

10 February 2004.

James Carey
Corporate Law and Governance Directorate
Department of Trade and Industry
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Dear Mr Carey,

Director and auditor liability consultative document.

I welcome the governments' commitment to "*.....maintaining an effective system of corporate governance and company law, which provides market confidence, strengthens trust, and enhances the quality of company reporting and decision-making . . .*" and this consultative document into director and auditor liability. With reform of company law now firmly on the political agenda, it can only be right that the role and responsibilities of public shareholders, directors, auditor and other stakeholders are firmly established here in the UK.

My perspective comes from being a working investor creating and running small businesses and being a passive investor by investing in publicly quoted companies around the world. In both roles, I believe that the owners of a business should be responsible for the oversight and development of their venture in trade and in the fact that most investors believe that the accounts of a firm are an essential tool in making business decisions.

I would suggest that the main purpose of company law should be to serve the needs of investors. It is on that basis that I submit my comments on your consultative document and answer some of the questions you ask.

I would like to confirm that I have made contributions to the DTI Company Law Review [CLR], the Auditing Practices Board on Aggressive Earnings Management, the Sandlers' Review Team on medium & long term retail savings, the Treasury Committees' inquiry into the financial regulation of Public Limited Companies and the Review of Non-Executive Directors. I have no objection to my views being put into the public domain.

1. INTRODUCTION

My comment on paragraph [para] 1.6 & 1.7

At long last an admission that some Judge created company law is no longer appropriate or adequate to maintain confidence in our system of law! I think your emphasis on the plight of *poor* company directors and auditors being legally pursued in breach of duty actions could be resolved by fully identifying the role of all stakeholders. In my view, company law should recognise the role of the owners in overseeing and developing their firm and the role of the "*hired hands*" doing the day-to-day operations of the company. On this basis, we should be able to develop meaningful owners meetings and a requirement that other stakeholders such as the day-to-day managers and auditors should be legally required to provide objective information on which business decisions could be made by the Owners and other stakeholders.

2. BACKGROUND TO THE CURRENT POSITION

My comments: There are 2 key problems to resolve in Company Law reform: (1) The owners of a company should have *sovereignty* over their property - company law should empower them to carry out that role. (2) Verified accounts are an essential tool in overseeing their firm - the faulty Judge created law following **the Caparo case needs to be corrected by parliament.**

Para 2.2 There needs to be a clear definition in law that the owners of a firm have sovereignty over their property and the board of directors are responsible to those owners. Reformed company law should encourage owners' meetings to discuss and resolve any conflicts in objectives and decide the future direction of their business. The board of directors should take instructions from the owners and report back to them. Remember that if this approach had been taken before the recent *Marconi plc* fiasco, a great British company would not have been brought to its knees.

Your questions on: Extending the duty of care

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

My Answer: Yes - Directors and auditors should have a duty of care to individual investors and a requirement that they give truthful and full answers to questions given to the owners. **The basis** for this is that without this information the owners of a company will not be able to individually or collectively through members meetings make the correct overseeing assessments and decide on the future direction of their firm. **Why?:** It is *in the public interest* that owners should be able to exercise their informed consent over the operation of their company. It is *in the public interest* that directors who mislead owners should face personal unlimited liability, as this is a driver to management quality. It is *in the public interest* that auditors who verify information given to shareholders should face personal unlimited liability, as this is a driver to audit quality. By doing this, the role of business risk assessment and future company development is placed firmly in the hands of the owners rather than in the transient care of the "hired hands".

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

My Answer: Yes - for the reasons given to Q1. **Why?:** This should be the required standard for publicly traded shares. For *private* companies, an auditor report should indicate those stakeholders who can rely on their verified information.

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?*

My Answer: Members of a company should decide at a members' meeting with their auditors the scope of those stakeholders who should be able to claim against the directors and/or auditors. The State may like to require that the minimum level is: individual investors, employees and the State. **Why?:** (1) I believe that the *public interest* is best served in this manner. (2) It's *common sense* and would bring credibility to our system of justice.

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

My Answer: See my answer to Q3 - on that basis, an auditors' *duty of care* would vary from company to company with the State imposing a minimum standard.

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

My Answer: Actions for loss should be against the wrongdoer. So if an auditor verifies information as "*true and fair*" and that information turns out to be faulty, the auditor should face personal unlimited liability as this is a driver to audit quality. If directors hide profit/losses overseas or fail to disclose contingent liabilities to owners, those directors should face personal unlimited liability as a driver to management quality. If owners at a members meeting decide to pursue a development which results in loss, their company will have to face that loss - it's only common sense!!

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?*

My Answer: It should be up to the courts to determine the loss in any particular case **but** this will require considerable re-education of the judicial mind set on investor rights and responsibilities before we can have confidence in their ability to operate in the business area and maintain public confidence in our system of justice.

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?*

My Answer: It should be up to the courts to determine the rights of stakeholders in any particular case **but** this will require considerable re-education of the judicial mind set on investor and other stakeholder rights and responsibilities before we can have confidence in their ability to operate in the business area and maintain public confidence in our system of justice.

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.*

My Answer: The auditors' *duty of care* should be extended to all owners equally as those owners are sharing in a venture in trade. It is *in the public interest* that information should be exchanged between owners before they exercise their collective wisdom over their property.

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)?*

My Answer: One of the most effective ways of preventing abusive actions is by having a fully reformed company law system with all stakeholders knowing their rights and responsibilities. I believe the State should ensure that public company owners are part of a meaningful and informed shareholder democracy.

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?*

My Answer: By extending the directors' *duty of care*, you will promote the delegation of business risk assessment and future company development into the hands of the owners. I believe this would be both in the owners' and States' interest and would promote more efficient capital markets.

Directors

Directors' and Officers' liability (D&O) insurance

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?*

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?*

My comment: The underlying problem of the D & O liability insurance issue is complex. On the one hand owners are requiring honesty from their directors - see my answer to your Q5 and actions in America (Sarbanes-Oxley Act) following Enron & WorldCom and in Europe following Ahold & Parmalat. On the other side, you have a UK Boardroom culture that says that they should have sovereignty over the firm and exercise power without personal financial responsibility. When you combine that culture with Big 4 accounting firms refusing to recognise the *conflict of interest* in their

selling audit and non-audit services to the same customer; it is perhaps not surprising that insurance underwriters are uncertain of the risks involved. In my view, it might be best to leave D & O liability insurance issues until parliament has decided stakeholders positions in a reformed Companies Act.

Non-executive directors

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

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?*

My comment: Derek Higgs and the Government believe in the unitary board system and in non-executive directors who are “strangers” to the company. Many owners argue that this structure hinders their oversight role over their property and would suggest that the EU two Board system (one to represent owners interests and one for the *hired hands*) might be better or a third alternative of having an owners audit committee to convey their wishes to an operations Board. Once this governance choice is decided for quoted public companies, the rights and responsibilities of non-executive directors as “strangers” to the company or as “part owners” will emerge.

Case management

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

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

My comment: How about a Consultative document on the case management of public shareholder cases? I would be glad to provide you with practical examples of some of the problems faced by the 12,000 Sound Diffusion plc and 31,000 Eagle Trust plc investors.

Directors – possible reform options

My comment: Too much emphasis on the interests of the “hired hands” rather than facing the reality that company law should service the needs of investors - the wealth creators!

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

My answer: **Option C** - Reforms based on the US model adapted to fit a European society. **Why?** The Americans are leading the way on corporate governance reform, the EU is slowly reducing the gap with its own variations of US reforms. The UK is dithering, awash with consultations, initiatives and sleaze on company law reform.

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?

My comment: I was disappointed that the CLR did not feel that it was in the *public interest* to discuss the need to reconnect public shareholders with their property. Further down the line, we will need to examine an extension of the tort of misfeasance.

(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?

My answer: **No.**

Q19 *In relation to the US model:*

(a) is there a case for the introduction of a statutory business judgment rule?

My answer: Yes but UK judges would have to considerably change their mind set on investor protection matters.

(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?

My answer: For publicly quoted companies the USA & EU are way ahead of the UK on these matters - we are going to have to fit in with the world standards set by others.

Auditors

Is the audit market sufficiently competitive?

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

My answer: Low-balling, political sleaze, offshore structures, LLPs and tax scam activities of the Big 4 are effectively destroying the credibility of UK accounting. Middle sized firms can capture the market by returning to the professional standards of the past.

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

My answer: Eliminate the Big 4 - our *national interest* and credibility will require it.

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

My answer: At present, quoted company meetings do not appear to discuss the merits of auditors before they vote for their appointment. Has this been reckless of our politicians to allow this to continue - do we need to develop the tort of misfeasance in public office?

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.

My answer: Re-engage owner involvement with their property and ensure that company law reflects the needs of the primary stakeholders.

Auditors – possible reform options

Q27 Would you favour minimal law reform? Why?

My answer: **No** - our present public company laws lack credibility.

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

My answer: **No** - world standards will not allow that.

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?

My answer: **No** - world standards will not allow that.

Consultation process

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

My answer: I enclose a summary of my comments on UK corporate governance which I submitted to the CLR. If it would be useful, I would be glad to provide you with an updated Sound Diffusion Action Group CD which gives extensive background information on the problems faced by UK investors on corporate governance and audit related issues. I have contacts with other investors such as Eagle Trust plc who have a wealth of practical experience on these major problems.

Yours sincerely,

Duncan Alexander

General

Company Law Reform needs to be seen in context of the reform and updating of many of our systems in business. Perhaps we can start by saying that sole trader, partnership, limited liability partnership [LLP], and limited company are all valid trading formats. It would seem to be logical to grow a business firm through these trading formats and it would seem to be equally logical to reverse this process if members of the business enterprise decided to contract their business. The Laws of our country should be flexible enough to facilitate these processes and our systems of control should be expected to deliver them.

Investors/Owners thus have a choice of trading formats to carry out their *ventures in trade*. One of their first decisions to be made is whether to trade with *unlimited* or *limited* liability. Our society seems to have accepted that the "*price of limited liability*" is the public disclosure at Companies House of the assets and liabilities of *limited* organisations.

It also seems to be generally agreed that size matters. The larger the business, the more impact it will have on the societies it serves and therefore it would seem wise to have more controls and openness over larger concerns. As a business firm grows, there will be an increasing need for the Owner(s) to delegate more of the day-to-day tasks in business to the *hired hands* and this will tend to lead to a split between ownership and management of the firms affairs. This then leads us to one of the central issues in Corporate Governance: Who should control the destiny of the business firm? -the Owners or the *hired hands* running the day-to-day work. This is not a problem in an Owner/managed business that an investor has created because they will dictate the destiny; and the firm will obey. Once we get into multi-Owner firms we will have to have rules so that Owners can exercise their *proprietary* role over the firms "destiny and hence the importance of your work on this matter.

In my view - and this is a massive over-simplification of my position!! - we have a new, very real problem when dealing with large organisations. Over the last decade or so a mutant business/political philosophy has evolved which endangers the complex relationships in the wealth creation process of business, it has emerged that the *hired hands* believe they have the right to dictate the destiny of the firm - that's power without personal financial responsibility. It is important that a *political* decision is made to establish if this development is in the *national interest* or not. This choice needs to be given to those that govern us in your final report.

We need to recognise that individual investors come together for a *venture in trade* and form a limited liability company or LLP whose objectives may change over a period of time. The larger the firm becomes the more control over day-to-day activities will flow to management. In your report you describe the "Scope Issue" - In whose interest should a Company be run? - "*Broad*" community of members **or** "*narrow focus*" section of some members. I would suggest in your final report that you should broaden the "Scope Issue" to include the Corporate Governance issue of: *Who controls the destiny of a firm - Owners or managers?*". Should members of a firm be involved in a *participating democracy* or just have a *ticket in a lottery*.

Owners put in the money / Managers run the day-to-day business. Small companies combine these roles and larger one separate them. The law should reflect this reality; at present it tends to be too rigid in separating the roles. The *proprietary role* is at present undecided at the *political level*⁸. [See page 14]

Once you have decided your *political* position on these three issues - *control of the destiny of the firm, participating democracy / lottery ticket, proprietary role*, - you can then create the rules to achieve it.

In my view what has emerged over the last decade is a "*super manager*" class who have overemphasised the short term path and have taken over the entrepreneurial function of the Owners. It is now time for Owners/investors/shareholders to recognise that their *venture in trade* is a participating democracy in which they have a proprietary role to play in controlling the destiny of their firm