

# News flash

## Are the Shareholders Revolting?

(Some directors may think so)

**C**ompanies are facing unprecedented scrutiny from their shareholders, who are no longer willing to sit quietly on the sidelines, whilst directors make decisions which affect their investments. Nicola Blakemore reports:-

**In the good old days, when stock markets were buoyant and profits were rolling in, shareholders were content to leave the board of directors to run the business, in the confident knowledge that share prices would go up and dividends would be paid.**

Those days are well and truly over. Stock markets are no longer going up. The only thing that shareholders believe is going up are directors' salaries. Shareholders are not happy! Who can blame them when they have seen the value of their investments plummet?

Shareholders want to have their say. After all, they own the company. However, the real sea-change in investor relations has come, not from the ordinary private investor, but from institutional investors, who are increasingly willing to use their influence.

Further, Government and regulators are giving shareholders unprecedented access to scrutinise every aspect of the company and the way that it is run.

### Shareholder Actions

In the United States, shareholders have for many years been able to pursue claims directly against companies and their directors in respect of losses incurred when share prices have fallen, due to the decisions of directors.

In the UK, these actions hardly exist. The law, as it currently stands, does not favour shareholder disputes. Directors are under no statutory or tortious duty to the shareholders. The law has developed mainly through case law and courts have

interpreted the directors' duty as being owed to the company itself, not to the shareholders.

There are signs, however, that UK shareholders are pressing for a change in the law, to allow actions against directors. The Court procedure rules now allow class actions, in the form of Group Litigation Orders, to be pursued. As a result, there have been several recent attempts by shareholder groups to pursue directors. So far, these attempts have failed and no cases have got off the ground. However, it may only be a matter of time before one succeeds. Then, the floodgates may open!

The Government's proposal for a statutory statement ("the Statement") of directors' duties in new company legislation will not change the status quo. However, the legislation will include an obligation on directors to have regard to the interests of other groups, such as shareholders, who may be affected by their decisions.

Although this Statement is not intended to create further duties, it is likely that, in the future, we will see shareholders trying to use this provision, if adopted, to pursue actions against directors.

Whilst shareholders may be unable to pursue a claim against the directors, the company is not precluded from pursuing such actions. Current boards of directors can be placed under pressure to commence actions against directors, if they feel their own position may be under threat.

The news may not be all bad for directors. The Government has recently consulted with regard to whether companies should be allowed to limit their directors' liabilities and to



- ▶ amend current legislation to prevent directors from being sued for making wrong business decisions. The consultation period has just ended. It remains to be seen whether the new legislation helps or hinders directors.

### **S310 A Companies Act 1985**

One of the focuses of the recent Government consultation was whether s310 A of the Companies Act 1985 should be amended.

Under the current law, companies are not permitted to exempt their directors from liability or indemnifying them. Companies are only allowed to reimburse their directors' legal costs, if the directors are successful at Court and to purchase Directors and Officers liability insurance on their directors' behalf.

This means that directors are faced with potentially crippling legal costs to fund themselves, if they wish to defend their actions. Many directors, especially those on the board of smaller companies, will not have the resources to do so, without insurance. Together with the litigation risks inherent in defending a claim, directors are forced to settle claims rather than defending themselves and their actions at court.

The consultation has requested views on whether companies should be allowed to do more to help their directors who are facing claims, eg. by allowing companies to advance legal costs or to pay the excess on their insurance.

Of course, shareholders will strongly oppose any proposals which would allow companies to limit directors' liabilities.

### **S727 Companies Act 1985**

The Government consultation also asked for responses as to whether s727 of the Companies Act 1985 should be amended.

This section allows a court to relieve directors from liability if the director acted "reasonably" and "in all the circumstances he ought fairly to be excused."

Directors rarely seek to rely on this section and it is of little use in negligence cases, as a director cannot be negligent and have acted "reasonably" at the same time. Also, according to a recent interlocutory decision, it will be up to the trial judge, hearing all the evidence, to decide whether a director should be relieved from liability under this section. Directors are obviously unwilling to incur enormous legal costs to pursue a defence to trial with no guarantee that arguments pursuant to s727 will be successful.

If amended, a provision similar to the business judgement rule in many US states could be brought in. This provision gives directors protection with regard to business decisions made honestly and in the best interests of the company, which turn out to be wrong.

### **Shareholder Activism**

Shareholders are not only trying to have their say in the courts, the company's AGM is becoming a popular, and very public, place to demonstrate their discontent.

Private investors have always used these opportunities to vent their anger at directors, but with little influence or effect. However, institutional investors with their large shareholdings are beginning to follow suit and to recognise their power to influence the board's decisions.

In fact, shareholders have had a number of recent successes. For example, shareholders have been able to sack an entire board. This an extreme example and not in the UK! It is unlikely to happen again, in the UK at least. Also, it may not have helped the company in any event, as the new board is using the same ideas as the old!

However, shareholders are finding they can make things awkward for directors and force directors to justify their decisions, and earn their salaries!

### **Corporate Governance**

Corporate Governance reforms are allowing shareholders to scrutinise the company more than ever before due to the increased access to information regarding all aspects of the company, including directors' pay and corporate governance. New regulations and reforms have facilitated the increased accessibility to company information, assisted by the growth of electronic means of communication.

Directors will find it harder and harder to hide unpalatable information from its shareholders.

### **Conclusion**

Directors are having a tough time from investors, but there has to be a question mark over whether this kind of shareholder activism will continue to increase. At the moment, shareholders are facing losses, pensioners are losing the value of their pensions, institutional investors, such as Life Assurance companies are concerned about their capital requirements, yet directors are seen to be oblivious to these problems.

Private investors have always been willing to vent their anger against the board, but with no real influence. The recent activism has occurred because institutional shareholders are showing their anger. In the future, when company profits grow again and fund values increase, will the institutional investors revert back to their old ways of silently watching from the sidelines and having discreet discussions with the board?

We will wait and see. Watch this space...

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