Surviving as a Director

SURVIVING AS A DIRECTOR

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1. INTRODUCTION

As a director you will probably be only too aware that the laws and regulations governing directors have become more complex and exacting over recent years. In particular, the financial penalties which can be incurred have increased dramatically. Unfortunately, commentators generally find it easier to emphasise the seemingly onerous nature of duties and the extent of the financial risks rather than give practical guidance about how directors can meet their responsibilities and minimise the risk of incurring personal liability.

This booklet is intended to help you put the risks in perspective. To start with it is worth remembering that laws and regulations are designed to protect the public from the dishonest and incompetent. They were not drawn up to inhibit legitimate business activities and should not be allowed to do so. The vast majority of directors are honest and able and should be quite capable of carrying out their responsibilities without fear of penalty, even when things do go wrong.

Your promotion to the board of directors involves more than an increase in status and responsibility. The whole nature of your role within the company changes significantly.

Your duties and responsibilities as a director stem from a large number of sources. It is not appropriate or possible to list them all in this document. However, you should be aware of the broad regulatory framework within which you are required to work. With a proper understanding of your role and the observance of some basic protective measures you should be able to reduce the financial risks to a tolerable level.

The laws regulating the conduct of directors make no distinction between executive and non-executive directors. The guidelines set out in this booklet apply to both.

This booklet deals with the law as in force in England and Wales on 30 April 2009. It is not designed to be a comprehensive guide, neither can it be relied upon as a substitute for detailed advice on the specific circumstances of a particular situation. If you would like any further advice or explanation relating to your responsibilities, please feel free to discuss these points with us.

2. YOUR ROLE

Decisions

An ordinary employee is usually required to provide a particular service to the company. You, however, are a trustee or guardian of the company's property and affairs and need to concern yourself with the wider implications of your actions. Every time you make a decision in relation to your company's business you must be satisfied that it is in the best interests of the company. This does not mean that every decision you take must turn out to be the right one. It simply means that when the decision was made it was reasonable for you to believe that the company would benefit sufficiently to justify the expense and risk arising from the decision.

When considering whether your actions are in the best interests of the company you should consider what would be most likely to promote the success of the company for the benefit of its shareholders and in doing so also be concerned about the likely consequences of any decision in the long term, the interests of employees, the need to foster the company's business relationships with its suppliers and customers, the impact of the company's operations on the environment, the desirability of the company maintaining a reputation for high standards of business conduct, the need to act fairly as between shareholders and any creditors particularly, if the company is in financial trouble. This list is not exhaustive, but highlights areas of importance that you should pay particular attention to.

Competence

An ordinary employee is generally expected only to demonstrate the level of expertise and competence which he actually has in doing the job. However as a director your performance will also be judged against an objective standard. You will be judged against the level of expertise that it would be reasonable to expect of a person in your position – for example, if you are the finance director you will be expected to have a good knowledge of financial and accounting matters. Similarly, more will be expected of a director of a company whose shares are listed on a stock exchange than of a director of a small private company.

Conflicts

As a custodian of the company's assets you must avoid placing yourself in a position that conflicts, or could reasonably be regarded as likely to give rise to a conflict, with the interests of the company. For example, making personal use of any information, property or opportunities

in relation to the company even where the company may not be able to take advantage of the information, property or opportunity. In addition to the aforementioned, a conflict is also most likely to arise where your company is dealing with another company in which you, a member of your family or perhaps even a friend has an interest.

It is essential to bring the nature of the conflict to the attention of your fellow directors in the manner appropriate to your type of company as prescribed in your company's constitutional documents. If you are allowed to vote on a resolution, despite being interested in the outcome of the board's decision, you must still exercise that vote in the best interests of the company rather than yourself. It is important to remember that there is also a continuing obligation to keep the board informed of the nature of your interest in a proposed transaction or arrangement or a transaction or arrangement that has already been consummated. If your original disclosure to the board proves to be, or becomes, inaccurate or incomplete you must inform them of this.

It is also important to note that there is also an express prohibition on a director of a company accepting a benefit from a third party as a result of his being a director or his doing (or not doing) anything as a director.

3. RESPONSIBILITIES

Service contract

If you are a director you should have either a service contract or a letter of appointment which specifies your responsibilities and the level of your authority within the company. Your responsibilities and level of authority may be supplemented from time to time by further directions from the managing director or the board.

Some executive directors prefer to operate without a service contract. This may be unwise. The service contract identifies your rights and the company's rights and obligations towards you. In addition it can be used to set out the principal duties you are expected to perform and the areas of the company's business for which you are responsible. This may provide useful evidence that a particular issue did not fall within your field of responsibility.

Whether you like it or not the law imputes a contractual relationship as soon as you are appointed a director. It is likely to be in everyone's interests, but particularly yours, if the terms and conditions regulating your executive responsibilities are expressly agreed between the parties concerned and clearly set out in writing. Even if you are an unpaid non-executive director your responsibilities, authority and liabilities should be spelled out clearly.

Constitutional Documents

A director of a company must act in accordance with the company's constitution.

It is important to note that the company's constitution not only includes the company's memorandum and articles of association, it also includes decisions taken in accordance with the articles, decisions taken by the shareholders, and statements of policy adopted by the board.

If you commit your company to a transaction which falls outside the powers contained in its constitution you may have to account for any loss that occurs – even if you believed you were acting in the best interests of the company at the time. For example, committing the company to borrowing more than is allowed by your company's articles could be a very expensive oversight if the amount involved is substantial. It is, however, possible in certain circumstances for shareholders to absolve the director(s) from liability.

Legislation

There is now a vast body of legislation and supplementary regulation governing the conduct of your company's

business affairs. While you cannot be expected to know the detail of all legislation which applies to your business you should have a broad understanding of what statutes and regulations apply to you, your company and the key areas of activity which they affect.

The principal statutes covering directors' duties are the Companies Act 2006, the Insolvency Act 1986 and the Insolvency Act 2000. The legislation then ranges from those statutes which are generally applicable to almost every type of company – taxes, employment, health and safety – through to those which may apply as a result of a company's status or particular field of business activity. These statutes often impose personal liability (including criminal liability) on directors of companies found guilty of offences or noncompliance.

For example companies whose shares are listed and traded on the London Stock Exchange (whether the Main Market or on AIM) must adhere to rules imposed by various regulatory authorities such as the London Stock Exchange, the Takeover Panel and the Financial Services Authority.

In addition, if your company has operations or a presence overseas you should also consider your liabilities in that particular jurisdiction.

Negligence

All employees, from trainees through to managing directors, have a responsibility to ensure that people who may be affected by their actions do not suffer as a result of a mistake or failure to carry out a particular task properly.

With each promotion to a higher level of management you will also inherit a responsibility for the people who are supervised by you to ensure that they are performing their functions adequately. If you fail to pay due care and attention to the calibre of new recruits or the quality of their performance you could be found to have acted negligently and be financially liable for any damage suffered by third parties as a result of your subordinates' actions.

As a result of this, when you are appointed to the board your exposure to potential claims increases greatly. As well as being responsible and accountable for major strategic decisions, which could have a material impact on a large number of individuals outside the company, you may indirectly assume responsibility for the conduct of

the whole of your workforce.

To mitigate this exposure to risk it is important that you and the other members of the board put in place and implement measures that ensure that decision making is appropriately delegated, company policy is strictly followed and there is sufficient transparency so that any mistakes can be easily identified and rectified.

4. THE BOARD

Collective responsibility

You should not underestimate the important role of the board in managing the risks associated with being a director of a company. First and foremost it is the collective responsibility of the board to ensure that your company's affairs are conducted in such a way as to comply with the regulatory framework referred to above. The board must look after the interests of the company as a whole and seek to maximise the return on capital invested by the company's shareholders.

The fact that the directors of a company are the joint custodians of the company's business and assets means that the board can only function properly where mutual trust exists. Although individual directors sometimes begrudge the need to return to the board for authority to take certain actions, the board regime can provide a discipline and protection which significantly limits the inherent risks for each individual board member. A collective decision by the directors is less likely to be challenged as being unreasonable than one made by a director without reference to his colleagues.

However despite this it is important to remember the personal responsibilities that you owe to the company. The fact that the board has collectively decided to take a course of action does not absolve you from liability. For example if the board is making a decision about the company's budget and financial planning that you disagree with and you are also the financial director or you have several years of experience in relation to finance you should ensure that any concerns that you have are brought to the attention of the board and recorded in the board minutes.

Composition of the board

If the composition of the board is properly balanced, with individuals working well together, and each director fulfils his responsibilities in a professional manner, the potential for individual directors to incur liabilities should be small. Every company and every individual is different and the appropriate composition of a board will vary considerably from one situation to another. The number and identity of each director on the board should be largely dictated by the size and complexity of a company's business and the skills, background and experience of each individual. It is essential that all areas of the company's business activities are properly represented.

The need for non-executive directors will also vary from company to company. However it is standard for a publicly quoted company to have independent non-executive directors on their boards. This helps to ensure that independent minds are brought to bear in analysing the soundness of particular strategies formulated by the executive directors. Whether your company is private or publicly quoted it is likely that the quality of boardroom decisions will improve, and the risk of subsequent criticism should be reduced, if the right person is appointed as a non-executive director.

Corporate governance

Corporate governance is concerned with the way in which a company is directed, administered or controlled. To ensure that the interests of your company and its many stakeholders such as its shareholders, employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large are protected, you and the other members of the board must ensure that there is transparency and accountability in the company's decision-making process.

The Combined Code on Corporate Governance (which is reviewed by the Financial Reporting Council) is the source of governance rules for UK-incorporated companies whose securities are admitted to listing on the Main Market of the London Stock Exchange and deals with directors, directors' remuneration, accountability and audit, relations with shareholders and institutional investors.

Whilst it is not legally binding, it should be complied with by listed (and AIM) company boards as a matter of good practice. The Listing Rules do not require compliance with the Combined Code, instead, they require companies to state whether they have complied with the provisions of the Combined Code and in instances where they fail to adhere to the standards recommended by the Combined Code the Listing Rules require that the company explain the reason for this deviation. Similarly, the AIM Rules for Companies, applicable to companies whose securities are traded on AIM, require a statement in the admission document as to whether or not the company complies with the corporate governance regime in the country of its incorporation and if applicable, an explanation regarding why the company does not comply with such regime.

With regard to financial reporting and accountancy, the Combined Code recommends that an audit committee, consisting of at least three (or in the case of smaller

companies, two) independent non-executive directors, should be established whose duties will include reviewing the scope and the results of the audit as well as the independence and objectivity of the auditors.

With regard to directors' remuneration, the Combined Code recommends that a remuneration committee should be responsible for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. To ensure objectivity, the Code recommends that the committee should comprise a minimum of three (or in the case of smaller companies, two) non-executive directors.

The Combined Code is based on the desirability of openness on the part of companies, integrity in their dealings and financial reporting, and accountability of directors to shareholders through the quality of information provided. Compliance will not only result in better protection for shareholders but, in addition, the individual director will have better protection from claims and liabilities and criticisms as regards the fulfilment of his responsibilities as a director.

Relationship with board members

The amount of time which an individual spends worrying about potential liabilities as a director will to a certain degree be a function of the confidence he has in other board members. In a perfect world you would want to have no doubts at all about the composition of the board and the individual qualities of your fellow directors but the majority of directors have to survive in a situation which is less than perfect. Nonetheless, it will be very difficult to function properly and minimise your own risk as a director if you do not trust your colleagues.

Good communication is an essential ingredient in ensuring that the appropriate degree of mutual trust exists between you and the other members of the board. It will be almost impossible to conduct the company's affairs efficiently if directors fail to keep each other fully informed of day-to-day developments in the company's business. Non-executive directors will be relying almost entirely upon information which is provided by the executive directors. Accordingly, directors should ensure that full and timely information about all important matters is passed to each other, including any non-executive director.

Performance of individual directors

Your ability to avoid personal liability may depend on the quality of performance of your fellow directors. Even if you avoid personal liability, your directorship of a company which has gone into liquidation may make it difficult for you to gain employment at board level elsewhere.

Clearly it is difficult to monitor closely the way in which your fellow directors are managing their own responsibilities. You should, however, endeavour to be fully aware of the financial position of the company even if financial affairs do not fall within your own areas of responsibility. Conversely, the financial director has a particular obligation to keep fellow directors informed of the company's financial affairs. Whatever your particular role you should not be afraid to ask your colleagues for information about their own areas.

Finally, when an individual director is performing his role less than satisfactorily, there are often tell-tale signs. These should not be ignored. Tackling problems of that kind early may protect the company's best interests as well as reduce your own exposure.

5. MEETINGS

Properly Convened Meetings

The importance of properly convened board meetings in providing protection for you cannot be overstated. On the one hand, this essential forum should allow you to monitor the progress of the company and the performance of fellow directors. On the other hand, the very fact that meetings are held and properly documented can be an important evidential tool should you need to justify your stewardship of the company's business and assets. If meetings are not held or no documentary evidence of what took place exists, your conduct could appear in a very bad light, for example in the event of a disqualification hearing, and could even tip the evidential balance against you.

Informed Debate

Board meetings do not have to be formal although they must be convened and conducted in the manner prescribed by the company's articles. For example, adequate notice of the meetings must usually be given to all directors. However, meetings need not be stilted affairs scripted by lawyers. Heavily procedural meetings are sometimes necessary but should not be adopted as a model for the open, informed debate which should go on at general board meetings when formulating business strategy. An essential 'check and balance' comes from the opportunity for one director to challenge the views of another.

The Importance of Minutes

Full minutes of the meeting should be kept so that the reasons behind the board's decisions, as well as the decisions themselves, are documented. It is even more important to do this in the case of difficult or delicate subjects. If a dissenting view is expressed – and no director should be afraid to voice opinions which differ from the majority view – it should be carefully minuted. The fact that alternative views are aired, and perhaps rejected by the majority, may provide important evidence to rebut the presumption that the board or a particular director acted unreasonably in pursuing a particular course of action.

The minutes should always be reviewed, not only by those present at the meeting for them to check the accuracy of what is recorded but also by the directors who were not present. This will bring everyone up to date with the company's situation and, if you were not at the meeting, provide an opportunity to challenge a decision with which you do not agree. It is also good practice for the minutes to be formally adopted at the next board meeting to

acknowledge that the whole of the board are happy with the substance of the minutes. Copies of any relevant material, either distributed in advance or produced at the meeting and on which opinions and decisions were based, should be referred to in the minutes and kept with them.

6. FINANCE

All directors should, of course, be well informed about those areas of the company's business for which they are directly responsible. However, information that relates to the company's financial affairs is particularly important for all directors – not just those with special responsibility for financial matters. All directors have a duty to the company and to themselves to ensure that they understand the financial position and are regularly updated. It is not appropriate, for example, for a director with responsibility for personnel to say that the company's finances have nothing to do with them.

The importance of remaining aware at all times of the company's financial position should not be underestimated. It could be critical, for example should legal proceedings be commenced against you after your company has become insolvent. A director can be required to contribute to a company's assets if he knew – or ought to have concluded – that there was no reasonable prospect of the company avoiding insolvent liquidation and he did not take every step to minimise the loss to creditors.

Unless you are the finance director it is unlikely that you would be criticised if financial information was deliberately kept from you or the information received was misleading. However, it will be difficult for you to defend yourself against an allegation that you ought to have known about the company's precarious financial situation if the information was available but you did not call for it or you received it but failed to spot or ask for an explanation about an obvious problem.

Management accounts, with cash-flow projections and profit forecasts, should be produced regularly and should be made available to all members of the board – well in advance of board meetings. If you do not have experience in accounting it is worthwhile learning some basic accounting principles and making sure you understand the way in which your company's finances actually work.

7. PAPERWORK

Establishing and maintaining an efficient reporting system and a proper procedure for the retention, retrieval and disposal of documents is vital. The effectiveness of these systems may provide invaluable benefits if a claim is made against you.

Contemporaneous records

It is essential that records are kept up to date and every development and transaction documented when it occurs. It is particularly important to ensure that minutes of meetings and oral advice from professionals is recorded as soon as possible. If left for any length of time the accuracy of the record may be questioned and, of course, there is also the possibility that no record will actually be made. These records may provide important evidence in any defence about your own, or another director's, conduct. The absence of a written record can at the very least indicate incompetence and, at worst, can lead to suspicions that the directors were trying to hide something.

Document retention

Even if you have made contemporaneous records you must be able to retrieve them efficiently at a later date. Given the high cost of space and equipment you will probably want to retain as few documents as possible.

To ensure that documents are not lost or destroyed prematurely suitable procedures for their retention and disposal should be established. Under the Companies Act 2006 accounting records must be retained by a private company for three years and a public company for six years. Tax records for any company must be kept for six years. The statutory registers should be kept indefinitely. It is recommended that minutes of meetings and documents relating to major strategic transactions should be retained for longer than the statutory minimum.

8. ADVISERS

All too often outside advisers are brought in too late to influence problems which have either occurred or will inevitably happen. The ability of a lawyer, accountant or other professional adviser to provide you with the quality of service you need will depend to a degree on the time they have invested in getting to know you and your business. It should be remembered that you and your company can assist that process by keeping your professional advisers appropriately informed of all developments.

A close relationship with your professional advisers may be important in limiting the exposure to liability of the company and its board in an environment of ever-changing legislation and new business requirements. Not only should the company be able to benefit from the independent and objective advice received, but the fact that a specialist was consulted may provide evidential support to help resist any accusation that the directors acted unreasonably.

Ideally, relationships with professionals should be at a level where the advisers can readily be called upon to advise at short notice should an urgent problem arise, without them having to bring themselves up to date with the company's affairs at such an important time. Trying to establish an immediate relationship of trust and mutual respect with new advisers can be difficult if your company is attempting at the same time to fend off an unwanted hostile takeover bid or when a regulatory authority has mounted a serious investigation into your company's affairs.

9. INSURANCE

Company's insurance

Clearly, all areas of the company's business activity should be protected by adequate insurance cover. As a director you could be found negligent for failing to ensure that the company is adequately covered by, for example, buildings, occupier's liability or product liability insurance. Making sure that the company is adequately insured will indirectly help to protect you.

Directors' insurance

It is possible for a company to take out a directors' and officers' insurance policy (D&O insurance) to insure you against personal liability arising from most of the liabilities which can be incurred – for example, against claims for negligence, default and breach of certain statutory duties.

Such an insurance policy can also indemnify you against the expense – including legal costs – of defending yourself against allegations or if you become involved in time-consuming investigations. Even where you have done nothing wrong the expense involved may be considerable and may not be recoverable from anyone else.

Usually a D&O insurance policy will cover both current and former directors (in respect of claims or investigations initiated during the period of insurance only). As policies are usually renewable annually no cover will ordinarily be provided to either an existing or a former director if the policy lapses. You may therefore wish to ensure that a stand-alone policy, with a one-off premium payment to provide cover for up to 25 years, is taken out by your company (or by you personally) to protect you at all times should no other insurance cover be available at the time a claim is made against you.

D&O insurance can protect your company as well as you personally because it will normally provide reimbursement where your company has been obliged or permitted to indemnify you.

Additionally, D&O insurance policies can be extended to protect you should you, as part of your normal duties, serve on the boards of other companies.

Before D&O insurance is purchased, ensure that your company is appropriately authorised to do so by its memorandum and articles of association and that the tax consequences are understood. You should consult an

experienced insurance broker who is a specialist in the field. Policies can contain many pitfalls, including narrow insuring clauses, conditions regarding liability and wide exclusions. All of these can lead to the insurer avoiding liability whereas you might have been adequately protected if proper advice had been obtained.

The fact that D&O insurance is taken out and maintained by a company must be noted in the company's annual report and accounts.

10. CONCLUSIONS

We live in increasingly litigious times and recent years have seen a growing tendency for claims to be made against directors. This is particularly true of directors of insolvent companies and of companies which have come under investigation by the regulatory authorities.

Directors have always been at risk and, in contrast to the position of the company's shareholders, the potential liability is unlimited. Although the risks and potential liabilities which you face are serious, they are no greater than those of other individuals who carry significant professional responsibilities. As with any other activity, the best way to guard against risk is to observe proper standards of conduct, to act with care, to be honest and diligent and to ensure that appropriate management systems are in place and are used.

It will be sensible for you to review your own position and that of your company with the benefit of professional advice, where appropriate, to assess the extent to which you can minimise your personal risk. Insurance cover is now available and, more importantly, such insurance can be purchased for your benefit by your company. This insurance will not of itself prevent problems and losses arising but it can provide you with a very significant level of comfort and assistance. This is particularly valuable in relation to the substantial expenses which can be incurred in resisting claims, defending proceedings or in assisting the regulatory authorities in any investigation.

For Further Information

If you would like further information on any of the matters discussed in this note, please contact Sean Geraghty or Vanessa Giadom on +44 (0) 20 7184 7000.