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Duties and role of a non-executive director from a legal standpoint

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Introduction

The amazing case of the Marquis of Bute and the Cardiff Savings Bank [1892] 2Ch 100:


- Directors' duties are a product of common law
- Like the rest of the common law, like it or not, they *evolve*


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What is a director?

Not defined in the Companies Acts!

- Includes "any person occupying the position of a director, by whatever name called"
- Note also the concept of shadow director


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What is a director?

Jessel MR in *Re Forest of Dean* (1879) 10Ch 451, 453

"It does not much matter what you call them as long as you understand what their true position is, which is that they are really *commercial men managing a trading concern for the benefit of themselves and all the other shareholders in it*"

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What's coming up

- Fiduciary duties of directors
- Standard of care applicable to fiduciary duties
- Proposals for statutory reform
- The special role of non-executive directors
- The impact of contract and statute - parallel legal status

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Fiduciary duties (1)

Nineteenth-century confusion

- Directors had really only recently been invented
- Agents?
- Trustees?
- Managing partners?

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Fiduciary duties (2)

Twentieth-century certainty

- Duty of good faith
- Duty not to exceed powers
- Duty to act for proper purposes
- Duty to avoid conflicts of interest
- Duty not to make a personal profit

All apply equally to executive and non-executive directors

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Fiduciary duties (3)

Good faith: *Re Smith and Fawcett Limited* [1942] Ch 304, 306

It is the duty of the directors of a company to exercise the powers conferred upon them "bona fide in what they consider - not what a court may consider - is in the interests of the company"

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Fiduciary duties (4)

Good faith – in whose interests?

- Reference to "interests of the company" usually equates to interests of present shareholders, though creditors' interests will be paramount if solvency in doubt.
- Shareholders can normally waive duty

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Standard of care (1)

More nineteenth-century uncertainty

- Emphasis on gross negligence
- No suggestion of an ongoing role
- Codification in 1925 in *Re City Equitable*

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Standard of care (2)

Romer J in *Re City Equitable* [1925] 1Ch407

- Only expectation is skill of person of director's knowledge and experience
- No need to give continuous attention
- Ability to delegate

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Standard of care (3)

Requisite skill

- Romer J: a director "need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience"
- The "I was not qualified for the job" excuse

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Standard of care (4)

Updated by Hoffman LJ in *Re D'Jan of London Limited* [1993] BCC 646:

"The duty of care owed by a director at common law is accurately stated in s214(4) of the Insolvency Act 1986. It is the conduct of a reasonably diligent person having both:

- (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions that as carried out by that director in relation to the company; and
- (b) the general knowledge, skill and experience that that director has".

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Standard of care (5)

Continuous attention

■Romer J: "He is not bound to give continuous attention to the affairs of the company; his duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee to which he may be appointed, and though not bound to attend all such meetings he ought to attend them when reasonably able to do so".

■The dilettante's excuse – now weakened

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Standard of care (6)

Delegation

■Romer J: "In respect of all duties which, having regard to the exigencies of business and the articles of association, may properly be left to some other official, he, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly"

■The classic non-executive director's excuse – now significantly updated

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Standard of care (7)

Delegation: *Equitable Life v Bowley and others* [2004] EWHC 2263 (Langley J)

- Duty to know and understand company's business
- Honesty is not enough
- Delegation does not remove duty to supervise

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Standard of care (8)

Langley J approved comments of Morritt LJ in *Re Barings plc No 5* [2000] 1 BCLC 523, 535

▪“(i) Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties directors”.

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Standard of care (9)

Morritt LJ in *Re Barings plc No 5* [2000] 1 BCLC 523, 535

▪“(ii) Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions”.

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Standard of care (10)

Langley J in *Equitable Life v Bowley*:

▪“The extent to which a non-executive director may reasonably rely on the executive directors and other professionals to perform their duties is one in which the law can fairly be said to be developing and is plainly ‘fact sensitive’. It is plainly arguable. I think, that a company may reasonably at least look to non-executive directors for independence of judgment and supervision of the executive management”.

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Standard of care (11)

Applied in *Secretary of State v Swan* [2005] EWHC 603

- Consideration of the claims of a whistleblower
- Unusual circumstances should lead to inquiry
- Reasonable reliance on professional advisers
- Duty to ask questions!

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Standard of care (12)

Final comments on fiduciary duties and standards of care

- Duties are owed to company – not to shareholders or customers or regulators
- Statutory duty to have regard to interests of employees but no sanction for breach
- Duties are individual – not joint and not joint and several
- Penalties are largely civil liability to company – and may be unlimited

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Proposals for reform

Company Law Reform Bill: seven proposed codified duties:

- To act within powers
- To "act in the way he considers, in good faith, would be *most likely* to promote the success of the company for the benefit of its members as a whole"
- To exercise independent judgment
- To exercise reasonable care, skill and diligence
- To avoid conflicts of interest
- Not to accept benefits from third parties
- To declare interests in proposed transactions with the company

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Do non-execs have separate duties?

No ... but some duties impact on them particularly strongly:

- Duty to know and understand company's business
- Duty to question
- Duty to supervise – especially the executive directors

Not easy!

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Non-executives - a separate *role*? (1)

Much discussed in recent years, especially:

- Higgs Review 2003
- Penrose Report 2004
- The FSA!

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Separate role of non-executives (2)

Higgs Review 2003: role of *all* directors:

- Entrepreneurial leadership
- Set strategic aims, supply financial and human resources and review management performance
- Set values and standards

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Separate role of non-executives (3)

Higgs Review 2003: role of non-execs:

- Constructively challenge and contribute to the performance of strategy
- Scrutinise performance of management and monitor reporting of performance
- Verify financial information is accurate and financial controls and risk management robust and defensible
- Remuneration of exec directors and role in appointment/removal of senior management and succession planning

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Separate role of non-executives (4)

Reflected in Combined Code:

- Induction, training and update of skills and knowledge
- Seek clarification
- Ensure concerns are addressed or recorded
- Remuneration of exec directors and role in appointment/removal of senior management and succession planning

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Separate role of non-executives (5)

Penrose Report 2004

“Equitable’s non-executive directors were so wholly dependent on actuarial input from the executive and in particular from the chief executive/ actuary that they were largely incapable of exercising any influence on the actuarial management of the Society”

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Contract and parallel legal status

Important to distinguish company law duties of directors from additional duties imposed by:

- Contracts – eg service contracts or appointment letters
- Statute law – scores of statutory duties and offences!
- FSA rules applying to approved persons (derive power from statute)
- Note that these do not *amend* or *enhance* the company law duties of directors – they *compete* with them and need to be ranked with them, especially when they *contradict* them.
- Significant application of duty to avoid conflicts of interest

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And the future?

- Being a non-exec is no longer a sinecure
- Being a non-exec is no longer a job for amateurs
 - Academics, civil servants and retired professionals?
- It is a real job that demands training and skills
- It is a responsible and increasingly full time job
- **It’s not going to get easier**

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