

NON-EXECUTIVE DIRECTORS

Liabilities and Risk Management

INTRODUCTION

Directors are under ever-escalating legal and regulatory pressures. Changes to worldwide securities and corporate governance regulations as a result of corporate scandals and heightened stakeholder awareness make being a director increasingly risky. In this more litigious climate, directors face potential claims from security holders, regulators and liquidators, amongst others, as well as from their own companies.

There is no legal distinction between executive and non-executive directors: all directors are subject to the same duties and liabilities. It is vital for all directors to understand the nature of these duties in the specific context of those companies of which they are a director, to evaluate the risk areas particularly applicable to those companies and to have in place their own personal risk management strategy.

In the rapidly expanding corporate governance arena, in particular, more and more emphasis is being placed on the distinct role and responsibilities of non-executive directors (NEDs). The purpose of this note is to look at the unique position of NEDs against the backdrop of directors' duties and the changing corporate governance landscape and to consider measures which can be taken to minimise their personal exposure to the risks and

stresses of litigation, fines and legal costs, as well as to reputational and career damage.

The focus of this note is on UK listed companies, although it may also be helpful to NEDs of other companies.

DIRECTORS' DUTIES

The Companies Act 2006 now codifies many general directors' duties, including duties to exercise independent judgment, to exercise all reasonable care and skill and to promote the success of the company for the benefit of all its shareholders, with regard to long-term and wider factors such as employees, the environment, suppliers and customers (the so-called concept of "enlightened shareholder value"). This Act also introduced a statutory right for shareholders to sue directors in the name of their companies for breach of duty.

More generally, statutory duties giving rise to personal civil and criminal liability for directors are mounting and directors of listed companies are subject to fines and public censure for contravention of the Listing Rules and other regulations. Developing awareness of corporate social responsibility issues can also subject directors to greater scrutiny, with those concerned seeking new ways to obtain redress in the media and the courts. Directors have to deal with unintended inconsistency between

regulations, such as the tension between the altruistic behaviour encouraged by the CSR lobby and the restrictions imposed by the new UK anti-bribery laws. The distinction in general and high level terms is obvious, but the devil lies in the detail.

THE ROLE OF NEDS UNDER THE UK CORPORATE GOVERNANCE CODE

The new benchmark for good governance of listed companies is the [UK Corporate Governance Code](#), although law and practice in this area is constantly developing and there is a whole raft of other rules, requirements, guidelines and guidance notes.

NEDs generally have less involvement in the company's affairs than executive directors, although they are expected to meet tough standards for the oversight of the governance of their companies. The Code emphasises the importance of NEDs, particularly independent NEDs, whose role is to:

- constructively challenge and help develop proposals on strategy;
- scrutinise management performance in meeting agreed goals and objectives;
- be satisfied about the integrity of financial information and that financial controls and risk management systems are robust and defensible; and
- take a prime role in succession planning and the appointment and, where necessary, removal of other directors.

The Code also recognises that NEDs will usually assume greater importance in exceptional situations such as takeovers and transactions between the company and other directors. NEDs may also be given specific responsibility for the supervision and/or operation of special projects.

STANDARDS EXPECTED OF NEDS

The FRC's [Guidance on Board Effectiveness](#) states that NEDs have a responsibility to uphold high standards of integrity and probity and that they should support the chairman and executive directors in instilling the "appropriate culture, values and behaviours in the boardroom and beyond".

A key question for NEDs is just how far do their duties and responsibilities require them to go to monitor and probe the decisions and actions of executive directors. The law is unclear and the NED's position will depend on the facts of the case. The NED's role is not to second-guess management and the line between challenging the executives and letting them get on with the job can be difficult to draw. It is certainly true that total delegation

to, and reliance on, management will not absolve the NED from responsibility and that some independence of judgment and enquiry is required.

INSURANCE AND INDEMNIFICATION

In practice, if a claim is alleged against a director for any wrongdoing he has two main sources of protection:

- indemnification by the company; or
- assistance from the company's directors' and officers' (D&O) liability insurance policy.

NEDs should ensure that they are entitled to as broad an indemnity from the company as it is permitted by law to give, keeping in mind that there are significant limits. Most obviously, claims made by the company itself are excluded, as are criminal or regulatory fines and defence costs of successful proceedings or investigations. Insolvent companies cannot, of course, honour any indemnity.

D&O insurance can plug some of the gaps, but it also has its limitations. Insurance will not cover loss due to the director's own fraud or dishonesty, wilful default or criminal behaviour, for instance, and there may be other policy-related exclusions such as for securities offerings. NEDs should carefully check the terms of their companies' insurance, including policy limits. Ideally, they should ensure that there are additional ring-fenced limits solely for the benefit of NEDs, now a common extension of cover.

PRACTICAL STEPS FOR NEDS

Whether or not a director is ultimately held liable for claims made against him, defence costs can be prohibitively expensive and proceedings can sometimes take years to resolve. Even where a director is eventually cleared, the damage to his reputation and career can be severe.

So how can NEDs protect themselves from claims in the first place? A director cannot remove personal risk entirely, but the following suggestions, some from the [Guidance on Board Effectiveness](#) and some just common sense, may be helpful.

NEDs should:

- accept appointment only where they have sufficient time to devote to the role;
- dedicate as much time as necessary to develop and refresh their skills and knowledge and to be informed about the company, its sector and its markets;

- insist on a comprehensive induction to the company and its business, management, major shareholders and locations;
- ensure they receive continuing relevant training, including on their duties and responsibilities, good governance and investor relations;
- attend as many board and committee meetings as possible and make sure they receive high quality information sufficiently in advance;
- seek clarification when they are in doubt and raise matters of concern for board or management consideration;
- keep detailed records of their interaction with the board, staff and shareholders;
- obtain independent professional advice whenever they judge it necessary;
- familiarise themselves with the key risk areas of the company's activities and ensure there are formal compliance programmes and procedures in place, and that they are observed and regularly reviewed;
- ensure that major identified issues are investigated and dealt with;
- be willing to impress on executive directors the need, on occasion, to test their decisions against independent scrutiny;
- arrange or support independent monitoring and/or execution of major projects where external skills or experience would make a real difference; and
- take into account shareholders' and other stakeholders' views, which may provide different perspectives on the company and its performance.

Prior to accepting any appointment with a company, prospective non-executive directors should also undertake their own thorough examination of the company, to satisfy themselves that it is an organisation in which they can have confidence and in which they will be well suited to working. By making the right enquiries, a prospective director can reduce the risk of unwelcome surprises and dramatically increase the likelihood of success. Some helpful advice to prospective directors on the due diligence process and sample questions they should ask was published in May 2011 by The Institute of Chartered Secretaries (ICSA) in its Guidance Note "[Joining the right board – due diligence for prospective directors](#)".

There is no doubt that the risk/reward ratio for NEDs has changed in recent years, although there is now more need than ever for able NEDs. In the real world, most directors carry out their duties and make decisions conscientiously to the best of their abilities, taking professional advice when needed. Cases in the UK courts have shown that successfully establishing a case for breach of duty against a director is extremely difficult except in the clearest of circumstances and, importantly, it remains the position under UK law that courts are reluctant to interfere with board decisions taken in good faith simply because the court itself might have reached a different conclusion on the same facts. Ultimately, NEDs should not be unnecessarily deterred by personal liability issues from providing a public good through serving on the boards of listed companies.

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