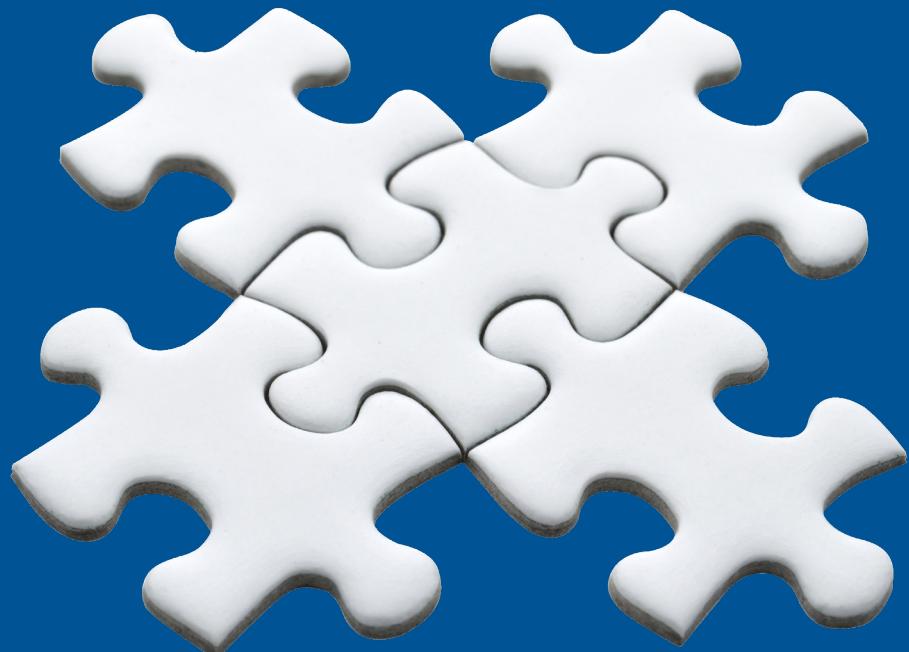


Advising the Board on **Director Duties Risk**

Reports looking at the full range of commercial risk



Risk, Resilience
and Reputation

Directors' risk report

Executive and non-executive directors have a wealth of responsibilities, but no matter the nature of a particular role or industry, or the day to day demands of a business, all directors remain subject to a core set of directors' duties. These duties should be key considerations for any decision-making process by a board of directors. Failure to properly comply with these duties can lead to serious consequences for directors and can even result in director disqualification.

Who is a director?

The definition of director is broad and includes any person occupying the position of director, regardless of how they are titled. As a result, any person exercising power within the company, particularly in relation to decision making and attending board meetings may well fall to be treated as a director in the eyes of the law (such as a 'shadow director' or 'de facto director'). In addition, the following also fall under the legal definition of a director:

- Executive director
- Non-executive director
- Nominee director
- Alternates (i.e. an individual appointed by a director to act in their place in cases of absence)

An important point to remember is that the law does not distinguish between different types of director and all directors are expected to meet the same standards and responsibilities – the only differences arise when considering an individual's personal experience. For example, a director with an accounting background would be expected to exhibit a higher degree of skill on financial and accounting matters than a director with a specialist, scientific background.

The role of a director

The board of directors is responsible for managing and taking decisions for the company. Directors make decisions collectively as a board and the decision-making process is usually set out in the company's articles of association.

When taking decisions, each and every director must have regard to their general legal duties which must be adhered to at all times. Importantly, a director's duties are owed independently to each and every company of which the director is appointed on an individual basis – the law does not

recognise any general duty in the interests of a group of companies collectively (to the benefit or detriment of different companies within that group). Directors' duties are not owed to any individual shareholder of the company.

Key statutory duties

There are seven general directors' duties:

- A director must act within the director's powers
- A director must promote the success of the company
- A director must exercise independent judgement
- A director must exercise reasonable care, skill and diligence
- A director must avoid situational conflicts
- A director must not accept benefits from third parties
- A director must declare any interest in a proposed

Risk thermometer



Appropriate skillset

- is the company's business one which you understand sufficiently (or can readily learn about)?

Conflicts

- do you have other interests which may conflict with the company or your involvement with it?

Board composition

- does the board composition address the needs of the company?

Dominant personalities

- is there a dominant director/executive or shareholder who may compromise the board's independent decision-making

Understanding all stakeholder interests

- directors need to consider not just shareholders' interests but also the company's broader environment



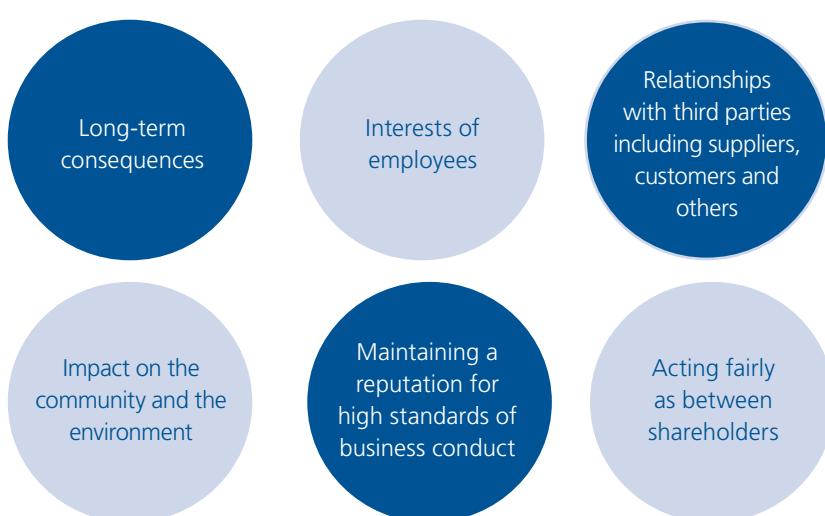
1. Duty to act within powers:

At all times a director must act in accordance with the company's constitution (which is largely set out in the company's articles of association).

Additionally, directors should only exercise their powers in their capacity as director for the purposes for which they were conferred and not for an improper purpose - such as a director using authority to issue shares in order to dilute the shareholding of a "difficult" shareholder to avoid the shareholder having the ability to block a resolution that the directors wish to propose. If a director is found to have used their power for an improper purpose, the director will be in breach of the director's duty to the company.

2. Duty to promote the success of the company:

When taking decisions, directors must act in a way they consider will promote the success of the company for the benefit of its shareholders as a whole. This duty is the main guiding principle for any actions taken by directors and in taking decisions, the directors must have regard to six key stakeholder factors:



This list is not exhaustive and other relevant stakeholder interests applicable to a specific business may also need to be considered.

There is one important modification to this duty, which is when the directors are required, as a matter of law, to consider the interests of creditors as well as the interests of shareholders. This is when the company is in, or is bordering on, insolvency, or liquidation or administration is probable (and when liquidation or administration is inevitable, the interests of creditors become paramount).

3. Duty to exercise own independent judgement:

A director must exercise their own independent judgement when exercising their powers and must not commit to acting (or not acting) in a particular manner at the request or direction of another person.

For example, directors are entitled to take advice but they cannot simply follow it without exercising their own discretion and judgement. Directors can also take a shareholder's views into consideration, but must still exercise their own independent discretion as directors before taking a decision (which may be contrary to the shareholder's position) for the company.

4. Duty to exercise reasonable care, skill and diligence:

When making any decision on behalf of the company, a director must exercise reasonable care, skill and diligence. This will be judged against the general knowledge, skill and experience expected of a person carrying out the role of a director. However, where a director has specialist knowledge, the standard will be higher and such a director will be expected to exercise the general knowledge, skill and experience that they actually have. For example, the expected knowledge skill and care of a qualified and trained accountant who is a director will be greater in respect of accounting matters than a sales director.

A director is not prevented from relying on the specialised experience or skill of other directors to inform a collective decision and there is nothing to stop a board from delegating or dividing up responsibilities. Nonetheless, each director must stay informed and meet the minimum standard of general knowledge, skill and experience expected of a director. When delegating or dividing up responsibilities, the board as a whole must be comfortable that those to whom they are delegating or assigning such responsibilities have the necessary knowledge, experience and skill to perform their role.

5. Duty to avoid conflicts of interest:

Directors should not place themselves in a situation where they have a personal interest which conflicts or may possibly conflict with the company's interests. This applies to situations of any direct or indirect conflicts and would include where a director sits on the boards of both counterparties to an agreement.

Examples of where conflicts of interest might arise include:

- where a director has multiple directorships;
- where a director diverts an opportunity away from the company into his own hands
- where a director carries out a business similar to (and potentially/occasionally in competition with) the company

Directors should be particularly careful where they learn of information or business opportunities in their capacity as a director of one company which may be beneficial or detrimental to another company of which they are a director.

This duty is not infringed if the conflict has been authorised by non-conflicted directors or the company's shareholders.

In the event of a breach, a director will not be able to defend themselves by claiming they were unaware of the existence of a conflict. However, it is worth noting that the duty will not be breached where:

- the situation cannot reasonably be regarded as giving rise to a conflict; or
- the conflict has been authorised by the directors.

Directors should be aware of any additional information or expectations on dealing with situational conflicts which may be set out in the articles of association of the company.

6. Duty not to accept benefits:

This duty prevents directors from exploiting their position as director for personal benefit by prohibiting the acceptance of benefits (including bribes) from third parties which are given because (i) a person is a director or (ii) because the director does or does not do something in their capacity as director.

Acceptance of a gift will not amount to breach where:

- the acceptance cannot reasonably be regarded as likely to give rise to a conflict of interest.

This duty continues to apply even after a person ceases to be a director in relation to things done or not done while they were a director.

7. Duty to declare interest in transactions:

The duties to act in the best interests of the company and to avoid conflicts of interest do not prevent a director from transacting with the company and it is often the case that, if the director declares their interest to the company, the conflict may be authorised or waived. However, in each such case, the director concerned should carefully consider whether it is still appropriate to participate in board discussions and receive board papers relating to the matter concerned. In many instances, a director would be expected to recuse themselves from the discussions.

Process for declaring interest:

When: Before the company enters into the transaction.

How: The declaration must be made at a board meeting or by notice in writing.

What: The declaration must include the nature and extent of the director's interest in the transaction.

Relevant Transactions: This duty applies to both direct and indirect conflicts, so it is important to note that directors may have an interest even if they are not party to the transaction personally.

Exceptions:

- The director was not aware of the transaction or their interest in the transaction. This exception does not apply if the director ought to have been aware of the transaction or interest.
- The interest is not likely to give rise to a conflict.
- The other directors of the company are already aware of the interest.

- If the interest concerns the director's service agreement.

Directors should be aware of any additional disclosure requirements required under the articles of association of the company. Directors should also check that, having declared an interest, they can still count in the quorum and vote on the relevant matter.

Expert perspective



Louis Cooper

CEO

Non-Executive Directors' Association

Our role at the Non-Executive Directors' Association ('NEDA') is to help non-executive directors, and board directors generally, understand what they are taking on when they sign up to be a director of a company. We are often surprised, based on our board training and education activities, that experienced directors do not always appreciate the full extent of the basic legal requirements, especially their key statutory duties as summarised very clearly in this briefing.

The professional role of a director

The expectations of the role that a company director performs have increased substantially, both internally (by the company workforce) and externally (by a broader range of company stakeholder groups and interested parties). Directors need to be professional in what they do and as part of that approach take control of their own 'continuing professional development' ('CPD') – directors need to keep asking themselves the questions... "do I remain fit for purpose"? ... "am I adding value to my board"?... "do I have the necessary personal competencies (see below)"?

Board effectiveness

The board director does not operate in isolation – he or she will be a member of the board and may also be a member of one or more board sub-committees. To be an effective board or board committee the directors must work together as a team – this might sound obvious but there are numerous examples of dysfunctional

or weak boards. The challenge for boards, especially the Chair as the leader of the board, is to ensure that it sees itself and is seen by others to be effective in what it does. Board effectiveness or board performance evaluations should provide a good sense check and, if undertaken in the right spirit and with full engagement, can help inform the development of both the director and the board.

Manage your personal risks

Individual directors need to consider themselves as a 'brand' and at all times should seek to protect their own reputation. Company annual reports now include an improved narrative of how the board directors have met their duty to promote the success of the company (S.172 Companies Act disclosures). On a personal level board directors also need to assess their own level of competency, based on a demonstration of the right blend of Knowledge + Skills + Attributes + Experience.



Breaching Duties

As a director's duties are owed to the company, as a general rule, only the company (or a liquidator or administrator) can bring a claim for a breach of duty against a director. However, there are limited exceptions to this general rule, the most common of which are:

- A liquidator may assign a claim for breach of duty to a company's creditors.
- Shareholders of the company may bring a derivative claim in the name of the company (where the company has declined to bring the claim itself). This would usually be where a company declines to bring claims against its directors.

It is important to note that directors' duties are cumulative and, just because a director is acting in compliance with one of the duties, there may still be a breach of another.

Different remedies are available to the company dependent on whether the duty is a fiduciary duty or non-fiduciary duty.

Remedies for breach of fiduciary duties include accounting for any personal profit made, damages, equitable compensation and withholding or confiscation of pay. The company is not required to prove a loss.

The remedy for breach of a non-fiduciary duty (eg. duty to exercise reasonable care, skill and diligence) is usually damages and the company will be required to prove that it has suffered a loss as a result of the breach.

There is a six year period within which a claim may be brought (from the date of the breach or once a continuing breach stops), except for certain cases of fraud involving property.

Protection and relief

Directors should consider putting in place directors' and officers' insurance (D&O insurance) to provide some protection to directors from liability. It should be noted that D&O insurance policies do not always cover breach of duty so it is important to check the details of the policy.

Alternative avenues of protection and relief for directors include:

- obtaining a formal consent from shareholders to approve or ratify the breach, either before or after the event;
- relief from the courts;
- indemnification by the company, although this is limited as a matter of law as to what may be covered.

Summary

Practical steps to avoid liability



Carefully read and review all board papers.



Ask further questions if you do not understand something or it is not clear to you.



Hold and attend regular board meetings so that you are kept up to date on the company's business, financial position and strategy.



Keep up to date, clear and detailed records of all board meetings and decisions, including an explanation as to how the directors' duties were considered (at least on decisions which are material to the company).



Declare any continuing conflicts or potential conflicts of interest and consider whether any new or specific conflict has arisen.



Review and understand the scope of any D&O insurance policy put in place by the company.



Seek professional advice where there is any doubt as to your duties.

Contacts



Alasdair Steele

Partner

T +44 20 7524 6422

E alasdair.steele@cms-cmno.com



James Parkes

Partner

T +44 20 7367 2580

E james.parkes@cms-cmno.com

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cms-lawnow.com

CMS Cameron McKenna Nabarro Olswang LLP
Cannon Place
78 Cannon Street
London EC4N 6AF

T +44 (0)20 7367 3000
F +44 (0)20 7367 2000

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