenture holders, register of members, and the register of directors' interests in the company etc. (*Companies Act* 1985 s. 191, s. 325, s. 356). Other kinds of information are available only to shareholders, such as minutes of the general meetings, terms of directors' service contracts and directors' reports etc. (*Companies Act* 1985 s. 383, s. 318). Further, directors must also disclose certain information about themselves, such as their names, particulars of any other directorships held within the last five years, interests in any securities in the company etc. (*Companies Act* 1985 s. 289, s. 324), interests in contracts with the company, (s. 317). when there is a sale of company assets to directors/purchases by the company of directors' assets (s. 320) or where they have received compensation for loss of office (s. 312). Their service contracts are open for inspection by members as is the level of remuneration they receive.

Although the volume of information presented through company circulars, AGMs and the Companies Registry may appear at first glance impressive, the information itself is either refracted through the perspective and views of the board and company employees or is presented in such a form as to render it inaccessible or incomprehensible to many shareholders. Nor do these forms of disclosure tend to inform the shareholder or stakeholder, as Mr Byers puts it:

> *'...how companies treat their workforce, how they have an impact on the environment, how they help the wider community, [how] they impact on the developing world'.*

DISCLOSURE TO STAKEHOLDERS

General meetings are viewed as a closed affair, an encounter between shareholders and their directors (art. 38, Table A). Other interested parties may wish to attend and participate in the general meeting, or question directors on controversial decisions. They may not do so. These parties may be employees, consumers, creditors, suppliers and representatives of the local community whose lives the activities of the company affect on a daily basis. They may have valid points to raise, matters to clarify or questions to ask of the directors. Their inability to do any of this at meetings is a great disadvantage. Of course, some of these stakeholders may prefer to meet personally with directors, or write to the company to obtain information which concerns them. Even so, given that the current duty on directors is to their company alone, they are not obliged to meet with stakeholders to discuss company affairs. Neither are they bound to provide any information requested. If these stakeholders are to be able to make informed decisions about the company and their relationship with it, then it is obvious that current practice must change.

Another interesting point to note is that employee participation at general meetings is an alien concept in the UK. Unless employees also hold shares in the company, they may not attend general meetings. Even if they do hold shares, they will, under the law, be deemed to attend these meetings as shareholders. Their rights and interests as employees take a back seat. It may, therefore, be the case that they are unable to question directors or obtain information from directors about company policy with regard to their rights as employees. Can employees obtain information from directors in other ways? In preparing the annual report directors are under an obligation to prepare a report for each financial year stating what action had been taken during the year to provide employees with information on matters concerning them, and what consultation with them or their representatives has occurred so that their views can be taken into account in decision making (s. 234 *Companies Act* 1985, Schedule 7 Part V). Pt V only applies to companies with 250 employees or more). It is not stated to what extent information is to be provided to employees or their representatives, or the level to which they must actually be consulted. Companies may therefore choose to give this provision their own interpretation and effectively insert what they like in the relevant section.

Pressure groups also find it difficult to obtain information about the company. To be sure, many companies adopt ethical policies to protect the environment, ensure fair wages for third world labourers, boycott third world producers who exploit child labour or pledge support for various charities. However, the relationship between companies and pressure groups is an uneasy one. If all is well, and the support for a particular cause is in favour of the company (such as raising its profile in the market), it may co-operate with pressure groups and form long term relationships with them. However, if the company itself is accused of engaging in unethical or bad practice, it may be very difficult indeed for pressure groups to obtain any relevant information confirming this or any other fact. Acquiring a shareholding in the company will usually entitle the individuals to attend the AGM to put questions to whoever agrees to answer them. However, as discussed earlier in this article, the utility of the closely scripted, well-managed AGM to the small shareholder is negligible. Indeed there is no obligation for companies to divulge information specifically to pressure groups. Information is certainly the key to exposing acts of a particular company but without proper means of access to such information it is difficult to compel change or promote good practice on the part of companies.

How can the flow of information be improved?

If the government is serious about disclosure and transparency, the flow of information from companies to interested/affected parties can be improved. A few suggestions include:

- making documents both more readily available and easily comprehensible. In the former case this can be done by encouraging the regular flow of up-to-date information (enforced by regulation, if necessary) to non-executive directors, shareholders and other interested parties; in the latter case, encouraging the provision via company web sites of policy and strategy details aimed at enhancing shareholder value, as well as financial and other information free from accountancy jargon. Interested parties should not have to rely solely on microfiche, Companies House Direct or flicking through an Annual Report and Accounts to access such information;
- making all board members available at AGMs for questions and providing a longer time for questions. Even better, overhaul the traditional structures and have more frequent 'mini' AGMs where directors agree to report back to a further meeting with answers if their questioners so request;
- providing guaranteed financial support in certain cases; for example, to non-executives in their role as monitors of the company.

Last but not least, selected interested groups could be allowed to participate in the decision making process of the company. In the Netherlands for example, there are specific provisions in the law for employee participation in the affairs of the company via works councils. Every company with 35 or more employees must have a works council which is entitled to information about the affairs of the company and must be consulted on every matter affecting the employees. Important issues such as termination of employment of a large number of employees, or a radical change in working conditions, must first be approved by the works council. Incorporating such features into UK company law might just encourage a practice of openness and transparency as the process of liaising and consultation with these groups will compel directors to furnish various kinds of relevant information.[4]

CONCLUSION

There will indeed be much debate about what disclosure should mean, who should regulate it and how much disclosure by the company should be compulsory. However if companies are seen to be transparent in their dealings, and not shy to disclose matters when asked to, then benefits will accrue to that company in relation to shareholder value as well as in maximising stakeholder input. It is undoubtedly necessary that the Company Law Review continues to facilitate the change from a closed to more open UK corporate culture. It is to be hoped that the present government encourages and nurtures this change within its forthcoming reforms.

[1] Miles, L and Proctor, G 'Apathetic Shareholders in Listed Companies: Dial M for Motivate?' *The Company Lawyer* (2000) Vol 21, No 5, 142-144 and Miles, L & Proctor, G 'Institutional Shareholders: Sleeping Partners in Corporate Governance?' *Scottish Law and Practice Quarterly,* (2000) Vol 5, No 3. 210-216.

[2] Finch, V 'Company Directors: Who Cares about Skill and Care?' *Modern Law Review* (1992) Vol 55, 179-214).

[3] Charkham, J & Simpson, A *Fair Shares* (1999) OUP, Chapter 14.

[4] Esen, R & Miles, L 'Board Structures and the Protection of Employees' Interests: The English and Dutch Positions' *The Company Lawyer*, (1996) Vol 17, No 8. 255-256

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