CAREY OLSEN

Directors' duties, liabilities and indemnities in Guernsey

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The advent of the solvency based approach to company activity in Guernsey brings into critical focus the scope and nature of the duties incumbent upon the directors of a Guernsey company. Gone are the prior capital maintenance provisions required under now superseded legislation and the need for Court approval of significant corporate actions. In its place directors have become responsible for ensuring that a company will not become insolvent as a result of such transactions, for example, in the case of a reduction of share capital. It is tempting to over-simplify the worlds in which directors operate into two of stark relief: the solvent and the insolvent. As will be seen from the analysis below, directors of Guernsey companies will be best advised to consider applying the solvency test routinely in order to understand fully both the scope of their duties at any given moment in time and the various interested parties who will benefit from the fulfilment of those duties.

Acceptable mechanisms of exculpation and indemnification are also covered briefly in this note.

Who is a director?

Section 131 of the Companies (Guernsey) Law, 2008 as amended (the "Companies Law") states that a director "includes an alternate director and anyperson occupying the position of director, by whatever name called".The Court will therefore look at the substance of the duties assumed by a relevant person in establishing whether he is a director or not. Directors of Guernsey companies must be:

- pre-registered at the companies registry in Guernsey (the "Registry") and have a Registry ID number;
- be eligible to be a director (i.e. not a minor or disqualified anywhere in the world);
- sign a written consent to act and declaration of eligibility;
- be entered in the register of directors; and
- be notified to the registrar of companies in Guernsey ("Registrar") on appointment and removal.

"Alternate directors" (i.e. representatives of a director acting, say, in the appointing director's absence) are caught by the Companies Law, with the effect that all the Companies Law's requirements as to directors now also apply to alternates. Alternates must also be pre-registered and satisfy the other eligibility requirements described above on appointment.

As is the case for directors, an alternate director is personally liable for his or her own acts or omissions and is an active participant for the purposes of scrutinising any collective responsibilities of the board.

A "shadow director" is a person in accordance with whose directions or instructions the directors of the company are accustomed to act. Professional advisers to directors are excluded from the definition. The Companies Law treats shadow directors (who will not be registered as such and do not claim to be directors) as directors if there is a pattern of behaviour, or course of conduct, in which a governing majority of the board does not exercise any judgment of its own but simply acts in accordance with the directions of the shadow director.

Both types of directors are "directors" for the purposes of the Companies Law and are therefore bound by the duties set out in this note.

Directors' duties

There are two types of duty which a director owes to a company – a fiduciary duty and a duty of skill and care. This distinction is important because the duties are fundamentally different and not every breach of duty will be a breach of a fiduciary duty. More than one of the general duties may apply in a given case.

The fiduciary duty

The directors of a company occupy a fiduciary position in relation to that company and consequently owe duties to it as a fiduciary. The UK Companies Act 2006 (the "UK Law") has opted for a limited codification of directors' fiduciary duties which can be regarded as a fair synthesis of the existing underlying common law fiduciary duties. The Companies Law does not contain such a list and the directors of Guernsey companies are not bound by the UK Law. However, the list in the UK Law is a convenient reference point for directors of Guernsey companies. It is key to note that the fiduciary duties incumbent on directors are very much creatures of the moment and have evolved over time. They are therefore subject to change and factual interpretation.

The fiduciary duty concerns a director acting in good faith in his dealings with or on behalf of the company, and exercising the powers and fulfilling the duties of his office honestly. The distinguishing obligation of a fiduciary is the obligation of loyalty and as such, is not concerned with tests of competence. This duty is owed to the company alone and not to its individual shareholders.

The UK law lists the fiduciary duties as follows:

- to act within powers;
- to promote the success of the company;
- to exercise independent judgment;
- to avoid conflicts of interest;
- not to accept benefits from third parties; and
- to declare an interest(s) in a proposed transaction or arrangement.

These duties are summarised below.

Duty to act within powers

This duty can be divided into two components:

- the duty to act in accordance with the company's constitution; and
- the duty only to exercise powers for the purposes for which they are conferred: this means that the directors are required to observe the spirit as well as the letter of the constitution of the company.This is aimed at preventing directors from abusing power, by doing acts which are within scope but done for an improper reason.The test is subjective.

Duty to promote the success of the company

Historically, this duty was formulated as the duty of a director to act in good faith, which means to act honestly and in good faith in what he considers are the best interests of the company. This duty is subjective where the director honestly and reasonably believed in good faith that he was acting in the best interests of the company and where there is evidence of actual consideration of the best interests of the company. Where there is no such evidence, the proper test is objective, namely whether an intelligent and honest man in the position of a director of the company concerned could in the circumstances have reasonably believed that the transaction was for the benefit of the company.

A director acting in what he does not believe to be the best interests of the company is in breach of the duty to act in good faith even if he is acting honestly. The best interests of the company are its interests as a commercial entity, and are generally (but not always) the long-term interests of the shareholders as a whole. In acting in the best interests of the company, the directors must strike a balance between the long term and the short term interests of the company.

It is perhaps helpful (although not mandatory) for directors of Guernsey companies to refer to (and ensure that their decision-making paper trail clearly reflects) the non-exhaustive list of factors that directors of English companies are obliged to consider when considering their duty to promote the best interests of the company:

- the likely consequences of any decision in the long term;
- the interests of employees;
- the need to foster the company's business relationship with suppliers, customers and others; and
- the impact of the company's operation on the community and the environment.

Duty to exercise independent judgment

This duty does not preclude a director from taking advice but it means thatthe final judgment is the director's responsibility and that unquestioningreliance on advice does not absolve directors from exercising theirjudgment on the basis of such advice. The duty is closely linked to the duty to avoid conflicts of interest (seefurther below) because breaches of a director's duty to use independentjudgment often involve a director's relationship with third parties withwhom that director is closely associated.

This general duty is best explained as follows:

- a director is under a duty not to fetter his discretion (unless authorised by the company's articles) (i.e. a director cannot make a prior agreement to vote a third party's interest on a particular transaction, thereby leaving himself no independent discretion as to how to vote in the board meeting);
- directors (both collectively and individually) have 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;
- whilst directors are entitled (subject to the articles of incorporation) to delegate particular functions to those

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- 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 delegated functions;
- each company in a group is a separate legal entity and the directors of a particular company are not entitled to sacrifice the interest of that company in favour of the group's interest; and
- a director of a subsidiary owes his duties as such only to the subsidiary and cannot be compelled to exercise his powers in accordance with the holding company's wishes.

The duties "to avoid conflicts of interest and not to accept benefits from third parties"

These duties arose from the duty of loyalty which a director owes to a company: a person in a fiduciary capacity must not make a profit out of his trust. This principle followed on from the more general concept that a trustee must not place himself in a position where his duty and his interest may conflict. Here, Guernsey law departs from the UK Law quite substantially by focussing on disclosure of any interest on the part of a director.

Before the Companies Law came into force, it was a fiduciary principle that a director must avoid actual or potential conflicts arising between his duties to the company and his personal interests. The test was whether a reasonable man looking at the facts would think that there was a real, sensible possibility of a conflict of interest arising. A director could be in breach of the rule even though the company had suffered no loss. Traditionally, a director would have been advised that he should not act for two companies with potentially competing interests unless he does so with the informed consent of both parties. Similarly, a director was bound not to benefit from third parties, i.e. he could not exploit his position for personal benefit for example, through the receipt of gifts and hospitality.

The Companies Law has lessened the impact of these common law duties. Subject to the terms of a company's memorandum and articles of incorporation, an interested director in respect of a Guernsey company may vote on a matter relating to the transaction, attend the relevant board meeting and count in the quorum, sign any transactional document on behalf of the company and do any other thing in his capacity as a director in relation to the transaction as if he were not so interested provided that his interest has been declared.

An "interest" in a transaction is described in the Companies Law as being where a director:

- is party to or may derive a material benefit from a transaction;
- has a material financial interest in another party to the transaction;
- is a director, officer, employee or member of another party (other than a party which is an associated company) who may derive a material financial benefit from the transaction; or
- is otherwise directly or indirectly materially interested in the transaction.

However, it is a criminal offence for a director to fail to disclose to the company the existence of the interest. Thus, the Companies Law is permissive in respect of a director having potential conflicts of interest but insists on transparency between director and company. Nonetheless, the company can in its articles of incorporation, reaffirm the traditional fiduciary principles, by divesting the director of his powers in circumstances where an interest does arise and can elect to define "interest" by reference to those principles rather than pursuant to the Companies Law.

Duty to declare interests in transactions and arrangements

This fiduciary duty has been entrenched in the Companies Law. Sections 162 to 167 (inclusive) of the Companies Law make it a criminal offence to fail to disclose an interest (defined above) in certain circumstances, unless the transaction is between the company and a director, in the ordinary course of the company's business and on usual terms and conditions.

A director, immediately after becoming aware of his interest in a transaction or proposed transaction, must disclose to the board the nature and extent of this interest. A general disclosure to a board that a director has an interest in a party will be regarded as a sufficient disclosure in respect of any transactions following the date of the disclosure to the board. We now recommend that companies maintain and regularly review and update a register of directors' interests which can then be referred to in board meetings.

It is not necessary for the director to make a disclosure if the transaction is between the company and the director, in the ordinary course of the company's business and on usual terms and conditions. A transaction on usual terms and conditions is presumed to be at a fair value.

A transaction in which a director is interested is voidable by the company at any time within three months after the date the transaction is disclosed to the board unless:

- the interest of the director was disclosed prior to the transaction;
- the transaction was ratified by the members under the Companies Law; or
- the company received fair value for the transaction.

This is so without prejudice to the right, title or interest of a person in property which he has acquired in good faith, for valuable consideration and without knowledge of the director's failure to disclose his interest.

The duty to exercise reasonable care, skill and diligence

The standards expected of a reasonably diligent director have their origins in common law. A director has to take such steps as would be taken by a reasonably diligent person having both:

- the general knowledge, skill and experience that may be reasonably expected of a person carrying out the same

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functions as are carried out by that director in relation to the company; and

- the general knowledge, skill and experience that that director has.

What might constitute a breach of a director's duty of care in one case, may not be so in another and therefore each case must be considered on its own facts and in light of factors such as the nature of the business, the manner in which work is distributed between directors and the company's other officials, any attendant regulatory regime and the economic climate in which the company is operating.

Care, broadly, means 'with some attention to detail'. A director must display reasonable care which an ordinary man might be expected to take in the circumstances on his own behalf, but not all possible care. A director is not liable for mere errors of judgment because a court will not undo decisions taken by directors in good faith in what they honestly consider to be the best commercial interests of the company.

Diligence means 'applying oneself scrupulously to the relevant matter'. This means that so long as a director holds office and is remunerated for that office, he must keep abreast of its financial affairs and play a suitable role in its management. It will depend on the facts of the case as to how much time a non-executive director should devote to the company. If he is appointed to his post because of his particular skill, he must apply that skill pursuant to the subjective test below.

Skill means 'competence' and is both objectively and subjectively analysed:

- Is the director's conduct comparable with that which may reasonably be expected of a person carrying out the same functions as those carried out by the director in relation to the company? If the conduct does not meet this standard, objectively determined, then the director will have breached the duty. This test imposes a minimum standard of care expected of all directors which cannot be reduced by reference to a particular director's general knowledge, skill and experience.
- It is then necessary to have regard to that particular director's general knowledge, skill and experience. If he has greater knowledge, skill and experience than might ordinarily be expected of someone carrying out the same functions that he does in respect of the company, a higher standard of conduct may be required of him. Similarly, if he has particular qualifications, more will be expected of him accordingly.

The beneficiaries of directors' duties

As an overriding principle, a director owes the above duties to the company alone. Only the company can enforce any shortfall in those duties. Directors are liable to the company for loss to the company and not more widely. During solvent times the interests of the company are determined by reference to the interests of the shareholders (both present and future) as a general body.

In what circumstances could directors be liable to shareholders directly? Any fiduciary duties owed to shareholders do not necessarily arise as a result of those which the director owes to the company and which have been explained above. The most obvious special circumstance where a director may owe a fiduciary obligation directly to a shareholder is where, for example, he has been involved in negotiations for the takeover of a company's business and has supplied a shareholder with specific information and advice upon which a shareholder has relied. The director is bound by a fiduciary obligation in this example because of the position of responsibility he has to act on behalf of or for the benefit of that individual shareholder as a result of the special situation.

Therefore, a personal claim against a director may only be brought by a shareholder where he can demonstrate a breach of duty owed to him personally and that he has suffered loss personally on a distinct and independent basis to that suffered by the company.

The shareholder remedy for unfair prejudice under the Companies Law is also important for directors to consider because their direction and management of the company may form the basis of a shareholder's application for relief. This cause of action is based on the ground that (i) the affairs of the company are being or have been conducted in a manner that is unfairly prejudicial to the interests of the members generally or of some part of the members, or (ii) that an actual or proposed act of omission of the company (including an act or omission on its behalf) is or would be so prejudicial. The action can be brought by a minority shareholder. The conduct in question must be prejudicial to the interests of that shareholder and must be unfair. Further information about this specific form of shareholder action does not form the subject of this briefing note and can be obtained on request.

The question which can trouble directors, especially in terms of financial turmoil for many companies, is the point at which they should consider the interests of creditors.

Where a company is insolvent the directors must consider the interests of the creditors as paramount and take those interests into account when carrying out their duties. The duty is to the company and not to the creditors directly. Further, the duty may also apply when a company is at a real (not remote) risk of insolvency. Section 434(2) of the Companies Law states that a director of an insolvent company will be culpable of wrongful trading if at some time before the commencement of the winding up of the company, that director knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation at that time. In assessing whether that director knew or ought to have concluded that there was no reasonable prospect of avoiding insolvency, section 434(4) of the Companies Law states that the facts which a director of a company ought to know, the conclusions which he ought to reach and the steps which he ought to take are those which would be known, reached or

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taken by a reasonably diligent person having both:

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

There is, however, a safe harbour under the Companies Law. The Court will not make a declaration in respect of a director under section 434(2) if it is satisfied that on becoming aware of there being no reasonable prospect of the company going into insolvent liquidation, that director took every step with a view to minimising the potential loss to the company's creditors that he ought reasonably to have taken.

A strict interpretation of section 434(2) of the Companies Law would mean that the directors of a company can only be liable to contribute to the assets of that company once it is in insolvent liquidation. It can be quite difficult even then for a liquidator to prove the circumstances of section 434(2) and thereby to render a director liable for wrongful trading. We consider that a diligent director should use section 434(2) as a guide as to how to proceed before the company enters into insolvent liquidation and specifically, at such time when it becomes clear that there may no longer be any reasonable prospect of an amelioration in the trading conditions of the company such that an insolvent liquidation becomes, in effect, inevitable. This is because the risk of a director becoming liable for wrongful trading is triggered as soon as he knows or ought to conclude that there is no reasonable prospect of the company avoiding insolvent liquidation.

Consequently, the almost routine application of the solvency test contained in the Companies Law as part of directors' deliberations in times of difficulty for many companies, will be evidence for directors to adduce in refuting claims pursuant to section 434(2), even though the Companies Law only technically requires its application in respect of significant transactions. As a consequence of such monitoring, directors will be better placed to take the action necessary to minimise loss to creditors in a timely fashion and to rely on the safe harbour provided by the Companies Law.

Other potential liabilities

The Companies Law contains many criminal penalties for misconduct in respect of (inter alia):

- the accuracy of declarations to the Registrar of Companies;
- accounts and auditors;
- disclosure of interests;
- issue of shares;
- the company's acquisition of its own shares; and
- making of dividends and distributions.

Additionally, the Companies Law prescribes situations where a director can incur civil penalties in the form of personal liability to third parties, for example, fraudulent trading, where the business of the company was carried out by any knowing person with an intention of defrauding creditors. The penalties for fraudulent trading are both criminal and civil in that the Court can order the director to contribute to the assets of the company.

We have not in this briefing note considered contractual mechanisms whereby directors may be rendered personally liable for the obligations of a company e.g. personal guarantees, whereby the directors have personally guaranteed a loan to the company and the company defaults under the terms of the loan. Carey Olsen would be happy to provide advice to directors in this regard on a case by case basis.

Contractual protection

Insurance and indemnity provisions are primarily sought by directors to cover the costs of defending legal proceedings brought against them personally in connection with their duties as directors of the company. Claims against directors may be brought by a company, individual shareholders (by way of an unfair prejudice claim), a group action or f the relevant company begins to enter a period of severe financial difficulty, an insolvency practitioner charged with managing the affairs of the company. There may also be the possibility of a form of derivative action by a shareholder. As litigation can be a protracted and expensive process, the extent of a director's liability becomes increasingly significant as they will be personally liable for the cost. If a director is seeking to rely on an indemnity from a company in insolvent liquidation, the ability of the company to meet that covenant will be very dubious.

Limitations on liabilities

The Companies Law precludes a company from exempting a director from any liabilityin connection with negligence, default, breach of duty or breach of trustin relation to the company. Guernsey companies are best advised toreview their memorandum and articles of incorporation, and any serviceor other agreements to ensure that any exculpation provisions includedare valid and if not compliant with the Companies Law, are duly updated.

Indemnities given by a company in favour of a director

A company cannot indemnify a director of a company or an associated company from liability in connection with negligence, default, breach of duty or breach of trust in relation to the company of which he is a director.

However, a company or associated company may purchase insurance to cover directors' liability for negligence, default, breach of duty or breach of trust in relation to the company. On account of the limitations surrounding the granting of indemnities by the company in respect of a director's liability to it, and the limitations in respect of indemnities in favour of directors in respect of liabilities to third parties, insurance is perhaps the only reliable resource for a director of an insolvent company. However, many policies will not cover legal fees until the claim has been concluded, which can leave directors with difficult cash flow positions in defending themselves.

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Further, a director may receive a qualifying third party indemnity from the company (covering them against liabilities to persons other than the company or an associated company) so long as the liability does not relate to:

- any liability of a director to pay a fine imposed in criminal proceedings;
- any sum payable to a regulatory authority by way of penalty in respect of non-compliance with regulatory requirements;
- any liability incurred in unsuccessfully defending criminal or civil proceedings; or
- any liability incurred to a director following an unsuccessful application for relief by the Court.

Ratification of certain acts of directors by shareholders

Given the potential implications of denying directors a right of exemption from liability or indemnification from the company in respect of conduct amounting to negligence, default, breach of duty or breach of trust in relation to the company, the Companies Law allows shareholders to ratify such conduct of a director by ordinary resolution. The memorandum or articles of incorporation of a company may increase the majority required to pass a ratification resolution. Shareholders who are "interested" in the ratification resolution are not eligible members for the purposes of the vote.

Ratification under the Companies Law encompasses conduct by directors who have exceeded their powers, although interested shareholders are not precluded from voting in respect of such ratification resolutions. Once a decision of ratification has been passed, and for so long as the decision subsists, the relevant director's or directors' misconduct is cured and there remains no cause of action in respect of which a company could litigate. However, given that decisions of companies are subject to change, directors should also consider obtaining instruments of release or compromise agreements contemporaneously with ratification resolutions to obtain enduring waivers and releases of claims.

FIND US

PO Box 98
Carey House
Les Banques
St Peter Port
Guernsey GY1 4BZ
Channel Islands

T +44 (0)1481 727272
F +44 (0)1481 711052
E guernsey@careyolsen.com

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Visit our corporate team at careyolsen.com

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