The actions of many directors of financial services companies are currently subject to intense scrutiny in these challenging economic times. It is therefore appropriate to re-examine the duties of directors, including the role of shareholders in governance.

Directorships are no longer sinecures to be held by well-meaning but naïve members of the great and the good. Directors need to approach their duties in a professional way, with some formality, and to adopt a systematic approach.

What are the duties of directors?

There are currently few, if any, statutory requirements of directors. Although the position of director is key in the conduct of companies, Irish laws are generally silent on how directors are expected to carry out their duties. Exceptions to this include health and safely legislation, competition, employment and environmental law, etc which impose specific duties on directors.

This is likely to change when the Company Law Review Group, under the chairmanship of Dr Thomas Courtney, completes its ambitious task of consolidating Irish company law into a single piece of legislation. That legislation is likely to express in statute law what are currently common law standards for directors. These duties are summarised in Table 1, with a comparison of directors’ duties as enacted in the UK’s Companies Act 2006. Under the UK legislation, the duty of a director “to act in the best interests of the company and its shareholders” is replaced by a duty “to promote the success of the company for the benefit of its members as a whole”.

Table 1: Comparing Irish and UK duties of directors

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<th>Directors’ duties in Irish company law</th>
<th>Directors’ duties in UK company law</th>
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<td>1. Act in good faith</td>
<td>1. To act within your powers</td>
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<td>2. Act honestly and responsibly</td>
<td>2. To promote the success of the company</td>
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<tr>
<td>3. Act in accordance with company’s constitution</td>
<td>3. To exercise independent judgment</td>
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<td>4. Not use company’s property, information, opportunities for own use or anyone else’s benefit</td>
<td>4. To exercise reasonable care, skill and diligence</td>
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<td>5. Not agree to restrict director’s power to exercise independent judgement</td>
<td>5. To avoid conflicts of interest</td>
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<tr>
<td>6. Avoid any conflict between director’s duties and his own interests</td>
<td>6. Not to accept benefits from third parties</td>
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<tr>
<td>7. Exercise due care, skill and diligence</td>
<td>7. To declare interests in proposed transactions with the company</td>
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UK directors are required to have regard to six “enlightened shareholder value” factors, which are subsidiary to the overall duty to promote the success of the company. These are:

1. Likely consequences of any decision in the long term
2. Interests of the company’s employees
3. Need to foster business relationships with suppliers, customers and others
4. Impact of the company’s operations on the community and the environment
5. Desirability of the company maintaining a reputation for high standards of business conduct
6. Need to act fairly as between members of the company

These duties are owed to the company as a whole, not to individual shareholders or third parties. While these six factors are not legal requirements for Irish company directors, they are a benchmark of best practice.

In demonstrating adherence to best practice, directors should ensure that board decisions are supported by formal board papers, adequate discussion and complete (but parsimonious) minutes of meetings. Board papers should include a thorough analysis of all the issues reflecting on the decision.

Conflicts of interest and representative directors

Some of the current national debate on how directors’ should behave reflects a lack of understanding of their duties. While politicians may wish to see banks lending more money to businesses in difficulties, directors have a fiduciary duty to act in the best interests of the bank, and that includes protecting the bank’s capital base by not lending money it doesn’t have. This duty applies regardless of the source of the capital – private shareholders’ money or government money. Bank directors are required to exercise independent judgement, and that includes not caving in to pressure from third parties (shareholders or not) such as politicians whose have a different agenda - to get re-elected.

The Irish Government has approached former politicians, civil servants and others to “represent the public interest” on the boards of the State-guaranteed, and at the time of writing possibly soon-to-be recapitalised, banks. It is interesting to note the very different approach being taken in the UK where banks are being allowed to operate at arm’s length without direct government representation on recapitalised bank boards. Maybe the UK government recognises the conflicts of interest entailed when large investors are represented on boards. The Irish government should examine recent litigation on the insider-trading risks involved in such arrangements. It is not the duty of any director regardless of how he was appointed to “represent the public interest”. Directors have a duty to be independent, to act in the interest of the company as a whole, i.e., in the best interest of all shareholders, treating all shareholders equally.

Some of the statements from the UK Treasury make a lot of sense to me. Banks should have the freedom to “protect and create value for the taxpayer”. Banks should operate “on a commercial basis at arm’s length”. The Treasury’s job is “to manage the taxpayer’s investments, not to manage the banks”. The Treasury has the power to veto bank board appointments, and has expressed an intention to “engage robustly” with bank directors, including ensuring that bank executives receiving fair pay, but not beyond fair pay.
The business judgment rule

Have Irish bank directors fulfilled their duties as directors? In my opinion, yes they have. Nothing in the press coverage of the credit crunch has indicated that bank directors have either breached their fiduciary duties by putting their own personal interests ahead of the shareholders, nor is there any evidence that bank directors did not exercise due care and skill. In the US, the business judgment rule is the standard for assessing whether a director has breached his/her fiduciary duty. Directors can use the business judgement defence, provided they can demonstrate the good faith exercise of their rational, unconflicted business judgement. This rule is implicit under Irish common law. A director has to satisfy the court that, having regard to all the circumstances, a director acted honestly and reasonably. With the benefit of hindsight, bank directors might exercise different judgements now, but I believe they honestly and carefully made what they thought were the correct judgements at the time.

Do shareholders have a role in governance?

Directors are appointed by shareholders to act on their behalf to oversee the work of managers who run the business on a day-to-day basis. The process involves a sub-committee of the board (in the case of listed companies) considering possible candidates, the board approving those candidates, who are then recommended by the board for ratification by shareholders at the annual general meeting. Thus, ultimately, it is the shareholders who appoint the directors to act on their behalf and to look after their best interests. Do shareholders approach this decision robustly, or do shareholders merely rubber stamp the board’s recommendation? Good governance requires shareholders to take their responsibilities seriously. If shareholders appoint inappropriate people to act to oversee their investment, then they, the appointing shareholders, have to bear the consequences that the directors they appointed did not do a good job. Shareholders who complain that the board has not done a good job should be required to answer the question – then why did you appoint those directors?

Greater shareholder activism and more vocal shareholders are evident during these economic times. One has to ask the question – why were they not more active during the good times?

To conclude

The purpose of business is to take risk. Boards have responsibilities to manage those risks. Even the best managed organisations are not immune from adverse economic circumstances. However, research has clearly demonstrated that companies with good governance are significantly more likely to survive adversity and live to enjoy the rewards of better times.

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