Directors duties in Guernsey

Briefing Summary: This note provides a brief synopsis of the common law duties owed by directors of companies ("**companies**") incorporated in the Island of Guernsey ("**Guernsey**"). As it focuses on common law duties, it does not offer any commentary on the duties of directors of companies arising under applicable Guernsey legislation, including the Companies (Guernsey) Law, 2008 (as amended) (the "**Companies Law**"). This note begins by summarising the common law duties owed by directors, before moving on to address the question of to whom such duties are owed. It then pauses to consider who can enforce a breach of directors' duties and to analyse the potential liabilities of directors to third parties, before finishing with a brief explanation of how the risks faced by directors can be mitigated.

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What common law duties do directors owe?

The common law duties owed by directors can be classed under two heads:

- the fiduciary duties, which comprise the core duty to act in good faith and particular applications of the core duty, namely the own judgement duty, the no conflicts duty and the proper purposes duty; and
- the duty of skill and care.

The distinction between these two heads of duty is that:

- the fiduciary duties are concerned with concepts of honesty and loyalty; and
- the duty of care and skill is concerned with the concept of competence and not loyalty.

Breach of the fiduciary duties therefore connotes dishonesty or disloyalty. Mere incompetence is not enough. A servant who loyally does his incompetent best for his master is not unfaithful and is not guilty of a breach of fiduciary duty.

Breach of the duty of care and skill, on the other hand, connotes a lack of knowledge, skill or experience.

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The fiduciary duties - the duty to act in good faith

The duty

The duty to act in good faith is the core duty of a director and means that a director must exercise his discretion ***bona fide***, i.e. genuinely and actually and not colourably or opportunistically, in what he considers – not what a court may consider – is in the interests of the company. The central point here is that the court will not interfere with, or second guess, a decision of the board of directors which has been made properly and in good faith.

This is therefore a subjective test.

Breach

A director will be in breach of his duty to act in good faith only if it is shown that he did not honestly consider his action to be in the best interests of the company.

However, there are limits on a director's ability to rely on his subjective honesty.

Firstly, whilst the test for breach of this duty is subjective it should be noted that:

- the court is able to assess the director's state of mind from an evidential perspective; and
- if the relevant decision appears clearly and objectively not to have been in the best interests of the company this could certainly cast doubt on the director's assertion that he genuinely believed that it was.

Secondly, the subjective test for breach of this duty applies only where the director did in fact consider the interests of the company. If therefore, a director either totally or partially failed to consider the interests of the company (or thought of the point but then dismissed it without some mental process of deliberation) and makes a flawed decision as a result, he will not be able to rely on his subjective honesty as a defence.

In such circumstances the court will examine the relevant decision objectively and assess whether it was within the range of decisions which a hypothetical director, acting ***bona fide*** in the apparent best interests of the company could reasonably have made in all the circumstances. If the relevant decision was within that range, then the director will not be liable for the consequential loss arising from his flawed decision. If the relevant decision was not within that range the director will be liable for the consequential loss arising from his flawed decision.

Other aspects of the duty of good faith – duty to the company alone

One general proposition in respect of a director's duty to act ***bona fide*** in the interests of the company is that his duty is owed to, and is to be performed in relation to, the company alone, i.e. the company's interests are to be considered separately and independently of the interests of any other entity and, in particular, those of any holding company.

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Of course, the mere fact that a director was appointed by, or known to, or associated with a holding company does not mean that he is ***ipso facto*** to be suspected, much less assumed, not to be performing his duty to the subject company, or to be incapable of doing so. Any such argument against a director would need to be examined on the usual principles of evidence and proof.

Furthermore, the requirement to act in the best interests of the subject company does not mean that a course of action cannot be in the interests of the subject company simply because it happens also to benefit, or even be in the best interests of, the holding company. The mischief at which this element of the duty is aimed is that of subordinating the best interests of the subject company to those of another entity, or allowing the interests of that other entity to intrude adversely on those of the subject company.

Other aspects of the duty of good faith – duty not to contravene statute/ regulation

Another general proposition in respect of a director's duty to act ***bona fide*** in the interests of the company is the duty not to cause or permit the company to contravene statutory or regulatory obligations which apply to it. This duty on the director exists quite apart from any statutory sanctions which arise as a failure to do so.

Other aspects of the duty of good faith – duty to comply with the articles

Another general proposition in respect of a director's duty to act ***bona fide*** in the interests of the company is the duty to comply with the subject company's articles.

The fiduciary duties - the own judgement duty

The own judgement duty is the duty of directors:

- not to fetter their discretion in the exercise of their powers; and
- not to abrogate their responsibilities.

The broad principle behind this duty is that the company is entitled to the benefit of an actual and freely arrived at decision by its directors. A director will therefore breach this duty if he merely does what he is told or acquiesces without question. Directors have a duty to make a decision, and their own decision. In addition, directors have a duty to oversee, and keep themselves sufficiently informed about, their company's affairs.

However the duty to exercise independent judgement does not mean a duty to act entirely alone. Where, a director does not possess a particular expertise but is aware that one of his fellow directors does, there is nothing in this duty which obliges the first director either to make a decision without ascertaining the views of the expert director or without having regard to them, or to make himself a sufficient expert in the area that he can assess the opinions of the expert director from a position of expertise. If it is the case that more expert fellow directors propose or support a particular course of action, the non-expert director does not, without more, act in breach of his duty to exercise his own independent judgement because he is influenced by that fact. This is always provided, of course, that he has weighed that fact critically, according to his own level of skill, expertise and general intelligent common sense, in permitting such influence.

The fiduciary duties - the no conflicts duty

The traditional description of the no conflicts duty is that no-one having fiduciary duties to discharge shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting or which may conflict, with the interests of those whom he is bound to protect.

The test for a conflict of interest is an objective one and is whether the reasonable man looking at the relevant facts and circumstances of the particular case would think that there was a real, sensible possibility of conflict, i.e. the conflict of interest must be real and not fanciful.

A conflict of interest can arise either:

- between the fiduciary's duty and his personal interests (a conflict of duty and interest); or
- between two different principals (a conflict of duty and duty).

Conflicts of duty and interest include instances where, for example, the director exploits corporate property, corporate information or corporate opportunity for his own gain.

Conflicts of duty and duty include instances where, for example, the director has competing directorships and prefers his duty to one company over his duty to the other. Whilst there is no rule that a person may not be a director of more than one company, even if both companies are in competition, such a circumstance would require:

- the director who is in that position to arrange his affairs so as to enable himself to discharge his duties to both companies as loyally as if each were his only principal; and
- the director to make full disclosure of the position to each principal and obtain the informed consent of each principal to him acting for the other.

If a director makes a profit out of a conflict of interest he will also breach the "no profit" rule, unless he has the informed consent of his principal.

The nature of the informed consent of the principal in respect of both the "no conflicts" duty and the "no profit" rule in the context of most modern companies (the articles of which should dis-apply the relevant common law in favour of relevant statute) will amount to the disclosure of the interest by the interested director to the board of directors of the company in accordance with section 162 of the Companies Law.

The fiduciary duties - the proper purposes duty

The duty to act in good faith asks the subjective question of whether the director exercised his discretion ***bona fide*** in what he considers is in the interests of the company and can lead to the director paying damages or compensation where he is in breach of that duty.

In contrast, the proper purposes duty asks the objective question of whether the director's decision or action was valid and legally effective in a formal or structural sense and can lead to the decision or action being set aside or declared invalid by the court.

The proper purposes duty therefore requires the court to:

- identify the power whose exercise is in question;
- identify the proper purpose for which that power was granted to the directors;
- identify the substantial purpose for which the power was, in fact, exercised (this is a question of fact); and
- decide whether that purpose was proper.

In one of the leading persuasive authorities, the directors (acting honestly, in good faith and without personal interest) issued shares in a company, not for the purpose of raising capital for the company, but for the substantial purpose of enabling a takeover by creating a new majority member. The court held that the directors had not exercised their power to issue shares for the proper purpose and invalidated the issuance of the shares.

The duty of skill and care

The duty

The duty of skill and care owed by directors is that of a reasonably diligent person having both:

- the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as those of the relevant director with regard to the company (this is an objective test); and
- the actual knowledge, skill and experience of that director (this is a subjective test).

This is therefore a combined objective and subjective test and the subjective element is capable of raising, but not lowering, the standards to be expected of an individual director.

The combined objective and subjective test operates in practice by:

- the court looking at the company of which the director in question is a director and the functions he exercises as a director thereof;
- the court then deciding what knowledge, skill and experience the hypothetical "reasonable director" of that company exercising those functions would have; and
- the court then objectively assessing the knowledge, skill and experience of the director in question against that reasonable director's knowledge, skill and experience.

If the director in question is found to have exercised ***less*** knowledge, skill and experience than the reasonable director he will be in breach of his objective duty of care.

If, however, the director in question has ***more*** knowledge, skill and experience than the reasonable director he will be judged against his own higher standard and will be in breach of his subjective duty of care if he fails to meet his own higher standard.

Breach

A director will be in breach of his duty of skill and care only if the court is satisfied that no reasonably diligent director with the material degree of knowledge, skill and experience could have acted in the way the particular director did act. The point here is that the court must be satisfied that the decision complained of went beyond a mere error of commercial judgment.

The court will determine whether a director is in breach of his duty of care and skill by reference to the facts as they appeared to the director at the time of the relevant decision, i.e. the director's decision will not be judged with the benefit of hindsight.

Understanding of the company's business

One general proposition in respect of the duty of care and skill which can be derived from the authorities is that the 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 as directors.

Delegation

Other general propositions in respect of the duty of care and skill which can be derived from the authorities are that:

- a director is, subject to the articles of the company and the Companies Law, entitled to delegate his functions to some degree although he cannot delegate his "irreducible minimum" duty to oversee and monitor the affairs of the company (even in areas where he may permissibly have delegated particular functions);
- the permissible degree of delegation in any situation is fact sensitive; and
- the court will determine the dividing line between permissible efficiency and impermissible abdication of responsibility.

Reliance on others

Further general propositions in respect of the duty of care and skill which can be derived from the authorities are that provided the director has examined the situation sufficiently rigorously and critically as to satisfy himself that there are no matters giving grounds for caution, enquiry or suspicion, i.e. whether any questions, particularly awkward ones, need to be answered:

- directors are entitled to regard information provided to them by fellow directors and management as accurate;
- a director may rely upon his co-directors to the extent that the matter in question lies within their sphere of responsibility given the way in which the particular business is organised;
- a director is entitled to rely upon the advice of fellow directors and management in areas in which those other directors, or management, may be reasonably seen by the director to have greater skill, expertise or knowledge than he does himself;
- whilst one of the duties of non-executive directors is to monitor the performance of the executive directors, such duty cannot go so far as to require the non-executive directors to overrule the specialist directors in their specialist field;
- the duty of care and skill is not a duty to ensure that the company gets everything right. The duty is to exercise reasonable skill and care up to the standard which the law expects of a director of the sort of company concerned and also up to the standard capable of being achieved by the particular director concerned; and
- a director is not obliged to supervise every aspect of his delegate's activity, nor to be responsible for day-to-day management decisions. What is reasonable in the circumstances will depend upon how the particular company's business is organised and the part that the director could reasonably have been expected to play.

To whom do directors owe their duties?

Directors owe their duties to the company of which they are a director. But what is the company for these purposes?

The answer is that the company is:

- the company's general body of members, which have an interest in the company using its assets to carry on its business activities and make a profit; and
- the company's general body of unsecured creditors and prospective unsecured creditors, which have an interest in the company having, or having access to, sufficient liquid assets to be able to pay off the creditors' debts and to do so in a timely manner.

The directors of a company are always considering both the members and the creditors. It is just that whilst the company is solvent, the payment of the creditors is a certainty.

However, when it can be seen that decisions about the company's actions could prejudice the creditors' prospects of recovering their debts in a potential liquidation, i.e. when the company is "on the brink of insolvency", the directors are required to give precedence to the interests of the creditors where that is necessary to give proper recognition to the fact that the creditors will have priority of interest in the assets of the company over its members if a subsequent winding up takes place.

The directors' duties are still owed to the company, i.e. not to the members or creditors directly, it is just that the consideration of the interests of members and creditors are used as a tool for judicial analysis of the facts.

Who can enforce a breach of a director's duties?

The basic starting point is that a company's property belongs to the company and not to its members. Accordingly, where a company suffers loss as a result of an actionable wrong done to it (such as a director breaching his duties to the company), the cause of action is vested in the company and the company alone can sue. This starting point is subject to three exceptions.

The first exception is where a member can bring a "derivative action". A derivative action is an action commenced by a member seeking relief on behalf of the company in respect of a wrong done to the company, i.e. the member's rights are "derived" from the company. Derivative actions are complex claims which are beyond the scope of this note, but are available in Guernsey based on the English common law rules which pre-dated the enactment of the English Companies Act 2006, i.e. basically where:

- the nature of the wrong committed by the directors was beyond the powers of the company or illegal;
- the wrong constituted a "fraud on the minority members" (noting that in this context a fraud is a civil wrong rather than a criminal deceit) and the alleged wrongdoers had control of the general meeting which was or would be exercised to preclude the bringing of an action against the wrongdoers; or
- the act required the sanction of a special majority which could not be obtained.

The second exception is where a member applies to the court under section 349 of the Companies Law (unfair prejudice).

The third exception is where the liquidator of the company or any creditor or member thereof applies to the court under section 422 of the Companies Law (remedies against delinquent officers during the course of a winding up).

Liabilities of directors for member's personal claims

Member's personal claims against directors are rare because of the application of the principle of reflective loss. This principle dictates that where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a member suing in that capacity to make good a diminution in the value of his shareholding, where it is merely a reflection of the loss suffered by the company.

Accordingly, a personal claim may only be brought by a member where he can demonstrate:

- a breach of a duty owed to him personally; and
- personal loss separate and distinct from that suffered by the company.

Liabilities of directors in relation to contracts

The general rule is that a director, being an agent of the company, is not personally liable to third parties on contracts between the third party and the company.

However, directors need to be aware that there are circumstances in which they can make themselves personally liable to third parties in contract including:

- breach of a contract of employment or letter of appointment;
- claims under a personal guarantee (directors are generally not personally liable for the debts of a company, however, to the extent that a director has given a personal guarantee for the company's liabilities, he may be contractually liable);
- liability under an underwriting agreement (which can contain warranties and indemnities to be given by directors personally in favour of the underwriter);
- claims under a written contract which the director signed, or an oral contract which he concluded, without making it sufficiently clear that he was acting as an officer of the company (the test applied by the courts is an objective one, meaning that the private thoughts of the protagonists are irrelevant); and
- by signing pre-incorporation contracts, i.e. contracts which are entered into before the date on which the company is incorporated.

Liabilities of directors in relation to torts

The general rule is that a director is not liable for the torts of the company of which he is a director. Torts include civil wrongs such as deceit and negligent misstatement.

However, a director may be personally liable in three circumstances where events occur in relation to the company:

- first, for his own torts committed in relation to the company's affairs, whilst acting as a director of the company. For example if the director, when driving on company business, causes personal injury to another person in an accident caused by his driving, the fact that he is on company business will be irrelevant to his personal liability if the elements of the tort are proved against him;

    1. second, where he assumes personal responsibility for the acts or omissions of the company which render the company liable in tort. A court is unlikely to find that a director has assumed such personal responsibility unless:the director has, on an objective assessment of the exchanges between the director and the third party, assumed personal responsibility to the third party so as to create a "special relationship"; and
    2. the third party must have relied on the director's assumption of personal responsibility and that reliance must have been reasonable; and

- third, where he procures or directs the acts or omissions of the company which render the company liable in tort. This limb should have limited application as a director should not be made liable where he did no more than carry out his constitutional role in the governance of the company by, for example, voting at board meetings. It is more likely to have application where a director's participation goes beyond the exercise of constitutional control and the director is decisive in driving the project through on behalf of the company.

Risk mitigation

The risks faced by a director can be mitigated in 4 ways:

- the provision by the company of a qualifying third party indemnity;
- the acquisition of insurance;
- ratification by members; and
- statutory relief.

Qualifying third party indemnities

Section 157(1) of the Companies Law, renders void any provision anywhere that purports to exempt a director of a company (to any extent) from any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company.

Section 157(2) of the Companies Law, renders void any provision anywhere by which a company directly or indirectly provides an indemnity (to any extent) for a director of the company, or an associated company, or a body corporate which is an overseas company and a subsidiary of the company, against any liability attaching to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company of which he is a director.

The only exceptions to section 157(2) are:

- the provision of insurance for directors – see paragraph 15 below; and
- the provision of qualifying third party indemnities.

A qualifying third party indemnity is an indemnity against liability incurred by a director to a person other than the company or an associated company which does not provide any indemnity against:

- any liability of the director to pay:

    1. a fine imposed in criminal proceedings; and/or
    2. a sum payable to a regulatory authority by way of a penalty in respect of noncompliance with any requirement of a regulatory nature (howsoever arising); or

- any liability incurred by the director:

    1. in defending criminal proceedings in which he is convicted;
    2. in defending civil proceedings brought by the company, or an associated company, in which judgment is given against him; or
    3. in connection with an application for relief under section 522 of the Companies Law in which the court refuses to grant him relief.

Insurance

Section 158 of the Companies Law provides that a company may purchase and maintain for a director of the company, or an associated company, insurance against any negligence, default, breach of duty or breach of trust in relation to the company of which he is a director.

Ratification

Section 160 of the Companies Law codified the ratification by a company of conduct by a director which exceeds his powers or amounts to negligence, default, breach of duty or breach of trust in relation to the company.

Under section 160 of the Companies Law, the decision of the company to ratify such conduct must be taken by the members, and may be taken by ordinary resolution unless the memorandum or articles require a higher majority (or unanimity).

Where the resolution is proposed as a written resolution, members with a direct or indirect personal interest in the ratification are not eligible to vote.

Where the resolution is proposed at a meeting, it is passed only if the necessary majority is obtained disregarding votes in favour of the resolution by members with a direct or indirect personal interest in the ratification (though such members may still attend and be counted in the quorum at the meeting).

The requirements imposed by section 160 of the Companies Law do not affect any other enactment or rule of law as to the requirements for valid ratification or any rule of law as to acts that are incapable of being ratified by the company. For this reason the common law on ratification is still relevant.

The common law provides that a breach of duty by the directors could be ratified provided that what had been done was not outside the objects for which the company had been formed and did not involve fraud on the company's creditors.

The dividing line between those breaches of duty that are capable of ratification and those that are not is not easy to draw. However, it is clear that the following could not be ratified by ordinary resolution:

- any breach of duty which results in the company performing an act which it cannot lawfully do;
- any breach of duty which results in the company performing an act which, although lawful, cannot be done under the company's articles without some special procedure being carried out, such as the passing of a special resolution;
- any breach of duty bearing directly on the personal rights of individual members as defined in a company's articles (for example, refusal to register a transfer of shares for an improper purpose); and
- any breach of duty involving fraud on the minority, that is, by which the majority of members expropriate the money, property or advantages of the company at the expense of the minority.

Statutory relief

Section 522(1) of the Companies Law provides that if in proceedings for negligence, default, breach of duty or breach of trust against an officer of a company or a person appointed by a company as auditor (whether he is or is not an officer of the company), it appears to the court that the officer or person is or may be liable but that:

- he acted honestly and reasonably; and
- having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused,

the court may relieve him, either wholly or in part, from his liability on such terms and conditions as it thinks fit.

Section 522(2) of the Companies Law provides that if any such officer or person has reason to apprehend that a claim will or might be made against him in respect of negligence, default, breach of duty or breach of trust:

- he may apply to the court for relief; and
- the court has the same power to relieve him as it has under section 522(1) of the Companies Law.