



KTI

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KTI Practical Guide

The Role of Directors & Observers



Foreword

The KTI Practical Guides have been produced as a resource for those approaching commercial arrangements relating to research and development involving Irish research performing organisations (RPOs)¹ and commercial companies, entrepreneurs and investors. The KTI Practical Guides are intended to explain common issues and the considerations that might apply.

The KTI Practical Guides, including those that relate to legal agreements supplemented by a suite of KTI Model Agreements, are available on the Knowledge Transfer Ireland website to download and use direct. Visit www.knowledgetransferireland.com/Model-Agreements

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This KTI Practical Guide to the Role of Directors and Observers was prepared for KTI by Ronan Daly Jermyn Solicitors (www.rdj.ie.)

¹ RPOs are considered to be Higher Education Institutes (Universities and Institutes of Technology) or State research organisations

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Introduction

This briefing note has been prepared with a view to providing guidance on the role of directors and observers generally and will be particularly relevant to those considering taking up such roles in start-up or spin out companies in their own right or as a nominee of another organisation. Investors in a company and, sometimes, other interested parties will often seek the right to appoint a director or observer to the board of a company. In deciding whether to seek and/or exercise director or observer appointment rights, the prospective appointer and the prospective appointee should ensure that they are familiar with the ambit of the applicable role, as the consequences of a breach of duty may be far reaching. For the purpose of this note we will refer to the person who exercises the right to appoint a director or observer (whether that person may be an investor, financial institution, a research performing organisation (“**RPO**”) or general shareholder) as the “**Appointer**”.

Company directors

Director Role

A director’s role in a company is to manage the business of the company on behalf of the shareholders to the best of his/her ability and in accordance with the duties imposed under law and in particular the Companies Act 2014 (the “**Act**”). The directors are delegated this power of management by the shareholders.

Why might someone seek a right to appoint a director?

A person who has invested in a company or who has an interest in the future performance of a company (for example a financial institution who has advanced lending facilities or a person who has another contractual arrangement with the company e.g. a licence) may seek to have the right to appoint a director to ensure that the company is being managed correctly, and that they have a means of protecting their investment/interests through input into company decisions. It also allows the Appointer to provide expertise to a company (through the knowledge and the experience of a nominee director), which is something that a spin-out, start-up or early stage company in particular, can benefit from.

Types of directors

The terms below are often used to describe different categories of directors. However, some of these terms have no statutory definition in the Act and the duties placed on directors by the Act apply to all directors regardless of their role in practice:

- Executive directors: An executive director is a director that takes an active role in the day-to-day management of a company. Often, an executive director will also hold a senior management position in the company.
- Non-executive directors: A non-executive director is a director who is not involved in the day-to-day running of the business. A director who has been nominated by an Appointer will most often be a non-executive director. In practice, such a role involves overseeing the running of the company on a strategic level, and providing advice and guidance to the executive directors in that regard.
- Nominee directors: A nominee director is appointed by an individual shareholder (for example an investor or an RPO), or group of shareholders and are recognised formally as being that shareholder’s appointee.
- De facto / shadow directors: These are persons who are not formally appointed as directors but may be held by a court to be acting as directors of the Company (discussed further below).

Qualifications

There is no particular qualification required to be a director. However, a director cannot be: less than 18 years old; “disqualified” under the Companies Act; adjudicated bankrupt; the statutory auditor of the company; or a corporate body or an unincorporated association (the role must be held by a “natural person”).

Duties of Directors

The primary duty of a director is to ensure that the company is run in accordance with the law, and in particular, the Act. Director’s duties are often divided into what are known as “statutory duties” and “fiduciary duties”.

Statutory duties

The statutory duties of a director arise under legislation. While in practice the executive members of the board of directors will take responsibility for making sure that particular filings and documents are maintained, all directors are responsible for ensuring that the statutory duties are complied with. Some of the main statutory duties under the Act are as follows.

- the general duty to ensure that the company complies with the Act;
- the duty to keep adequate accounting records;
- the duty to prepare financial statements (annual accounts);
- the obligation to have statutory financial statements audited where certain thresholds are met;
- the duty to maintain certain registers and other documents;
- the duty to file certain documents with the registrar of companies;
- the duty of disclosure (discussed below); and
- the duty to convene general meetings of the company (annual general meetings and extraordinary general meetings).

It should be noted that the above list of statutory duties is not exhaustive and that other statutory duties arise, both under the Act and other relevant legislation (including EU legislation).

Fiduciary duties

Fiduciary duties are owed by a director to the company. These duties have been identified through case law over time and are codified in the Act. However, the fiduciary duties set out in the Act are not exhaustive and should be seen as the minimum standards to which a director should meet. The main fiduciary duties owed by a director are as follows:

- to act in good faith in the interests of the company;
- to act honestly and responsibly in relation to the conduct of the affairs of the company;
- to act in accordance with the company’s constitution and exercise his/her powers only for the purposes allowed for by law;
- not benefit from or use the company’s property, information or opportunities for his/her own or anyone else’s benefit unless the company’s constitution permits it or a resolution is passed at a general meeting;
- to not agree to restrict the director’s power to exercise independent judgment unless it is expressly permitted by the company’s constitution;

- to avoid any conflict between the director's duties to the company and the director's other interests (unless the director is released from his/her duty to the company in relation to the matter concerned); and,
- to exercise the care, skill and diligence which is reasonably expected of a person in the same position with similar knowledge and experience as a director.

There is a wealth of information available on both the statutory duties and the fiduciary duties of directors. For the purpose of this note, we will focus on the specific duties outlined below as these are particularly relevant in the context of a nominee director (though are equally applicable to all directors).

Duty of disclosure

This duty requires a director to disclose certain personal information for inclusion in the register of directors and secretaries (including name, address, date of birth, nationality, occupation and other directorships) and this information will become publicly available in the Companies Registration Office. A nominee director who has been appointed to the board will need to be particularly mindful of the duty of disclosure.

In addition, a director has an ongoing duty to disclose his/her interests in any shares of the company (or related companies) and any interest (either direct or indirect) in any way in a contract or proposed contract with the company. The disclosure requirements may be relevant in circumstances where ongoing contractual arrangements (for example, banking facilities or perhaps licences/assignments in the case of an RPO Appointer) are entered into between the company and the director or his/her Appointer and the nominee director holds any beneficial interest in such contract. If such an interest in a contract arises, disclosure should be made at a meeting of the directors.

Duties of directors in the case of insolvent companies

Directors have a particular set of obligations in cases where the company becomes insolvent. This can be particularly relevant in the case of early stage companies which are often pre-revenue and have a high failure rate. Insolvency arises where the company is unable to pay its debts as they become due, or will be incapable of doing so in a short period of time. The director's duties at this point pivot from being owed solely to the company, to a position where the directors also acquire a duty to have regard to the interests of the creditors of the company.

A director of an insolvent company can be held personally responsible (without limitation of liability), for all or any part of the debts of the company as the court may direct if found guilty of fraudulent or reckless trading (in addition to possible criminal sanctions including fines or imprisonment). Fraudulent trading arises where a director is knowingly party to the carrying on of the business with the intent to defraud creditors. Reckless trading arises where in the course of the winding up of a company it appears that any person was, while an officer of the company knowingly a party to the carrying on of any business in a reckless manner.

If a company is experiencing financial difficulties, it is important for directors to ensure that all directors meetings and business decisions are recorded in as much detail as possible so that the directors have a record of the reasoning behind various decisions to point to should the company ultimately cease to trade.

Duty to act in the interests of the company

Directors have a fiduciary duty to act in the interests of the company and to avoid any conflicts of interest. Nominee directors are usually under an obligation to their Appointers (whether under a contract of employment or other form of agreement or obligation) and as such can find themselves in a precarious position. The courts have been slow to acknowledge the difficult, if not impossible, position of the nominee director in this regard. A new provision contained in the Act does go some way to at least acknowledging the position of the nominee director in this regard and provides that without prejudice to the directors duty to act in good faith, a nominee director is entitled to have particular regard for the interests of the shareholder who nominated him/her (being a shareholder who had a right to nominate

a director under the company's constitution or a shareholders agreement). However, this provision may provide little comfort in reality, as while regard may be had to the interests of the Appointer, this does not relieve the director of his duty to act in the interests of the company (even if this conflicts with the interests of his/her Appointer).

Duty not to benefit from or use confidential information or property

A director is disallowed from using the company's information for any other person's benefit unless the use is allowed for in the company's constitution or by a resolution. As such, a nominee director cannot disclose either board papers or board discussions to any third party (including the Appointer of that director) unless the necessary resolution has been passed or provision made in the company's constitution. In the absence of such constitutional provision or resolution, it is important that an Appointer ensures that the agreement under which the right to appoint a director arises makes adequate provision for information rights of the Appointer and that this information is sought and obtained through the company directly rather than through the nominee director. From a practical perspective, the wording of the Act prohibits a director making even incidental personal use of company property (including mobile phones or laptops) and most company constitutions would include a provision allowing reasonable incidental use of such items.

Consequences of a Breach of Duty

Penalties for criminal offences

The Act makes provision for summary and indictable offences and sets out four separate categories of offence. Category 1 offences are the most serious and are punishable on indictment by a maximum fine of €500,000 and a maximum term of imprisonment of ten years.

Civil penalties – restriction and disqualification

A restriction order is a court order which can be made against a director where the company goes into liquidation. There is an obligation on a Court to make such an order unless the director can satisfy the Court that he/she acted honestly and reasonably in his/her management of the company and there is no other reason why it would be just and equitable to make such an order. The effect of a restriction order is that the director cannot be involved in the management or general running of a company for a period of time, unless the company meets certain criteria.

Disqualification is a court order which can be made against a director where he/she has been found to have acted recklessly/fraudulently or dishonestly in relation to the running of the company, or otherwise breached his/her duties as a director. A full list of grounds upon which a disqualification order can be brought is set out in the Act. Where a person has been disqualified, he/she may not be part of the management or formation of any company, amongst other things, for the period of the order.

Imposition of personal liability in certain instances

A director can be made liable for debts incurred by the company (without limitation of liability) in cases of fraudulent or reckless trading (as discussed above), and upon other breaches of a directors duties such as a failure to keep proper accounting records. This will often coincide, with a restriction or disqualification order.

Potential for imposition of any liability on Appointer

Company law related sanctions for directors are personal in nature, and do not readily become attached to their appointers. However, this is not something that should be taken for granted. In circumstances where the Appointer causes the nominee director to breach his/her fiduciary duties to the company, such an Appointer could be found to be vicariously liable for the actions of its nominee director or could potentially be found to be a shadow director (see below).

Observers

Role

An observer is a person entitled to attend directors' meetings on behalf of a shareholder. Observers are often appointed by shareholders to ensure that the company is being run prudently. An Appointer would typically choose to have an option to appoint an observer rather than a nominee director in order to avoid the statutory and fiduciary duties which come with holding a directorship (discussed above). Observers are a creation of contract only, and the role doesn't have any statutory powers or definition. The powers and entitlements of observers are only those which are given in the agreement through which the appointment right arises (usually a shareholders agreement).

Observers are usually given an entitlement to receive notice of board meetings (together with board documents), attend, and sometimes to speak. Observers are not entitled, however, to vote on any matters or take part in any decision making processes.

Liabilities / Risks

As noted above, observers are appointed and empowered pursuant to contract, and do not have any rights or duties which arise from statutes. However, where an observer can incur duties and obligations is where that person acts, whether intentionally or not, as a director. A key risk which observers must be cognisant of then is falling into the position of a "de facto director" or a "shadow director".

De facto directors

A director in Ireland is defined in the Act as to "include any person occupying the position of director by whatever name called". A De facto director is defined in the Act as a person who occupies the position of director of a company but who has not been formally appointed as such. Such a finding generally arises where the company behaved in such a manner which suggested that a person was a director and the person acquiesced in this, or where a person behaved as if he/she was a director and the company acquiesced in this. The Act does provide a "carve out" in that an advisor or professional won't be considered a de facto director if he/she is acting in a professional capacity for the company (e.g. a business consultant). Courts and regulatory agencies will look to the substance of the arrangements, as well as what is set out in the agreement under which the appointment right arises in determining whether a person is acting as a de facto director.

Shadow directors

The Act defines a shadow director as "a person in accordance with whose directions or instructions the directors of a company are accustomed to act". In order for a person to be found to be a shadow director, that person must direct or instruct the formally appointed directors as to how to act (instructions/directions given solely by a person in a professional capacity are outside the scope of the shadow director provisions) and the formal directors must do what they are told to do by that person. In addition, there must be more than one such instruction or direction, there must be a pattern.

An observer is less likely to fall under this heading than that of de facto director. However, it is important for an observer to note the possibility of such a finding, particularly in circumstances where he/she gives advice to the board of director on a regular basis for whatever reason.

Consequences of finding of de facto or shadow director

The consequences of a person being found to be a de facto or shadow director are wide ranging as the fiduciary duties set out in the Act will apply to such a person in the same manner as if he/she were a formally appointed director. In addition, a finding that a person is a de facto or shadow director could potentially result in that person: being liable for fraudulent or reckless trading; subject to disqualification or restriction proceedings; and/or subject to the provisions of the Act which prohibit the entry into of loans and credit transactions with directors.

Confidentiality

As a creation of contract, the parameters of an observer's duties and entitlements to access and disperse confidential information are a matter of negotiation between the Appointer and the company, and should be reflected in the relevant document that caters for the appointment. The observer should ensure that they have clear guidelines as to his/her entitlement to obtain information, disclose information (if at all) and the terms upon which his/her Appointer can retain and utilise the information which is obtained through the observer (indeed such entitlements may overlap with what information the Appointer is entitled to as shareholder/investor under the shareholders agreement). Generally speaking however, an observer can assume that he/she has a duty to maintain the confidentiality of any information which is obtained as a result of the role and should not disclose any information unless empowered to do so by the terms of his/her appointment.

Managing Risk Associated with Director / Observer Position

Acting “honestly and reasonably” in the case of a director

The most practical means for a director to protect themselves from any adverse consequences in the role is to act honestly and reasonably in all dealings in the role. Acting honestly and reasonably is a stated defence to most offences or liabilities in the Act, and is a defence generally in law to allegations which rest on negligence or misconduct.

Some practical means of ensuring that a director can show themselves to have acted reasonably and responsibly are

- to keep proper records of any significant communications regarding the company;
- to have proper reporting procedures between the directors and the company, and (in the case of nominee directors) the director and the Appointer;
- to ensure to properly record and give proper notices of any potential conflicts;
- to give proper care and attention to any documents which directors are to approve and to make notes of any reservations which they may have in relation to them; and
- to be aware of the general day-to-day operations of the company and towards possible difficulties which may arise.

The above “housekeeping” would be particularly relevant in circumstances where the company is experiencing any financial difficulty so that the reasoning behind certain decisions can be pointed to at a later stage.

Indemnity from the company

Given the various obligations and liabilities which can attach to the position of director, it is always prudent to consider whether an appointee can avail of an indemnity (most usually included in a company's constitution) against liability which might be incurred.

Whilst the Act prohibits a company from indemnifying any officer of the company from any liability in respect of negligence, default, breach of trust or breach of duty, it does not place a blanket prohibition on a company from exempting or indemnifying any officer and does allow the company to indemnify a director for legal costs in civil or criminal proceedings provided that he/she is successful in defending such proceedings. While this may provide some comfort it is unsatisfactory for a director to solely rely on such an indemnity as despite the existence of the indemnity, the company might have insufficient funds to meet the cost of legal proceedings.

Directors and officers (D&O) insurance / other insurance

Due to the onerous nature of directors' duties, the scale of the potential liabilities and the fact that a default by one director could impact the other non-defaulting directors, insurance policies which cover

these liabilities have developed on the market. The Act expressly permits the purchase of directors and officers insurance by a company.

In the case of a nominee director, the Appointer should also consider if any of their current professional indemnity policies would cover any liabilities arising from the role of the nominee director or if such a policy could be put into effect.

Procedural issues

Mechanics of appointing/removing directors to and from the board

The procedure for appointing directors is set out in the Act and is subject to the terms of the relevant company's constitution. Generally, directors are appointed either by ordinary resolution of the shareholders or by the directors who have the power to appoint any person as director either to fill a casual vacancy or as an additional director. Each director appointed to the company must consent to his/her appointment and sign a statement acknowledging the duties and obligations imposed by the Act.

Registration of directors

It is the duty of the directors to register any change in directors or of their particulars in the Companies Registration Office within a fourteen day time period. Most usually, this duty will be delegated by the directors to the company secretary.

Confidentiality agreements / letters of appointment

Most often, the right to appoint a director/observer will be set out in a shareholders agreement and in the case of an observer this will usually be the only document that regulates the observer position. In the case of a director, a letter of appointment is often entered into between the company and the director dealing with (amongst other matters) time commitment, confidentiality of company information, intellectual property rights and non-compete provisions. In the case of a nominee director it will be particularly important that the provisions of the letter of appointment do not conflict with the obligations of the director to his/her Appointer (especially in circumstances where the nominee director is an employee of the Appointer), particularly relating to the creation or any intellectual property and the ambit of any non-compete obligations.

Compliance with Appointer internal policies

In advance of appointing a nominee director an Appointer/nominee should consider what notifications/compliance matters may need to be attended to in order to comply with any internal policies of the Appointer. Often such institutions will ask employees to disclose any directorships and any required internal housekeeping in this regard should be attended to.

Conclusion

This note summaries some of the key duties and considerations for directors and observers on a company board. In the context of nominee directors, while the ability to appoint a director or an observer can be a useful right for an Appointer, it is not a decision that an Appointer or the proposed director/observer should take lightly, given the potential duties and obligations that flow from such roles. In circumstances where such a right is exercised, the Appointer should be mindful of the steps that can be taken to mitigate such risks and implement these to the extent possible. Key in this regard will be educating the potential director/observer on the requirements of the role and perhaps even providing "director training" so that the role is entered into with full knowledge of both the duties involved and the potential liabilities that may arise.

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