MAYER | BROWN

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# Legal Update

## How the pandemic has increased existing risks for directors – and created new ones

Throughout the COVID-19 pandemic, directors of companies across all industry sectors, ranging from small family enterprises to large multinationals, have been working flat out to keep businesses afloat. But as life begins to return to a semblance of normality, what risks will those directors face themselves during the challenging months ahead? We consider some of the key exposures which directors and officers need to keep in mind, and manage, in these uncertain times; where problems might emerge; and how such risks might be mitigated.

As with most things, awareness is key. With a cautious note of optimism, the best protection for those managing businesses is to be aware of the extent, and implications, of the relevant legal obligations and risks, to ensure that decisions and actions are taken having due regard to those obligations and risks, and to establish procedures in advance, to enable issues to be dealt with appropriately and expeditiously as they arise.

## The obligations of directors

### DIRECTORS' DUTIES TO THE COMPANY

All directors – including executive and non-executive, de jure and de facto, nominee, and (while there remains some uncertainty as to the precise extent) shadow, directors – owe duties, including fiduciary duties, to their companies, meaning that the director must put the interests of the company ahead of his or her own. Whether or not an individual is a "director" (and, consequently, subject to the relevant duties) will depend on the specific circumstances of his or her role.

Particularly in the current environment, it should be borne in mind that the duties continue to apply to furloughed directors; discharging those duties during a period of furlough will of course present its own challenges. Similarly, the position of nominee directors, who are subject to the same duties, is likely to become a significant area of focus if and when shareholder disputes emerge.

Possible complications can arise in the context of individuals with multiple-directorships (particularly of companies within the same group). Where the companies' interests are ordinarily aligned, the roles can, and often do, become blurred; while the interests of the group should of course be considered, the duties owed to each company must be observed.

## WHAT ARE THE PRINCIPAL DUTIES?

The main duties owed by company directors, long-present at common law, are codified in sections 171 to 177 of the Companies Act 2006.

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| **s.171** Duty to act within powers | **s.172** Duty to promote the success of the company | **s.173** Duty to exercise independent judgment |
| **s.174** Duty to exercise reasonable care, skill and diligence | **s.175** Duty to avoid conflicts of interest | **s.176** Duty not to accept benefits from third parties |
| | **s.177** Duty to declare interest in proposed transaction or arrangement | |

The duties codified in the Companies Act are not exhaustive. Certain duties owed at common law and in equity, such as the equitable duty of confidence, have not been codified but remain in force.

Perhaps the most significant duty to keep in mind is the duty to promote the success of the company. This is a broad fiduciary duty which applies generally to every aspect of a director's role. It is a subjective duty of loyalty to the company, requiring the director to act in the way in which he or she believes, in good faith, to be in the interests of the company. In discharging the duty, directors are required to bear in mind the interests of various stakeholders, including shareholders, creditors, employees, and the community in which the company operates. Managing a business with the single aim of maximising shareholder value is, increasingly, insufficient.

Directors also owe a general duty to exercise reasonable care, skill and diligence, meaning that their performance is also assessed objectively. This obligation applies to a director's consideration of the interests of the stakeholders identified above.

Certain other duties, notably the duty to avoid conflicts of interest, will arise only in specific circumstances. Directors should adopt robust procedures for identifying the circumstances which may trigger these duties, to ensure that they are not inadvertently neglected – particularly when decisions are made under pressure.

## INSOLVENT COMPANIES

The general duties described above will continue to apply to directors of companies which experience financial distress or become insolvent, even after the company has entered a formal insolvency process; indeed, the approach or onset of insolvency brings with it a further layer of duties and risks for directors.

Our insolvency specialist colleagues have written about duties owed, and considerations to be borne in mind, in the context of insolvency here. With respect to English companies, it should be noted that the UK Government has introduced the Corporate Insolvency and Governance Act 2020, discussed below.

When a company becomes, or is likely to become, insolvent (so, when a director can no longer be confident of the company's solvency on either a cash flow or balance sheet basis), directors will owe additional – paramount – duties to consider and act in the best interests of the company's creditors as a whole.

Directors also need to be mindful of the causes of action which become available when a company has entered into a formal insolvency process, which we address below. During any insolvency, the appointed insolvency officeholder has a duty to investigate the affairs of the company and has substantial powers to collect in information and documentation to assist in that investigation.

During any insolvency process, directors may also be targeted for their actions whilst the company remained solvent. In particular, any insolvency officeholder is likely to examine whether any dividends or other distributions have been made lawfully.

## Who can bring a claim against directors, and how?

The duties owed by directors are owed to the company, and any cause of action arising from a breach of those duties vests in the company itself.

Generally, the power to decide whether to bring a claim on behalf of the company will be vested in the board of directors. However, in certain circumstances, shareholders of the company are able to pursue the company's directors – and any third parties implicated in the relevant breach – on behalf of the company on a derivative basis. Derivative claims of this sort, ordinarily brought under the statutory mechanism provided in the Companies Act 2006 (but also available at common law in certain circumstances), will require the Court's permission to proceed, although not to file. If and when values of companies' stock – and, thus, shareholders' holdings – fall significantly, the derivative action mechanism may become more prevalent as a means by which aggrieved investors seek redress.

Shareholders of public companies are able to bring claims directly against directors in respect of statements and actions which have, allegedly, caused loss to the shareholders. The most common mechanisms for shareholders to bring claims of this nature against directors include:

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| **Section 90 FSMA** | Claims for compensation in respect of untrue or misleading statments or omissions in listing particulars or prospectuses |
| **Common law negligence** | Claims alleging <u>negligent</u> mistatement by directors |
| **Common law deceit** | Claims alleging <u>fraudulent</u> misstatement by directors |

An alternative means of recovery for potential claimant minority shareholders is by way of unfair prejudice petitions, on the basis of section 994 of the Companies Act 2006. While these will principally target the majority shareholders in respect of management decisions that, on the case theory, have prejudiced the minority shareholder, the petitions will commonly join directors as co-respondents. The courts have a broad discretion in relation to unfair prejudice petitions, and while the most appropriate remedy will usually be a share purchase order, damages awards against directors are also possible.

When a company is in a formal insolvency procedure, any claims against directors can be pursued by an appointed insolvency officeholder. Under the Insolvency Act 1986 insolvency officeholders (and in certain instances other stakeholders) are able to bring claims against parties including directors in specified circumstances. These circumstances include where the company has:

1. entered into a transaction at an undervalue;
2. deliberately preferred the interests of one creditor to another; and/or
3. carried on business with the intent to defraud creditors.

In addition, a director who continues to trade at a time when they knew (or ought to have known) that there was no prospect of avoiding an insolvent liquidation or administration, and fails to take every step required to minimise potential loss to creditors ("wrongful trading"), can be required to contribute personally to the company's assets.

In a move to reduce the pressure on directors during the current period, the government brought into force the Corporate Insolvency and Governance Act 2020 on 26 June 2020, which modifies the wrongful trading regime temporarily, with (retroactive) effect from 1 March 2020 until 30 September 2020. Under this temporary measure, the court will assume that the director in question is not responsible for any worsening of the financial position of the company (or its creditors) during this period. It should be noted, however, that certain companies, including insurance companies, banks and parties to capital market arrangements, are unable to benefit from this measure. Nonetheless, these welcome, albeit temporary, measures remove some pressure for directors of financially stressed companies in the short term, although the causes of action referred to above, including in relation to fraudulent trading, remain. It is essential, that directors carefully document their decisions contemporaneously and seek legal and financial specialist advice where appropriate.

### REMEDIES AND SANCTIONS

If a breach of a duty other than the (non-fiduciary) duty to take reasonable skill and care occurs, and the relevant conduct has been neither authorised nor ratified, the injured party (again, in the ordinary course, the company itself) may be able to pursue a broad range of remedies. Culpable directors may be ordered to pay damages to the company. As fiduciaries, they may also be required to account for any profits made in breach of duty. Directors found to have received payments or property from the company as a result of his or her own wrongdoing can be ordered to restore the position. Aside from financial relief, the court can also set transactions aside and/or award injunctions.

Some measure of comfort – and guidance as to how best to approach duties – may be drawn from the fact of the court's ability to grant directors relief from liability if it considers that the director has acted both honestly and reasonably; and, considering all of the circumstances of the case, the director ought fairly to be excused.

In addition to private claims for compensation, the courts have wide-ranging powers to disqualify individuals from acting as directors, or from otherwise becoming directly or indirectly involved in company management, for a period of up to 15 years[1]. In addition to the spectre of disqualification in light of criminal convictions (for example in relation to breaches of competition law or anti-corruption and bribery legislation), in the civil context the High Court also has disqualification powers in circumstances where the company has become insolvent, and the director is deemed to be "unfit"[2]. While the threshold for disqualification is high (and beyond simple negligence, as one would expect), the potential professional, financial and reputational damage of such a sanction will be evident.

## Pre-COVID factors contributing to the increased risk of individual exposure

The onset of COVID-19, and the accompanying economic strains, arrived against a backdrop of already-increasing litigation, and regulatory, exposures for individual directors and officers. Both anecdotal and survey evidence indicates a marked increase in recent experience of claims and/or regulatory investigations specifically involving individual directors, including criminal claims against directors. Further, the ability to pursue post-insolvency claims against directors is growing as a result of the increased availability of specialist insolvency litigation funding, coupled with the incentive of D&O insurance which may provide a pot of gold at the end of successful claims. Meanwhile, recent case law on attribution has narrowed the scope for directors to raise the illegality defence in response to claims by the company.

1 Under the Company Directors Disqualification Act 1986

2 Section 6 of the CDDA 1986

The legal bases of individual liability for directors – both civil and criminal – are wider than ever before, and include such areas as financial reporting, bribery, corruption and fraud, data protection, cyber security, competition infringements, health and safety, environmental factors, and modern slavery (although the UK Home Office's recent guidance on modern slavery reporting recognised the challenges posed by COVID-19 to the reporting requirements). Added to this is the trend of recent years – exacerbated by recent high profile corporate collapses – towards greater individual accountability for corporate decisions and actions, and the increasing calls for ethical boardroom conduct. This was exemplified by the Institute of Directors' manifesto in the run-up to the December 2019 election, pushing political parties to create greater controls over corporate governance, in recognition of the "*understandable demand for board members to be held more accountable for failures of oversight and direction*".

Two highly significant, and related, factors, the growth of which has accelerated in recent years, are the development of the UK's (still somewhat fledgling) collective litigation regime; and the widespread availability of litigation funding to support collective actions.

While this jurisdiction has traditionally seen less collective litigation than, say, the US, a number of recent high profile cases have served to highlight the availability of collective redress mechanisms in the courts of England and Wales. Recent years have also seen an increase in the number of market players, such as litigation funders, insurers and specialised legal advisers seeking to develop and pursue collective actions in the UK.

One example of the impact of these factors is in the context of securities litigation targeting company directors, which has seen a marked increase in recent years, in part as a result of the so-called "Morrison effect", stemming from a 2010 US Supreme Court decision which held that US courts do not have jurisdiction over claims brought by a particular category of shareholder[3]. Particularly given the size of the London capital markets, claimant shareholders have begun to target London-listed issuers on the basis of alleged breaches of obligations to the markets.

The result of these dynamics is that putative claimants, including shareholders, creditors, employees or other stakeholders, are increasingly able to pursue claims that may previously have been unviable. In view of the scale of many collective actions in particular, this presents a genuine and growing risk to businesses and directors in the UK.

## Risk factors arising out of COVID-19

A recent Concept Note published by the British Institute of International and Comparative Law predicts a "*deluge of litigation and arbitration placing a strain on the system of international dispute resolution*" in the wake of COVID-19. Whilst the courts will do their best to promote alternative dispute resolution to relieve the anticipated strain on the judiciary, and much emphasis is (rightly) being given to the need to prospective litigants to act responsibly and reasonably[4], it appears inevitable that the pandemic will give rise to litigation.

We have identified some key areas of risk below. These are not exhaustive, and much will depend upon the circumstances of the individual directors, as well as the sectors in which they are operating. Although each of these areas will give rise to different challenges, directors should approach each of them on the basis of the duties and other obligations summarised above.

3 *Morrison v National Australia Bank, 561 U.S. 247*, according to which US courts do not have jurisdiction to hear "foreign cubed actions"; i.e. claims by non-US investors in respect of shares in non-US companies which were purchased outside of the US.

4 See, for example, the UK Cabinet Office "*Guidance on responsible contractual behaviour in the performance and enforcement of contracts impacted by the COVID-19 emergency*", published 7 May 2020.

## Insolvency risk

- Many businesses will, of course, face significant solvency issues as the economic consequences of the pandemic, and the measures taken in response to it, develop and become more apparent. The likelihood of insolvency places acute additional pressures on directors.

## Shareholder claims

- The extreme market volatility experienced in the wake of the pandemic will only add to the already significant risk of securities litigation discussed above. Shareholder class action claims in the US, resulting directly from the COVID-19 outbreak, have already commenced.
- Indications have started to emerge of likely increased shareholder scrutiny of, in particular, statements and actions of directors and officers, which subsequently turn out (or appear) to be untrue or misleading, with regard to, for example, the organisation's preparedness for and/or reaction to the pandemic.
- We anticipate an increase in claims based on event-driven precipitous stock value drops, often as a result of "bad news" stories emerging. Claims are likely to arise in the context of monitoring, reporting on, and dealing with adverse developments; any "disaster plans" that were, or should have been, in place; responses to cash flow issues (for example, taking on additional debt burdens); supply chain and/or force majeure issues; and, of course, any specific problems which may emerge, such as employment- or cyber-related issues.

## Employment related claims

- COVID-19 is a public health crisis and risks to the health of employees should be at the forefront of directors' minds. Directors are obliged to take the interests of employees into account when taking decisions or actions, and many companies, and directors, will, of course, have regard to more than simply legal issues when making decisions which concern the safety of workers. However, from a purely legal perspective, there is an obvious risk to companies which do not safeguard workers' health sufficiently, in the form of the potential for claims from the affected individuals.
- Leaving health aside, many companies have had to confront difficult employment-related decisions, often involving redundancies, negotiating variations to employment terms or furloughing employees. Decisions taken in this context may become the subject of close scrutiny in the months ahead.

## Data protection and cyber risks

- Another fertile area for claims, including potentially massive collective actions, is in the context of data protection and cyber risks. Already a significant (and growing) area of risk for organisations of all sizes, cyber security and data protection have taken on even greater significance in the face of a reported increase in scams and phishing attacks during the COVID-19 pandemic. The risk of data breaches may be exacerbated further if measures have not been taken to maintain data security whilst employees work from home. Directors may have to look into whether their organisation needs to improve the capability and security of remote working platforms (which is potentially a drain on limited resources). Aside from claims by individuals, the Information Commissioner also has significant powers to fine corporates in respect of data breaches.
- From the perspective of individual directors, should their organisations be unfortunate enough to fall victim to a breach of some description, the decisions taken, both pre-breach (in the context, for example, of ensuring adequate cyber security and breach prevention) and post-breach (for example, how quickly, efficiently, and appropriately the responsible directors responded to the breach) are likely to come under scrutiny. For public companies, regrettably such incidents are also likely to cause, potentially significant, stock price falls, which may in turn lead to shareholder claims and possible regulatory action.

## Competition claims

- Anti-competitive behaviour on the part of businesses of all sizes has come significantly more into focus over recent years. Many competitors are reported to be working together in order to combat the pandemic, often with the blessing of the UK regulator, the Competition and Markets Authority ("CMA"). However, directors should remain cautious to ensure that steps taken or relationships developed during the crisis do not give rise to the potential for allegations of anti-competitive behaviour to arise.
- Breaches of competition law can lead directly to disqualification proceedings and criminal sanctions against responsible directors; this is an area in which the CMA is increasingly active.

## Fraud risks

- As at any other time, but perhaps more acutely in the current challenging economic environment, directors should be ever-mindful of the importance of avoiding conduct that may constitute "white collar" offences.
- Areas that may be watched very closely, by the Serious Fraud Office and other stakeholders, over the coming months will likely include market manipulation and investment fraud (we expect financial transactions which might bear the hallmarks of insider trading to come under particularly close scrutiny); frauds relating to charities; healthcare fraud; and fraud in the context of government contracts and, of course, government relief programmes.

# How might risks be mitigated?

Whilst the challenges faced by businesses – and their directors – will often be unique to the particular circumstances prevailing, there are a number of practical steps which may assist in mitigating risk factors more generally.

**Planning ahead**

1. Ensuring sufficient engagement with all stakeholders, at all times, to ensure that relationships are maintained, and interests considered.
2. Reviewing the business's insurance position and, in particular, ensuring that D&O insurance cover in particular is up to date and covers the risks which are anticipated in the medium term; and, should problems emerge, ensuring that notification requirements and other conditions of the policy are complied with.
3. Preparing and reviewing contingency plans, with a particular focus on creditors' interests.
4. Reviewing key risk management procedures, including anti-bribery and corruption.
5. Reviewing and updating data protection and IT security measures.
6. Reviewing financial information regularly in order to detect any signs of financial distress at an early stage.
7. Taking stock of any government schemes or assistance which might be available (but ensuring that the particular assistance sought is appropriate for the business and is properly claimed).
8. Putting in place clear procedures for responding to litigation. Should the prospect of litigation arise, directors should ensure that they deal with issues in a structured and timely manner, including making any necessary notifications to their insurers and taking appropriate legal advice.

### Decision making

9. Crucially, having regard to all stakeholders in the business (including not only the shareholders, but also employees, creditors, suppliers, and the community in which the business operates), when making both short- and long-term decisions and considering the potential impacts of those decisions, and taking on board the views of non-executive directors.
10. Thoroughly documenting decision-making processes and the reasons behind decisions, including consideration and assessment of competing factors in line with applicable requirements. Where factors obviously need to be taken into account, for example the interests of employees, the consideration of steps taken (and not taken) should be clearly documented in meeting minutes. It is much easier to defend decision making which has been clearly documented, and clearly identifies the relevant factors which have been taken into account.
11. Documenting all disagreements between directors, setting out clear reasons why any contentious decisions have been taken.

### Communication

12. Communicating regularly with Board and other management teams (including regular full Board meetings, and separate meetings to address group companies).
13. Communicating regularly with suppliers, funders and stakeholders.

### Advice

Finally, directors should make sure they take appropriate professional advice where possible. Obviously, many companies expect to encounter cashflow difficulties in the coming months, and it may be difficult to justify additional expenditure. However, given the range and technical complexity of the risks faced by modern businesses, it is more crucial than ever for directors to ensure that they seek appropriate financial and legal advice, so as to protect the position of the company and to demonstrate that decisions have been taken in a properly informed manner.

## Conclusion

These are difficult times to be a company director. However daunting the coming months may appear, however, there are steps which directors can take to mitigate the risks they will face. Fortunately, those steps – taking and acting upon appropriate advice, taking properly documented decisions and so on – are exactly the steps which directors of well-governed companies are used to taking on a daily basis.

This article does not provide legal advice. If you have any questions on this article, or would like to discuss the issues discussed, please contact James Whitaker, Tom Wild, or Sheena Frazer.