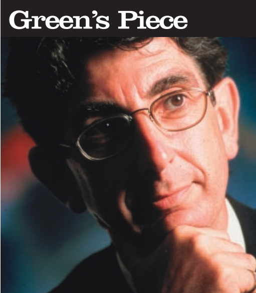

# If a director's CAP FITS

**John M Green** is a company director and writer, and was formerly an investment banker and lawyer

**John M Green** suggests three reforms that the Federal Government could consider in its review of directors' liability.

Non-executive directors (NEDs) frequently and loudly fret about liability. Yet, the cases actually launched against NEDs to date are a trickle. This apparent disconnect is easily explained: while the probability of a suit is low, the personal consequences are titanic.

NEDs mostly join boards after their executive careers, when the capacity to replenish their retirement savings wanes sharply. So, just one serious legal claim and a lifetime's savings is potentially blown, as well as a reputation. And, for what? $100,000 or $200,000 a year in fees? Up against unlimited liability, a weak business judgment rule and a newly burgeoning litigation funding industry, NEDs have the odds stacked hugely against them.

No wonder fewer new candidates are lining up. No wonder many experienced NEDs are declining new boards. And, no wonder many CEOs moan that boards are becoming too risk averse, stifling innovation.

Given the Federal Government's welcome review of directors' liability, here are three reform suggestions to help reverse these counter-productive trends and also better align boards with shareholder interests.

### 1. Cap a NED's liability

Let's cap a public company NED's liability in proportion to his or her director's fees, except if personally guilty of fraud.The cap should be an amount that rational shareholders, who want to attract directors into the game, would today consider reasonable, perhaps twice the fees received over time but starting high, with an initial absolute maximum of, say, $1 million.

Here's a simplified and fictional example. Gina Smith becomes a NED of XYZ Limited for a $200,000 annual fee. From her very first day on the board, Gina's liability is capped at $1 million for her first five years. For each year beyond five, her cap increases by her $200,000 fee. Though nominally the same amount as her total fees, Gina's cap in reality equals twice the amount after considering the personal income tax she has paid on them.

Why cap the NEDs' liability at all? Because it's fair to do so. Under the statute, all directors are equal even though this is plainly wrong. The *Corporations Act* makes no distinction between a full-time CEO who is a day-to-day manager and a part-time NED who is not. Courts may well weigh this distinction just as they have the differing roles of chairs and other NEDs, but that is hardly guaranteed.

It is absurd that NEDs are in this precarious position. CEOs and other senior executives of large companies are paid millions, usually rightly, to lead and manage a company day-to-day. But NEDs are part-time, attending meetings every month or two. They must, therefore, rely heavily on managers for their information and this is most often the root of their trouble.

NEDs are not managers but principally monitors installed to overcome 'agency costs'. Shareholders (principals) want management (their agents) to run a company so as to increase shareholder value. But they worry that management, if unchecked, may prefer to empire-build and gold-plate the perks. To counter this, shareholders hire NEDs to oversight management, but not to be management. Fair-minded shareholders should accept that this distinction warrants a very different liability regime.

### 2. Charity NEDs

NEDs of not-for-profits should receive additional and special consideration. The law reeks of injustice by not giving fair credit to volunteers who take no fees yet provide a crucial public service. Even so, accountability remains important so they must retain some liability.

I suggest a liability cap of a fixed flat amount, say $50,000 for directors of small charities or clubs and $100,000 for large ones. Again, a personally fraudulent NED would have no cap.

### 3. Give credit for NEDs' shares

My third proposal is that NEDs who are found liable can offset against any judgment the actual cost of any shares or other securities they hold in the company.

Previously in *Company Director*, I advocated offering greater incentives to encourage NEDs to own larger shareholdings than they do already, hampered as they are by the effective illiquidity and severe cramping of any sensible portfolio diversification that such holdings bring.

But shareholdings also mean NEDs face a double whammy if a company plunges into trouble. They are on the hook personally for directors' liability, and they will also have lost considerable personal wealth alongside other shareholders.

This last proposal is designed to give fair credit to those NEDs who have shown additional faith in the company and have sought greater shareholder alignment by investing their own savings in the firm's shares.