

General

Directors owe a fiduciary duty to the company of which they are a director. In addition, a director also owes a duty of skill and care to the company. These duties were originally laid down at common law, although now in the UK many of them have been codified in the Companies Act 2006. However, in Gibraltar they continue to be defined by common law (i.e. by case law and precedent).

Fiduciary Duties

A director owes a fiduciary duty towards the company to act honestly and in good faith, in the best interest of the company and to use the powers granted to him for the purposes for which they were conferred. This includes a duty to take proper care of the assets of the company, not to make a personal profit (unless permitted in the Articles or approved or ratified by the company) to avoid conflicts with the company and not to compete with the company.

However, these fiduciary duties may be modified by

- Contractual techniques. Such techniques modify fiduciary duties by agreement; for example, through trade custom, the use of exclusion clauses or duty defining provisions and by disclosure and consent.
- Structural techniques. These techniques are used to organise a firm in such a way as to prevent breaches arising; for example, the separation of functions, independence policies, stop and watch lists and Chinese walls.

None of these methods can completely avoid the potential for conflicts to arise and some will not be appropriate in the context of directorships.

Duty of Skill and Care

Case law has recently modified the directors' duty to exercise care, skill and due diligence with regard to the performance of his duties. As now determined, the duties of a director must be exercised by a reasonably diligent person with both:

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

So the "hypothetical director" sets the lowest acceptable standard but the actual director's attributes can raise the bar above those standards. Thus, for example, a director who was also an investment banker would be expected to exercise a higher duty of skill and care with regard to the investments of the company than a director who was not an investment banker and did not have similar experience.

UK Developments

The UK has codified the duties of a director in the Companies Act 2006. These are now:

- *To promote the success of the company for the benefit of its members* - this replaces the common law formulation of the "best interests of the company". In considering the success of the company, the directors must have regard, inter alia, to
 - the likely consequence of any decision in the long term;
 - the interests of the employees
 - the need to foster the company's business relationships with customers, suppliers and others;
 - the impact of the company's operations on the community and the environment;
 - the desirability of maintaining a reputation for high standards of business conduct;
 - the need to act fairly between members of the company.
- *To exercise reasonable care, skill and diligence* - this reflects recent case law.
- *To act within the powers conferred by the company's constitution* - this reflects current case law.
- *To exercise independent judgment* - this reflects current case law.
- *To avoid conflicts of interest* - this board is able to ratify any conflict but private companies must not have anything in their articles preventing this. Public companies need express authorisation to be able to do so. However, the provision also requires a director to avoid situations which "may conflict" which could make multiple directorships difficult, especially if they are in the same area of business. The "safe harbour" of ratification by the board is thus very important.
- *Not to benefit from a third party* - this could impact on hospitality and gifts.
- *To declare an interest in a proposed transaction if one exists.*

Liability of a Director

The courts have generally held that directors are not guarantors of a company's success. The obligation of a director is to act in the way that he reasonably considers (not what a court may consider) likely to promote the success of the company for the benefit of its members as a whole. Courts have acknowledged that directors are in control of an entrepreneurial venture and that a degree of commercial risk taking is a necessary part of earning a sufficient return on the capital invested. It has also long been accepted that directors are not liable for mere errors of judgment; nor will a director be disqualified from holding office on the grounds of ordinary commercial misjudgement.

To the extent that a director is in breach of his fiduciary and general duties, those duties are owed to the company so shareholders and third parties will normally not have an action against the individual directors (the rule in *Foss v Harbottle*). This rule was confirmed in *Prudential Assurance Co. Limited v Newman Industries Limited (No 2)* and is often referred to as the rule against "reflective loss". That is a shareholder may not recover a sum equal to the diminution in the market value of his shares caused by the breach of duty by the directors as the "loss" is merely reflective of that suffered by the company. However, there are a couple of exceptions to the rule. Firstly a shareholder may sue where he has a cause of action and the company has no cause of action to do so. This is particularly the case where the loss would otherwise be irrecoverable as a result of the defendant's actions preventing the company from making the claim and so allowing the defendant to escape liability. Secondly, a shareholder may sue if he suffers a separate and independent loss from that suffered by the company as a result of a breach of a separate fiduciary duty owed to the shareholder independent to that owed to the company.

While a court may relieve directors from liability if they acted honestly and reasonably, it will only do so if it thinks they ought reasonably to be excused. Prudent directors will therefore take every reasonable step to prevent liability arising in the first place. The holding of regular board and other management meetings and reviews, accompanied by clear minutes have proved in practice to be the best evidence of the steps the directors took and why.

The Companies Act of Gibraltar (s204) makes any indemnity given by a company in respect of the liabilities incurred by its directors void to the extent that it relates to any negligence, default, breach of duty or breach of trust provided that it may indemnify him in respect of defending such proceedings to the extent he is found not guilty or the court otherwise orders.

Specific Scenarios

Let us consider three different scenarios where companies have moneys under investment and to consider whether the different procedures under which they operate increase the exposure of the persons or entities acting as directors.

Scenario 1 - Discretionary portfolios

Where the directors have given authorisation to a bank or asset manager to use their discretion as to what securities to hold by considering pre-agreed criteria and adhering to an investment profile mandate detailing issues such as risk appetite, security preferences, preferred base currency, income requirements, investment restrictions, time horizons etc etc. If the directors, appoint their own investment adviser and regular supervisory reports on the asset managers prove that the directors, are in control and able to make quick decisions in times of market volatility, will they be fully protected in these circumstances?

It would appear that the company has given discretion to, and entered into a fiduciary relationship with, the bank or asset manager. Provided the Memorandum & Articles of Association of the Company allow such delegation and the directors exercise reasonable care, skill and diligence in selecting the advisor and the pre-agreed criteria and investment portfolio, then that would seem to be in order.

However, the directors continue to have a duty to monitor the performance of the bank or asset manager to ensure that it complies with the pre-agreed criteria and investment profile, and also to ensure that such criteria and profile continue to remain appropriate in the then prevailing circumstances. If the directors appoint another investment advisor to assist them with this task, this would again, seem appropriate although the ultimate responsibility still lies with the directors. They would therefore need to review the reports of the second investment advisor and could not just leave things in the hands of that adviser. The directors would also need to respond appropriately to any advice given by the second adviser. However, any such arrangement should be reviewed in the context of the mandate given to the first advisor to ensure that there were no conflicts. It would seem that in circumstances such as these, provided they acted as indicated, the directors were behaving in an appropriate manner.

Scenario 2 - Advisory and execution only portfolios.

Where the ultimate beneficial shareholder receives advice from the bank or asset manager and in turn makes recommendations to the directors but where the ultimate beneficial shareholder has no official capacity in the company as an investment manager or similar. Potentially, and as seen recently in other jurisdictions, the ultimate beneficial shareholder may sue the directors for improperly researched investment decisions even when he/she has made the recommendations to the directors. What are the director's liabilities? Would they differ if the ultimate beneficial shareholder were to be appointed as Investment Advisor to the Company?

Even in these circumstances, the Directors should have a clear idea as to what the investment profile of the company is with regard to risk appetite, income requirements and so on and the directors should be ensuring that the advice from the adviser fell within the required criteria. Part of the fiduciary duty owed by a director to the Company is to exercise independent judgment. Whilst this does not prevent the taking of advice, the slavish following of advice is not acceptable. Therefore, in circumstances such as these, where the company has not given a discretionary mandate to an appropriate investment advisor and the directors are making the decisions themselves, following the advice of the ultimate beneficial shareholder without the directors giving any consideration as to whether that advice is appropriate in the circumstances and falls within the required criteria, would, in the authors' opinion, leave the directors exposed for not performing their duty.

Also, in the circumstances described, it would appear that the person giving the actual advice (the bank) is one step removed from the company and therefore the company may not have any claim against the bank if it followed the advice which turned out to be negligent as it was not the banks' client. Continuing to act on "advice once removed" could expose the directors to liability. The directors should therefore be ensuring that any advice is given directly to the company by the bank with the contractual relationship between these two entities. It could then be reviewed with the ultimate beneficial shareholder, taking his advice as to whether the company should follow the advice of the bank; although it would remain the ultimate responsibility of the directors and so the directors could not slavishly follow what the ultimate beneficial shareholder said and still need to exercise their own judgment. It would depend upon the relationship between the bank and the company as to whether it was appropriate in the circumstances for the secondary investment adviser also to be appointed to assist the directors. For example, does the bank owe a fiduciary obligation to the company to provide the best advice? Or is it only offering its own "in-house" products? In the latter case, a second adviser may be worthwhile.

Unless the ultimate beneficial shareholder has particular investment advisory skills upon which it would be reasonable for the directors to rely, it is unlikely that appointing him as an investment advisor to the company would particularly change the situation and remove the responsibility from the directors.

However, if the ultimate beneficial shareholder does have the necessary relevant experience, for example, he is or was a banker who is/was involved in investments, then it may be reasonable for the directors to rely on his advice and appoint him as an adviser to the company. The contract with him should specifically state that he represents and warrants to the company that he has the appropriate expertise to give such advice. Notwithstanding this, it would still be appropriate to have a contract between the bank and the company for the reasons outlined above and for the adviser to advise on the suggestions of the bank. Although, even in these circumstances, the ultimate responsibility still lies with the directors.

Scenario 3 - Similar to 2, but with a significant variance.

The ultimate beneficial shareholder (or another 3rd party) is authorised to trade directly with the bank or asset manager and the directors receive regular statements/valuations in the post. What are our liabilities if the ultimate beneficial shareholder (or 3rd party) has been appointed as investment manager to the Company and also when he/she has no official capacity in the Company.

This is really not an acceptable position for the directors. They appear to be completely delegating authority to someone who has no official capacity in the company. In fact, such a person appears to have no actual or ostensible authority to bind the company or to be making decisions on its behalf. Receiving regular statements/valuations in the post is not an acceptable performance of their duties by the directors. It is not a case of the Directors slavishly following the advice of someone without considering that advice, they are not even having any input at all in the process. Even if they have hand down any investment criteria, they are doing nothing to ensure that any investments fall within them. This is a complete negation of their duties. Even if the ultimate beneficial shareholder is appointed as an investment advisor, unless he has particular skills in that field so it would be reasonable for the directors to rely on his advice and a proper contractual delegation has been made and a mandate given to him along with investment criteria guidelines (along the lines of scenario 1), it would not make the position any better.

Conclusion

In conclusion, with regard to the specific scenarios outlined, the circumstances set out in scenario 1 would appear to be acceptable provided some basic rules are followed. With a restructuring of the relationship with the bank to make it directly between the company and the bank, scenario 2 would also appear to be a workable scenario; again provided certain basic rules are followed. Without that restructuring there must be some questions as to whether the directors are performing their duties properly by accepting advice from the adviser when they know it is actually coming from the bank but by doing so they are reducing the ability of the company to claim against the bank if it gives negligent advice. Even if the adviser has some experience, he will not have the deep pockets of the bank.

What is not acceptable is scenario 3, unless the ultimate beneficial shareholder is also an experienced investment adviser upon whom it would be reasonable for the directors to rely; although in such a case the arrangement should fall into scenario 1. However, again, unless the adviser is actually providing the advice himself, do the directors want to deny the company the benefit of a direct relationship with the bank?

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