



Considerations for investor directors of distressed companies

Corporate briefing
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Private equity and venture capital investors frequently appoint directors to the boards of their portfolio companies in order to monitor their investment and to provide guidance and support to management. There will inevitably be tensions between the duties which an investor director owes to the investor which appointed him and the duties which he owes to the company. These tensions can develop into serious conflict situations when the company is in financial difficulties. The codification of director's duties by the Companies Act 2006 has caused investors to re-evaluate how they manage these conflicts, at a time when an increasing number of their portfolio companies are likely to be facing an uncertain future.

This note considers the risks for investor directors of companies on the verge of insolvency and the steps which should be taken to minimise the likelihood of claims against investor directors personally and damage to the reputation of the investor director and the appointing investor. This note also sets out some practical suggestions to assist investor directors in handling conflict situations which typically arise where the interests of the investor and the portfolio company diverge.

COMPANIES ACT DUTIES

The Companies Act 2006 sets out a raft of duties owed by directors (many of which are broadly similar to duties owed under the pre-existing common law). Potentially the most problematic of these duties from the point of an investor director are the following:

- a duty to act in a way which he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole;
- a duty to exercise independent judgment; and
- a duty to avoid a situation in which he has an interest or duty which conflicts with the interests of the company.

Director's duties are owed to the company. In the case of a solvent company, a claim against a director for breach of duty can therefore only be made by the company itself or, in certain circumstances, by one or more shareholders on behalf of a company (these are known as derivative actions).

A director may be held personally liable for a breach of duty, and he may also be disqualified from acting as a director in serious cases. Investor directors will typically have the benefit of an indemnity from the company for breaches of duty, and may also be insured for any breaches at company level (under a directors' & officers' policy), and possibly at fund level as well. However, avoiding legal liability is only part of the issue; an investor should also be aware of the



risk to its reputation associated with an allegation of breach of duty by an investor director and/or any accusation that the investor or its appointed director has behaved irresponsibly.

DISCHARGE OF DUTIES

It will generally be harder for a (non-executive) investor director than an executive director to discharge his director's duties because he will typically also be expected to play the role of investor representative. It should also be noted that directors have a general duty to exercise reasonable care, skill and diligence, and the relevant standard of care will be higher in the case of directors who have particular knowledge, skill and experience, such as financial expertise (which will often apply in the case of investor directors).

The situational conflicts which would typically apply to an investor director (such as having an economic interest in the performance of the relevant fund, being involved in the management of the fund, or being on the boards of other, potentially competitive, companies) and any other conflicts which arise from time to time will need to be authorised by the board or shareholders in accordance with the new Companies Act. It should be reasonably possible for an investor director to discharge his other directors' duties under normal circumstances; the interests of the investor and the company's interests will usually be well aligned, and an investor director ought to be able to exercise his judgment in an objective manner, provided that he remains vigilant of the risk of bias.

INTO THE RED ZONE

When a company becomes insolvent (either in the sense that it is unable to pay its debts as they fall due or on a balance sheet basis) there is a shift in directors' duties towards the company's creditors. Unfortunately it is not possible to determine with any certainty when this shift occurs, and it will depend upon the particular circumstances of each case. In addition to the Companies Act duties outlined above, when there is no reasonable prospect of the investee company avoiding insolvent liquidation, each director also has a duty to take every available step to minimise the loss to the company's creditors. Continuing to trade without properly discharging this duty constitutes wrongful trading (in addition to any other claims which may arise).

WHEN INTERESTS DIVERGE

The problems begin where there is a fundamental divergence of interest or opinion between the board of the company and the investor (or the investor group), and this situation frequently arises where the company is in financial trouble, for example:

- where the investor wishes to realise its investment by way of a pre-pack sale or a trade sale at a low valuation (possibly by invoking a drag-along provision), which may return little or nothing to ordinary shareholders; or
- where the company needs further investment to survive and the investor declines to follow on and/or the investor is unwilling to support the terms of a new investment from a third party.

Circumstances such as these will often set the investor on a collision course with management, and clearly this can place an investor director in a difficult position.



The simplest way for an investor director to avoid a serious conflict of interest in these circumstances is to resign (although he will continue to be accountable for any failure to discharge his duty to the company or the creditors up to the date of his resignation). Where an investor has observer rights, a former investor director or another investor representative could still attend board meetings and calls in order to monitor the business (although any observer should always take care not to put himself in a position where he may become a shadow director). However, it may not always be appropriate for the investor director to resign: negotiations with the company may be ongoing, and where there is still a chance of the investor realising significant value from its investment in the company it will usually want the investor director to remain on the board.

NEGOTIATING THE MINEFIELD

If an investor director chooses to stay on the board in the circumstances described above, he will need to take extra care to conduct himself in such a way as to avoid breaches of duty. There are a number of things an investor and the investor director can do to help the investor director manage potential conflict situations and generally fulfil his other duties:

- The investor director should keep in mind his ongoing duty to avoid conflict situations, and formally declare and seek authorisation for new situations which arise, or where the nature of an existing conflict situation changes.
- The investor director should review the company's articles of association to familiarise himself with any provisions dealing with the management of conflict situations. Well-drafted articles will typically contain provisions permitting a conflicted director to absent himself from board discussions in relation to conflict matters, and withhold information from the board which may be subject to a duty of confidentiality to someone else (e.g. the investor).
- The investor director should take care to maintain a clear distinction between board business and investor or shareholder discussions. This may sound obvious, but board calls and meetings can frequently stray into matters which are more appropriate for separate discussion between the board and investors or between investors; this is more likely to occur where more than one investor is represented on the board. The business discussed at board meetings and during board calls should therefore be restricted to matters relating to the operation of the business.
- If possible, the investor should arrange for a person other than the investor director to act as the investor's representative, and to handle any negotiations or discussions on behalf of the investor: this is important in maintaining a clear division between board business and shareholder business. Relieving an investor director of the task of being the investor's spokesperson allows him to concentrate on discharging his duties to the company, and will enable him to avoid becoming involved in awkward discussions relating e.g. to the investor's funding intentions. A separation of the roles of investor director and investor representative is good practice whether the company is in financial difficulty or not, but it is acknowledged that this may not always be practically possible.
- The investor and investor director should consider whether it is appropriate for the investor director to continue to participate in all discussions between the investor's principals or managers, or whether it would be preferable for him to absent himself from certain discussions (e.g. regarding continued funding). Again, this may not be practically possible



where the investor director is the only person with a detailed knowledge of the company and its situation.

- The investor director should continue to act in an honest and professional manner in all dealings with the other directors and shareholders. Bear in mind that (whilst the company is solvent) it is the company to whom directors' duties are owed, and it is therefore the board which will decide whether to bring an action against a particular director. An investor will also wish to avoid giving the board and other investors grounds for allegations of unreasonableness or unprofessional conduct against the investor or investor director which could damage their respective reputations.
- Where insolvent liquidation is unavoidable an investor may consider paying its share of the associated wind-up costs (or the costs of any other formal insolvency process the company enters into). As a shareholder an investor would have no obligation to meet any wind-up costs, but it may be beneficial for its reputation to do so. If a portfolio company goes into liquidation in circumstances where, for example, the company's employees have not been paid their salaries, this is likely to reflect poorly on the investor.

AVOIDING WRONGFUL TRADING CLAIMS

Where an investor director (or any other director) continues on the board of an insolvent, or potentially insolvent, company he will need to be mindful of his duty to minimise loss to the company's creditors. There are a number of practical steps directors can take to minimise the likelihood of wrongful trading claims (and reputational damage), as follows:

- Regularly review the company's financial and trading position. Use up to date accounts (including, if possible, daily trading accounts) and projections to assess whether the company is or is about to become, technically insolvent or at the point of wrongful trading.
- Hold regular board meetings to evaluate all options available to protect and improve the position of creditors. Keep good records of board decisions and the rationale for making them (which should focus on the interests of the creditors).
- Where a decision is made to continue trading, minimise costs and do not incur new credit unless it can be repaid.
- Where a restructuring/rescue is pursued, have a contingency plan in case it fails and decide when it should be implemented.
- Do not dispose of company assets for less than their true market value, and do not prefer any creditor over others without good justification.
- Seek professional advice from an insolvency practitioner. In addition to the benefit derived from such advice, it is also helpful for the directors to be able to demonstrate that they consulted an appropriate expert.

DUTIES OF INVESTOR DIRECTORS – FREQUENTLY ASKED QUESTIONS

How do the duties owed by a non-executive investor director differ to those owed by an executive director?

The duties owed by non-executive directors and executive directors are exactly the same. All directors also have a general duty to exercise reasonable care, skill and diligence, and the



relevant standard of care will be higher in the case of directors who have particular knowledge, skill and experience.

Who can claim against a director for a breach of duty?

Whilst the company remains solvent, and in the absence of any allegation of fraud, an action may only be brought by the company, or the shareholders by derivative action. Where the company is insolvent, the company's primary duties shift to the creditors. If the directors have breached those duties an administrator or liquidator may commence a claim against the directors personally.

What are the sanctions for breach of directors' duties?

Each of the statutory duties set out in the Companies Act is enforceable as a fiduciary duty, with the exception of the duty to exercise reasonable care skill and diligence. This means that a director in breach is potentially liable to the company not only for damages but also to restore the company's property or to account for any profits made. The transaction in question may in certain circumstances be voidable at the company's request (or, if an insolvency process has commenced, an administrator or a liquidator can pursue an antecedent transaction claim). The duty to exercise reasonable care, skill and diligence is not a fiduciary duty and therefore the only remedy is damages. Serious breaches of duty may result in a director being disqualified.

What should an investor director do if he becomes aware that he has or may have a conflict of interest in relation to the company?

Being in a conflict situation or in a situation which possibly may give rise to a conflict constitutes a breach of duty, and the director must declare his interests and seek authorisation of the conflict situation immediately.

What guidance is there for managing conflicts?

The company's articles will frequently provide some guidance on managing conflict situations, and may, for example, permit a director to absent himself from any discussions and to abstain from voting in relation to a matter where he has a conflict, and permit him to withhold certain information which is the subject of a duty of confidentiality in favour of someone else.

Must all conflicts be authorised?

Conflicts in relation to existing or proposed transactions or arrangements (e.g. a conflict of interest of an investor director in relation to a proposed follow-on investment by his appointing investor) do not require authorisation, but they must be declared. The articles will typically contain rules as to whether a director can vote in relation to proposed or existing transactions or arrangements.

What can I do to protect myself from any claims for breach of duty?

Investor directors should ensure that they have the benefit of an indemnity in respect of claims from the company. The company's articles will often contain indemnity provisions, and investor directors may also have the benefit of a separate indemnity letter or agreement. Directors' indemnities are subject to certain limitations set out in the Companies Act. Insurance is available in respect of claims, and a standard D&O policy will provide cover subject to certain limitations and exceptions. Many investors also carry their own separate insurance which covers investor directors.



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CLARITY MATTERS

CONTACT

Please talk to your usual Nabarro contact or

Ted Dewhurst, Senior Associate **T +44 (0)20 7524 6880** t.dewhurst@nabarro.com

London

Lacon House, 84 Theobald's Road,
London WC1X 8RW
T +44 (0)20 7524 6000
F +44 (0)20 7524 6524

Sheffield

1 South Quay, Victoria Quays,
Sheffield S2 5SY
T +44 (0)114 279 4000
F +44 (0)114 278 6123

Brussels

209A Avenue Louise,
1050 Brussels, Belgium
T +32 2 626 0740
F +32 2 626 0749

Alliance firms:

France August & Debouzy
Gilles August
T +33 (0)1 45 61 51 80
www.august-debouzy.com

Germany GSK Stockmann & Kollegen
Rainer Stockmann
T +49 (30) 20 39 07 - 0
www.gsk.de

Italy Nunziante Magrone
Gianmatteo Nunziante
T +39 06 695181
www.nunziantemagrone.it

Spain Rodés & Sala
Gonzalo Rodés
T +34 932 413 740
www.rodessysala.com

Nabarro LLP

Registered office: Lacon House, 84 Theobald's Road, London, WC1X 8RW.

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