McCann FitzGerald

Briefing
Non-Executive Directors:
Do Your Job or Pay the Price...

INSTITUTE OF DIRECTORS IN IRELAND

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The legislative expectations made of executive and non-executive directors are almost identical although, in corporate governance, the respective roles have evolved differently. While an executive director must be closely involved in the management and operations of a company, a non-executive director also has an important function in overseeing the company's affairs, systems and controls. This is in order to ensure that, as best as can be, the company is being operated lawfully and properly. A recent case in the UK highlights this.

Different, but not?

The Companies Act 2014 makes few distinctions between the roles of executive and non-executive ("NED") directors[1]. In the ***Tralee Beef and Lamb case*** (2008) the Supreme Court suggested that NEDs may have different (not necessarily lesser) duties to executive directors but offered little further guidance.

In insolvency situations, a director can be subject to a restriction order (making it difficult to act as director of other companies) unless a court is, amongst other criteria, satisfied that the director has acted honestly and responsibly. There is some evidence in cases on director restriction orders that Irish courts believe that a NED, having little involvement in operational matters in a company's business, is on the board to supervise the executive directors and the employees and has an oversight function in ensuring robustness of a company's systems and controls; to that extent the duties of an executive director and those of a NED may be applied differently.

1 Membership of a statutory audit committee is a rare exception, as section 167(4) of the Companies Act 2014 requires at least one member to be an independent non-executive director.

Further judicial guidance is required on the practical difference(s) of the respective duties imposed on NEDs and on executive directors. As mentioned, the 2014 Act does not generally make any distinction between the roles or between the fiduciary duties of directors of each type, as codified in the 2014 Act. Those fiduciary duties require every director to, amongst other matters, act honestly and responsibly in relation to the conduct of the affairs of the company and to exercise reasonable care, skill and diligence.

Words, and action

Although the law on disqualification of directors in the UK is not the same as the law in Ireland, the concept of a director acting responsibly is a feature common to both jurisdictions. Therefore the decision in a recent English case, S***ecretary of State for Business, Energy and Industrial Strategy v Selby*** (2021), are instructive: were the facts to occur in respect of an Irish company, it is likely that a restriction order (at the very least) would be made. The case makes it clear that a non-executive director must not only know her or his duties, but must also do enough to discharge those duties.

B was a NED and the chairperson of a private company. Prior to his appointment as director of this company, B had enjoyed a long and distinguished career in management. In the judge's view, B was a "distinguished city man".

At one stage the company had been destined for flotation. Instead, however, it went into insolvent liquidation when, between 2012 and 2013, it entered into 28 deals that were later adjudged to have been connected to a fraud on the UK Revenue ("HMRC"). When the Secretary of State sought to have B disqualified from acting as a director, the case focussed on B's competence and not his probity.

As B had understood it, his role in the company had been to leverage his contacts and reputation in order to expand the company by attracting investors (indeed, he spent the first two years getting to know the underlying business and deciding how he would profile the new company as an investment). B did not have any other role or involvement in the relevant company although he was a co-signatory on its bank accounts. B spent a day a month at the company's premises and saw management accounts from time to time and signed annual accounts on behalf of the board.

B claimed that, as a NED, he had not taken any active part in the day-to-day management but, rather, that he had delegated responsibility for the company's operations to his fellow directors (also founders of the company).

Findings of the Court

Case law on the duties of a director has established that a director must keep herself or himself informed about the company's affairs and join with co-directors in supervising and controlling them. However, this will not prevent:

- the sensible delegation or division of tasks as between directors, provided that the delegating director supervises the delegation. Proper delegation never involves 'abdication' of responsibility; nor
- a director from relying on the experience and expertise of colleagues, provided that there is no reason for suspicion about their integrity, skill, competence or resources to do the job. However, that reliance must be consistent with the discharge of express statutory duties.

The court found that, in failing to investigate an extraordinary uplift in the company's turnover and subsequently in failing to engage properly with HMRC once it had launched an investigation into the 28 controversial deals, B had abrogated his duties. He had ignored warning signs and 'red flags'.

Some of B's identified shortcomings were:

- *Failure to inform himself about the company's affairs*. B had been "blind as to what was actually happening". Until a meeting he attended with HMRC in 2013, he had been unaware of the 28 deals. Earlier that same year, he had signed the company's accounts for the period to 28 February 2013, which encompassed 27 of the controversial deals. The directors' report, which alluded to the expansion of the company's business (referring to "a number of experimental trial contracts relating to high volume waste water"), had been written by a founder director and B had assumed that these related to trials of some sort relating to the company's core business, rather than, as was the case, a new business.
- *Failure to investigate reasons for the surge in the company's turnover* (which B could see from the management accounts). This failure was regarded as a reprehensible abrogation of duty.

  B needed this information in order to protect the shareholders' investment; it would also inform his role in ensuring that the company was in a position to be taken to market in the then-proposed IPO. Moreover, B had known that he needed the information: that was the very reason why he had taken two years in which to familiarise himself with the underlying business before seeking investors for the new company. Indeed, in the judge's assessment, this was basic information which any NED would require in order to inform herself or himself as to how the business was being run by those to whom it had been delegated.

  Even if B's recollection that he had been told that the uplift in turnover was related to trials of some sort had been correct, in fulfilling his role he would still be bound to ask for details about those trials; to what product-areas they related; and how trials (which normally would be booked as an expense) had generated both large turnover and significant profit. The effort required on his part would have been minimal.

- *Failure to engage with HMRC once it had launched an investigation*. The judge was highly critical of B's serial failures to engage with HMRC, including meeting with HMRC only once during the period from 24 October 2013 until the company's liquidation and failing, even when aware of HMRC's concerns, to make sure that he saw relevant paperwork and thereafter to respond to correspondence from HMRC despite it having been addressed to him.

  It appears that B did not check or chase up what, if any, progress was being made, relying on others to sort it out. He continued to leave things to another person even when advised that that person was not providing HMRC with the required information. (B's reliance on the founders was so complete that, even after the UK's Insolvency Service outlined the disqualification case against him, B replied saying that a founder was dealing with it. Indeed, B decided to represent himself at the disqualification hearing).

Conclusions

It is recommended that every NED conducts due diligence on the relevant company before agreeing an appointment as director and that a formal letter of appointment is prepared to set out the precise role and time involvement that is expected of the NED. Every NED must understand her or his duties as a director, if necessary requesting training from the company's professional advisers.

A NED must have an enquiring mind as to the company's business and, in particular, must fully understand the reasons for any significant rapid increases in turnover or profits (asking questions, and getting satisfactory answers, where appropriate). 'Red flags' and alerts must not be ignored.

Delegation of tasks is permitted but such delegation requires supervision: delegation must never become 'abdication'. Taking the time to read board packs and to attend board meetings is critical in the oversight of the company's affairs, systems and controls in order to ensure, as best as can be, that the company is being operated lawfully and properly.

By these measures the risk of legal or other action against a NED will be minimised.

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