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Advising the Board on **Joint Venture Governance Risk**

Reports looking at the full range of commercial risk

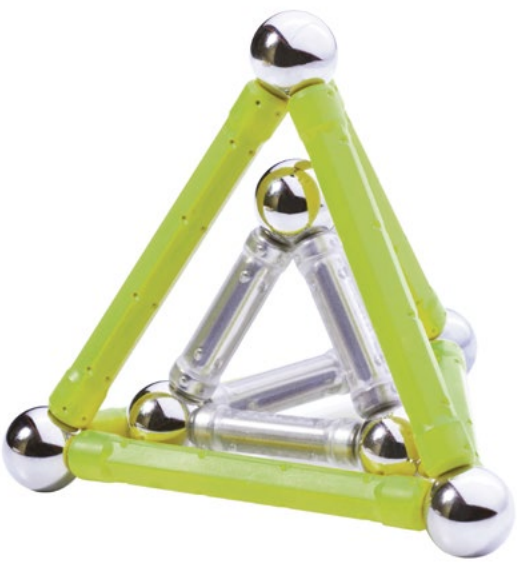
Risk, Resilience and Reputation

Directors' risk report

Proper governance is a crucial aspect of managing companies, and particularly so in the context of joint ventures where typically directors will be nominated by the shareholders. There is often a range of contractual arrangements between the joint venture company and its shareholders/their groups, which may give rise to potential and actual conflicts of interests, especially where the joint venture company suffers financial distress and/or insolvency.

Directors of a joint venture company owe their duties in relation to the management of that company to the joint venture company and not to the shareholder that appointed them. The interests of shareholders (and group companies who may be sub-contractors to the joint venture company) will not necessarily coincide with those of the joint venture company. It is critical for directors to be aware of their duties and for any conflicts of interest to be properly managed.

The number of formal insolvencies in the UK has been increasing, with a number of high-profile failures involving groups with interest in multiple joint ventures, including Carillion. It is important that directors of joint venture companies, who are under the same obligations as directors of other types of company, are aware of their additional duties, as well as the additional personal risks, should the joint venture company experience financial difficulties.



Stakeholder risk thermometer

CLOSER TO RISK

Directors

Risk of personal liability for:

- Breach of duty (under both Companies Act 2006 and Insolvency Act 1986)
- Wrongful trading and other breaches of the Insolvency Act 1986

Board/company

- Risk of decision-making process being blocked, leading to significant risk and cost impacts

Shareholders

- Reputational risk associated with board failures; loss of value
- Risks of shadow directorship, if the shareholders' involvement with the joint venture company amounts to customary exercise of control over all or part of that company's business

FURTHER FROM RISK

Expert perspective

Charles McLeod MBE
Independent director,
McLeod Partnerships Ltd

What's your experience in this area?
I've spent the last twenty-five years bidding, winning, constructing and operating infrastructure projects, as well as advising government and authorities. For the last eleven years, I've been acting as a board director representing institutions such as Aberdeen and PiP, contractors such as Kier and senior lenders when they have replaced the board. Almost all of these projects have been distressed, including the Royal Liverpool University Hospital project where I worked with CMS.

What's your approach?
When a project is distressed, being an effective director is all about understanding what is going on in the project, while managing relationships with the customer, senior lenders, your own investor and those with your fellow shareholders. You have to get involved in the detail: the underlying technical issues, the economics and the legal documents.

It's important to tackle any conflicts of interest head-on, for example where a shareholder has other interests in the project as a sub-contractor. I think we'll find more focus on this area in the structuring of shareholder agreements in the future.

What challenges have you faced?
Across schools, hospitals, highways, waste to energy and social housing, I have encountered construction issues, service failures, payment mechanisms that didn't work and lots of disappointed or angry customers and lenders. And then Carillion collapsed, creating a lot of issues for boards where I was involved, especially on hospital projects. We had to act quickly to secure the continued provision of services. As a director I had to focus on the interests of the company and senior lenders and not my own position – not always easy!

What next?
Sadly, I don't think that we are going to see defect free construction in the near future. Nor have we seen the last contractor or service provider get it wrong. And it will be interesting to see how public Infrastructure is going to be funded in the future.

Selected directors' duties in a joint venture context

The duty to promote the success of the company

Directors have a statutory duty to promote the success of the company for the benefit of its shareholders as a whole. This includes a duty to have regard to the need to act fairly as between shareholders in the company. This duty is owed to the company on whose board the directors serve, which in a joint venture context is the joint venture company and not the shareholder that appointed the individual to the joint venture company's board.

For so long as a joint venture company is operating successfully, it is likely that the interests of its shareholders will broadly coincide with those of the joint venture company and that the risk of decisions taken by the board favouring one shareholder to the detriment of another shareholder is low.

However, when the joint venture company's business is stressed, there may be tension or a divergence of interests. The director's primary duty will be to promote the success of the joint venture company. A failure to discharge this statutory duty will expose the director to the risk of claim for breach of duty, and to liability for that breach. However, there may well be explicit and implicit pressures applied by a shareholder to seek to influence the decisions taken by its nominated director at the joint venture company's board.

Depending on the extent to which the joint venture company is underperforming, the focus of a director's duties may shift from the shareholders entirely to the creditors of the joint venture company. In broad terms, the greater the risk of insolvency, the more likely it is that creditors' interests take precedence over (or exclude altogether) the interests of shareholders. This can be particularly challenging in circumstances where there is no shareholder value remaining or a director is under pressure to commit less time to the joint venture company.

Understanding the statutory test for insolvency is important and directors should take advice promptly where a joint venture company is in potential financial difficulties or it is clear that there will be a shortfall in project revenues at a future date.

The duty to declare interests in proposed and actual transactions or arrangements

Directors have a statutory duty to:

- Declare direct or indirect interests that they may have in a proposed transaction or arrangement with the company, before the company enters into the relevant transaction or arrangement. A failure to do so will constitute a breach of duty.
- Declare direct or indirect interests that they have in transactions or arrangements that have already been entered into with the company, as soon as is reasonably practicable. A failure to do so will constitute a breach of duty and is also an offence which may give rise to fines.
- Update both categories of declaration, where the original declaration proves to be, or becomes, inaccurate or incomplete.

There are often contractual arrangements between a joint venture company and its shareholders or members of their groups. In many cases these will be matters in which a shareholder nominated director has an indirect interest, not least as a consequence of being employed by the shareholder (or a related group company). These arrangements are matters which will need to be formally disclosed.

The joint venture company should maintain an accurate and current register of declarations of interests and each director should regularly review and where necessary update relevant declarations. It is also good practice for the need to make further declarations of interest to be considered at each board meeting.

The duty to avoid conflicts of interest

Directors also have a statutory duty to avoid a situation in which they have, or can have, a direct or indirect interest that conflicts, or may conflict, with the interests of the company. This duty does not apply to the transactional conflicts referred to above, but it still very relevant in a joint venture context.

This duty is not infringed where either the interest cannot reasonably be regarded as likely to give rise to a conflict of interest or (and of more relevance here) where the matter has been authorised by the non-conflicted directors.

Where the company's articles contain provisions for dealing with conflicts of interest, this duty is also not infringed by anything done (or omitted to be done) by the directors in accordance with those provisions.

Additional considerations in the event of financial distress

Alongside the usual directors' duties outlined above, if the joint venture company suffers financial difficulties, there are additional considerations for directors.

Management and resignation

As a general principle, directors can resign at will. However, where a company is in financial difficulties, a director's principal duties are owed to creditors and he/she should not just resign if doing so would adversely impact on the management of the company or the position of creditors. The exception to this principle is where a director is unable to influence the board to act in the interests of creditors.

Interests of creditors

Where funders have rights on default, funders may ask for additional persons to join the board and the existing board members must carefully consider the interests of all creditors, including authorities, in relation to those requests.

Wrongful trading

There is a risk of personal liability for directors if a company continues to trade when the director knew, or ought to have known, that there was "no reasonable prospect" of avoiding insolvent liquidation.

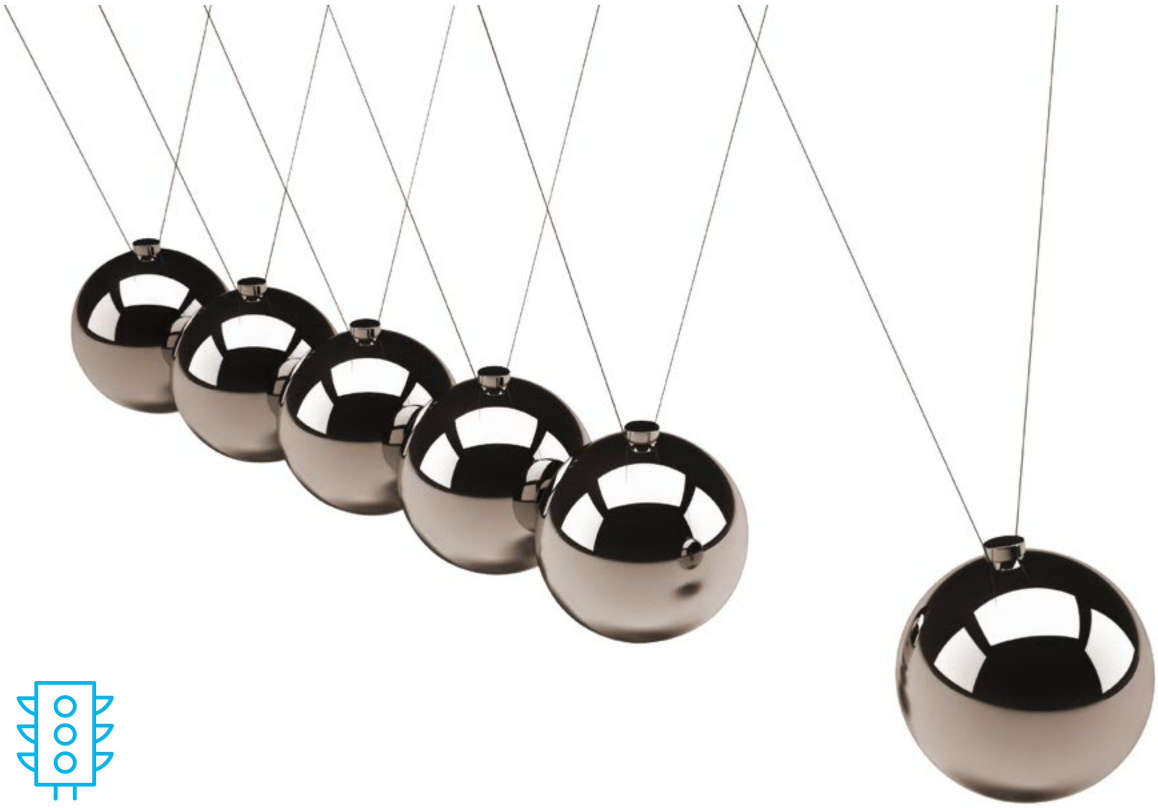
Reviewable transactions

Directors can become personally liable should they cause the joint venture company to enter into transactions during the period leading up to formal insolvency which constitute transactions at an undervalue or a preference.

Further, directors can be personally liable where they cause the joint venture company to enter into any transaction or arrangement that constitutes a breach of duty, for which there is a summary remedy under insolvency legislation.

Disqualification

In the event that a joint venture company enters formal insolvency, the appointed insolvency practitioner will report to Secretary of State for Business, Energy and Industrial Strategy on the conduct of the directors. If this conduct does not meet the required standard, a director can be disqualified from acting as a director in the future. Additional personal liability can be imposed on directors as part of disqualification proceedings.



Managing directors' conflicts

It is inevitable that conflicts will arise in relation to a joint venture company – and crucial for its directors to be alive to the risk of conflicts and to be fully aware of both their statutory duties in this regard, and of how conflicts are addressed in the articles of association of the company, and in any shareholders' agreement.

The way these conflicts are to be addressed needs to properly managed, via:

— Appropriate provisions in shareholders' agreements and articles

— Proper oversight and controls exercised by non-conflicted directors on boards

— In certain circumstances, establishing sub-committees of the board or board protocols to manage circumstances of conflict: this can be particularly difficult in joint venture companies where unanimity is often required for board actions under the constitutional documents

Disputes and dispute committees

We have seen an increasing use of board committees to consider and manage the conduct of disputes with shareholder group members, and the drafting of the terms of reference for such committees is important.

Key issues include:

— The membership of the committee (and how this fits in with shareholders agreement requirements)

— The extent of the committee's role

— Access to external advice, and the budget for this

— The extent of reports to the full board (and what information might be retained or redacted) – in some cases this may be by way of high level summaries of the committee's business

— How legal professional privilege is preserved

— Any need for a waiver of shareholder's general rights to information.

Managing confidentiality issues

A director, while in office, has the right to be informed about the company's affairs and to inspect all the company's books and records. This right must be exercised for a proper purpose, to enable the director to discharge his/her personal obligations to the company and his/her statutory obligations.

Each director owes a duty of confidentiality to the joint venture company. Where the director is appointed by a shareholder, he or she must not, without the authority of the company, disclose to that shareholder any confidential information relating to the company which has been gained by him or her as a director of that company.

However, the right to information will also usually be governed by the shareholders' agreement. Shareholder nominated directors will often be specifically authorised to disclose confidential information to the shareholder that appointed them. The shareholder may have an explicit right to require that the joint venture company provides specific categories of information, and sometimes a more general right to request information.

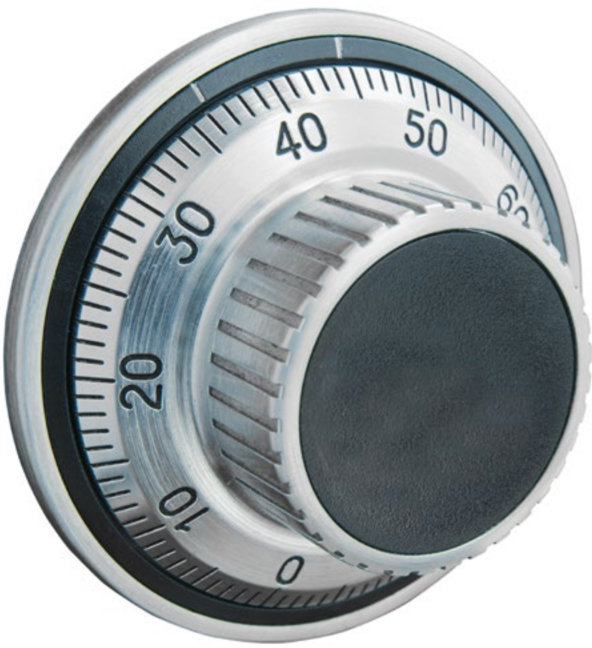
Directors should be aware of these confidentiality provisions and also consider if they are appropriate in all circumstances.

For example:

- It may be appropriate when putting together board packs, and drafting board minutes, to deal with categories of information differently (for example by way of oral presentations on particularly sensitive areas)
- Non-conflicted directors may wish to exclude conflicted directors from parts of meetings and provide redacted board packs if these contain information which is not appropriate to be shared with them
- Board committees may be appropriate to consider particularly sensitive issues

Where listed companies are involved, directors should of course also comply with the rules in relation to disclosure of price sensitive information.

If the joint venture company enters into a formal insolvency process, the appointed insolvency practitioner steps into the shoes of the joint venture company and so will have a right to access the books and records, together with all legal and financial advice obtained by the board in that capacity.



Summary: practical risk management for directors

Be aware of duties, and seek specialist advice where unsure.

Keep proper board minutes and review, and update, conflicts position and policies.

Be familiar with rights and obligations under articles and shareholders' agreements.

Consider how best to manage shareholder group disputes.

Ensure confidentiality issues are properly addressed.

Hold adequate and regular training.

Ensure a separation of board and shareholder decision-making (ideally with different constituent groups).

Ensure all relevant matters are reported to insurers to maintain D&O cover.

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Please note that this report does not address regulatory issues for financial services companies where additional governance considerations and duties will apply.

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