

# **CORPORATE GOVERNANCE AND KEY COMPANY LAW ISSUES IN CHALLENGING ECONOMIC TIMES**

## **INTRODUCTION**

Directors stand in a fiduciary relationship to the company and there are general fiduciary duties imposed upon them by the common law and statute. A director's duty is to the company and not to individual shareholders. Company law in Ireland places the burden of proof on a director to show that he acted reasonably.

The downturn in the economy means company directors are faced with new challenges including identifying new risks and ensuring there is a strategy in place to manage such risks.

The following note sets out who is a director, the duties of a director, the role of the Director of Corporate Enforcement and certain key issues for directors of Irish companies to be aware of.

### **1. WHO IS A DIRECTOR?**

Section 2(1) of the Companies Act 1963 defines a director as including "any person occupying the position of director by whatever name called".

#### **De facto directors**

A de facto director is a person who has not been formally appointed but who in effect acts as if he were a director. De facto directors are included in the definition of director in section 2(1) of the Companies Act 1963 (above).

#### **Shadow directors**

A shadow director is someone who has not been formally appointed but in accordance with whose directions or instructions the directors of the company are accustomed to act. It is important to note that persons advising the Company in a professional capacity will not be deemed to be shadow directors.

#### **Nominee directors**

A nominee director is one who is expected to act in accordance with some understanding or arrangement which creates an obligation or expectation of loyalty to some person other than the Company. The Companies Acts, 1963 to 2006 (the "Companies Acts") do not provide for nominee directors. While there is some case law that allows nominee directors to have some regard to the interests of their nominators, it is clear that a director's primary duty is to the company.

If a director states that he or she is a nominee director, it can be argued that the person for whom they are nominee is either a de facto director or a shadow director.

### **Executive and non-executive directors**

The difference between executive and non-executive directors arises from the fact that an executive director will also be an employee of the company whereas a non-executive director is not employed by the company. Non-executive directors are frequently people from outside the company who have a special expertise or experience which may be valuable to the rest of the directors.

The Companies Acts do not make any distinction between executive directors and non-executive directors. In the recent Supreme Court judgement in an appeal against an order restricting Simon Coyle as a director of Tralee Beef and Lamb Limited (In Liquidation), the Supreme Court recognised a distinction between the nature and extent of a non-executive director's responsibility and that of an executive director. However, the Supreme Court held that a non-executive director has an overriding duty to supervise and control the affairs of the Company.

## **2. DIRECTORS' DUTIES**

Directors have a fiduciary duty which arises from being in a position of trust. These duties are primarily owed to the company itself. Directors' duties arise from both common law and statute.

### **DIRECTORS' DUTIES UNDER COMMON LAW**

The common law duties of directors have developed from the body of law which has arisen through judges' decisions in court cases. The fiduciary duties of directors at common law can be summarised as follows:

- (a) Directors must exercise their powers in good faith and in the interests of the company as a whole.

This duty places a duty to act in the interests of the company as a separate legal entity.

- (b) Directors are not allowed to make an undisclosed or secret profit from their position as directors. Directors must account for any secret profit which they have made from their role as director.

This common law duty precludes a director from benefiting where their personal interests and duty as a director conflict.

- (c) Directors are obliged to carry out their duties using due care, skill and diligence.

A subjective test is applied in relation to the care, skill and diligence required. The level required is that care, skill and diligence which would be exercised in the same circumstances as a reasonable person having the knowledge and experience that may reasonably be expected of such a person in the same position as the director.

### **DIRECTORS' DUTIES UNDER STATUTE**

Directors' duties under statute arise principally under the Companies Acts and also under other related legislation (EU Regulations etc.). Directors' duties also arise under other legislation relating to the conduct of business in general for example employment law, health and safety law or other sectoral regulation relating to the particular business of the companies concerned.

The Office of the Director of Corporate Enforcement lists the principal duties of directors which arise under statute as follows:

- (a) Duty to maintain proper books of account;
- (b) Duty to prepare annual accounts;
- (c) Duty to have an annual audit performed;
- (d) Duty to maintain certain registers and other documents;
- (e) Duty to file certain documents in the Companies Registration Office;
- (f) Duty to convene general meetings of the shareholders;
- (g) Duty to comply with Companies Acts rules on dealings between company and director; and
- (h) Duty to creditors during insolvency.

### **3. DIRECTOR OF CORPORATE ENFORCEMENT**

Under the Corporate Law Enforcement Act, 2001, the Office of the Director of Corporate Enforcement was established with the specific role of supervising compliance with Irish company law.

The functions of the Director of Corporate Enforcement (the "Director") are as follows:

- (a) to enforce the Companies Acts;

- (b) to encourage compliance with the Companies Acts;
- (c) to investigate suspected offences under the Companies Acts;
- (d) to refer cases to the Director of Public Prosecutions where the Director has reasonable grounds for believing that an indictable offence has been committed under the Companies Acts;
- (e) to supervise liquidators and receivers in the discharge of their functions under the Companies Acts;
- (f) to perform such other functions in respect of any matters to which the Companies Acts relate as the Minister for Enterprise, Trade and Employment considers appropriate and may by order confer on the Director;
- (g) to act as a member of the Irish Auditing and Accounting Supervisory Authority.

The Director has the power to investigate the affairs of a company in certain circumstances which suggest fraud or other illegality.

The investigation may be in the form of an investigation by an inspector appointed by the High Court at the request of the Director; or

- (a) the Director may directly appoint an inspector to establish the beneficial ownership of shares or debentures of a company; or
- (b) the Director may conduct a private examination of the company's books and records.

The Director also has the power to:

- (a) demand that the company's books and records be produced for examination;
- (b) require directors and other persons to explain the company's books and to answer any questions which he might have; and
- (c) obtain relevant documents from third parties to assist his investigation.

The Director has considerable powers under the 2001 Act in relation to the winding up of companies. In official liquidations, the Director's powers include the following:

- (a) the right to inspect the company's books and papers;
- (b) the right to apply to the High Court for the examination of persons believed to be indebted to the company, or holding any of its property, or in possession of information relating to the affairs of the company;
- (c) the power to enforce an order made by the Court for payment of his costs and expenses by means of search and seizure; and
- (d) the power to bring an application for the arrest of an absconding contributory or officer of the company and the detention of his/her property.

In respect of voluntary liquidations, the Director is given certain new powers similar to those which apply in the case of official liquidations, such as:

- (a) a right to apply to the Court for an order permitting inspection and copying of the company's papers; and
- (b) a right to apply to the Court for the examination on oath of persons believed to be indebted to the company, or holding any of its property or in possession of information relating to the affairs of the company.

In the case of both voluntary and official liquidations, any instance of suspected criminal behaviour discovered by a liquidator must be reported to the Director of Corporate Enforcement as well as to the Director of Public Prosecutions.

### **Directors — Restriction and Disqualification**

Liquidators of insolvent companies are now required to apply to the High Court for the restriction of the directors of such companies, unless exempted from doing so by the Director on the basis that they acted honestly and responsibly.

The Director may apply to the High Court to have a director disqualified from acting for a period of five years as a director of a company or acting in support of any company where they have shown by their actions that they are not suitable to be involved in the management or promotion of a company, for example:

- (a) a company in which they are involved being struck off the Register of Companies for failure to file all outstanding annual returns;
- (b) three or more convictions for failing to comply with company law over a five-year period; or
- (c) two or more offences of failing to keep proper books of account.

### **Unliquidated insolvent companies**

Directors of unliquidated insolvent companies may also be restricted. The Director has extensive powers in relation to unliquidated insolvent companies. He has the power to invoke many of the provisions that apply to official liquidations to unliquidated insolvent companies including the power to seek to have the Court assess damages against the company directors and other officers where company property has been misapplied or retained or the property has been misapplied or retained or the individual has been guilty of a breach of duty of trust in relation to the company.

## **4. KEY ISSUES FOR DIRECTORS OF COMPANIES IN FINANCIAL DIFFICULTIES AND HOW BEST TO MANAGE THEM**

As discussed above, when a company enters into insolvent liquidation, the liquidator is obliged to investigate the conduct of the directors of the company and report his findings to the Director of Corporate Enforcement. Unless the Director of Corporate Enforcement relieves him of his obligation, the liquidator must apply to the High Court seeking

declarations of restriction against all individuals who were directors of the company within twelve months of the date of liquidation.

## **1. RESPONSIBILITIES AND DUTIES IN PARTICULAR WHEN A COMPANY IS FACING INSOLVENCY**

In order to defend an application for restriction, a director must be able to show that he acted honestly and responsibly in relation to the affairs of the company during his entire tenure as a director of that company.

**Below are some general suggestions for directors who wish to ensure that they would be able to demonstrate that they acted honestly and responsibly:-**

- Ensure that the company is maintaining proper books and records and that all annual returns and Revenue returns are made up to date.
- Attend all board meetings and ensure that attendance and any contribution to the meeting is duly noted.
- Ensure board packs are received in advance of meetings.
- If board meetings are not being held on a regular basis, a non-executive director should write to the executive directors seeking explanations and if unsatisfactory responses are received, pursue the matter in writing until it is resolved. Any reasons offered for lack of board meetings should be considered carefully
- Maintain and document all contact with fellow directors on an on-going basis.
- Ensure up to date and accurate financial information is being received on a regular basis.
- Obtain legal advice prior to sanctioning any significant transactions.
- Certain functions may be delegated to other individuals but a director remains under a duty to supervise that delegation.
- Every director is deemed to know and appreciate the distinction between the company as a separate legal person and themselves. Therefore, all company property, in particular company funds, must be kept separate and distinct.
- With regard to international group companies, a director is under a duty to inform himself about the affairs of the Irish subsidiary as opposed to the group as a whole, even if his decision making discretion is minimal regarding the Irish subsidiary.
- If the company generates significant cash transactions ensure the records and systems are sufficient to ensure it is possible to track those cash receipts through the records of the company.

- A non-executive director in a company with just two directors may be required to show a greater level of supervision than in a large company with several directors.
- On resignation, ensure resignation is duly notified to the Companies Registration Office.

**If the company is encountering financial difficulties, directors should:-**

- Obtain financial and legal advice as soon as possible.
- Avoid taking on new debt.
- Ensure that selective payment of the liabilities of the company is avoided.

**2. WHEN IS A DIRECTOR PERSONALLY LIABLE?**

Where a company is insolvent, its directors can be held personally liable (without limitation) for a company's debts if found liable for reckless trading<sup>1</sup> or fraudulent trading<sup>2</sup>.

Reckless trading is defined in the Companies Acts as an officer of the company who was 'knowingly a party to the carrying on of any business of the company in a reckless manner'.

The test for recklessness is an objective one and applies as follows:

- (a) where a person was a party to the carrying on of the business and having regard to the general knowledge, skill and experience that may reasonably be expected of a person in his position, he ought to have known that his actions or those of the company would cause loss to the creditors of the company or any of them; or
- (b) he was a party to the contracting of a debt by the company and did not honestly believe on reasonable grounds that the company would be able to pay the debt when it fell due for payment as well as all its other debts (taking into account the contingent and prospective liabilities).

Fraudulent trading is defined in the Companies Acts as arising 'where a person is knowingly a party to the carrying on of a business with intent to defraud creditors of the company, or creditors of any other person or for any fraudulent purpose, that person shall be guilty of an offence'.

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<sup>1</sup> Section 297A Companies Act, 1963 (as inserted by Section 138, Companies Act, 1990)

<sup>2</sup> Ibid.

Where a company is in liquidation, the directors are under a duty to co-operate with the liquidator. If a director of an insolvent company fails to satisfy the High Court that they acted honestly and responsibly, they will be restricted for up to a period of five years.<sup>3</sup>

Such a restriction prevents a person from being a director or secretary or being involved in the formation or promotion of any company unless it is adequately capitalised. In the case of a private company, the capital requirement is €63,487 in allotted paid up share capital and in the case of a public company, €317,435. Such a company is also subject to stricter rules in relation to capital maintenance.

### **3. LOANS TO DIRECTORS AND SUBSTANTIAL COMPANY PROPERTY TRANSACTIONS WITH DIRECTORS**

#### **SECTION 31 OF THE COMPANIES ACT 1990 (“Section 31”)**

Section 31 sets out the prohibition on companies against the provision of loans, quasi-loans, credit transactions, guarantees and the provision of security in favour of directors and other relevant persons. This legislation was drafted to prevent company directors transferring company property to themselves and thereby abusing of the position of director to the detriment of the shareholders and creditors of the company. Section 31 does not prohibit directors from providing loans etc. to/for the benefit of the company.

Section 29 of the Companies Act 1990 provides a corresponding protection to creditors and shareholders in respect of substantial property transactions involving directors. If a director or connected person is acquiring a non-cash asset of the company of a certain value, then that transaction must be approved by an ordinary resolution of the company (excess of 50% of the votes in the company).

Less severe restrictions apply to Section 29 than Section 31. However, non-compliance can result in the transaction being voidable at the instance of the company (including a liquidator).

#### **ACTS PROHIBITED BY SECTION 31**

A company may not:

- make a loan or a quasi-loan to a director of a company or its holding company or to a person connected with such a director;
- enter into a credit transaction as creditor for such a director or person so connected;
- enter into a guarantee or grant security in connection with a loan, quasi-loan or credit transaction to any other person for such a director or a person so connected.

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<sup>3</sup> Section 150, Companies Act 1990



The prohibition in Section 31 only applies where a transaction is made for the benefit of the directors of the company or other related persons. The persons to whom Section 31 applies against are connected persons as defined in Section 26 of the Companies Act 1990 and set out above.

## **FIVE EXCEPTIONS TO SECTION 31**

There exist five exceptions to Section 31 which are as follows:

- **THE DE MINIMUS EXCEPTION**

Section 31 will not prohibit a company from entering into an arrangement with a director or person connected with a director if –

- a) the value of the arrangement, and
- b) the total amount outstanding under any other arrangements entered into by the company with any director of the company, or any person connected with a director

together, is less than 10% of the relevant assets. Relevant assets are the net assets of the company as per the last financial accounts (or called up share capital if newly incorporated and no accounts exist).

- **VALIDATION PROCEDURE**

Section 31 will not prohibit a company from entering into a guarantee or providing any security in connection with a loan, quasi loan or credit transaction made by any person for a director of the company or of its holding company or person connected with a director if approved by a special resolution of the company passed not more than 12 months previously.

A majority of directors must swear a statutory declaration that having made a full enquiry into the affairs of the company and that the company having entered into the transaction will be in a position to pay its debts in full as they fall due.

The statutory declaration must contain the circumstances of the guarantee or security, the nature of the guarantee or security, the person or persons to whom the loan, quasi-loan or credit transaction (in connection with which the guarantee is to be entered into or the security is to be provided), the purpose for which the company is entering into the guarantee or is providing the security. The statutory declaration must also contain an independent person's report which must state that the belief of the directors' is a reasonable one. The independent person may be the auditor of the company or someone qualified to be an auditor. In practice, it is difficult to obtain the independent person's report because the Institute of Chartered Accountants in Ireland recommend that its members do not provide such a report as it is potentially forward looking.

- **GROUP RELIEF**

Section 35 allows a company to enter into a loan, quasi-loan or credit transaction and to guarantee and give security in relation to loans to any company in the same group.

- **DIRECTOR'S EXPENSES**

Section 36(1) provides that Section 31 shall not prohibit a company from doing anything to provide any of its directors with funds to meet vouched expenditure properly incurred or to be incurred by him for the purposes of the company or the purpose of enabling him properly to perform his duties as an officer of the company or doing anything to enable any of its directors to avoid incurring such expenditure.

Any liability falling on any person arising from any such transaction shall be discharged by him within six months from the date on which it was incurred.

- **BUSINESS TRANSACTIONS**

Section 31 shall not prohibit a company from making any loan or quasi-loan or entering into any credit transaction as creditor for any person if –

- a) the company enters into the transaction concerned in the ordinary course of its business; and
- b) the value of the transaction is not greater, and the terms on which it is entered into are no more favourable, in respect of the person for whom the transaction is made, than that or those which—
  - (i) the company ordinarily offers, or
  - (ii) it is reasonable to expect the company to have offered,

to or in respect of a person of the same financial standing as that person but unconnected with the company.

### **CONSEQUENCES OF BREACH OF SECTION 31**

A breach of Section 31 is voidable at the instance of the company. This means that the company has the power to rescind the transaction. Any director or connected person shall be personally liable and is liable to account for any profit made or indemnify the company for any loss suffered.

In the event that the company becomes insolvent within 12 months of any of the above transactions occurring, the directors who authorised the transaction shall be personally liable without limitation.

Any company officer who permits or authorises the company to enter into a prohibited transaction or had reasonable cause to believe the company was entering into a prohibited transaction is guilty of a criminal offence. The maximum penalty under the Companies Acts is a fine not exceeding €12,697.38, imprisonment for a term not exceeding 5 years or both.

#### **MASON HAYES+CURRAN CONTACT DETAILS**

<b>Name</b>	<b>Direct Line</b>	<b>Email Address</b>
Gerard Ryan Partner	01 – 614 5004	gryan@mhc.ie
Dylan Latimer Solicitor	01 – 614 5834	dlatimer@mhc.ie

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