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# PART 2: A BRIEF INTRODUCTION TO THE FIDUCIARY AND COMMON LAW DUTIES OF DIRECTORS IN BERMUDA

by Gary Harris, Seth Darrell, Kendall Evans, Matthew Ebbs-Brewer

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Once parties to a potential transaction involving the acquisition of a Bermuda company have decided between a merger, an amalgamation, a direct offer or a scheme of arrangement (Business Combination) (which was addressed in part 1 of this series), the duties of the directors of the Bermuda Company need to be considered.

Although there is no single statutory prescription in Bermuda that sets out all of a director's duties, the broad principles applicable to directors whose companies are involved in Business Combinations are set out in section 97 of the Bermuda Companies Act 1981, as amended (**Companies Act**). These principles, together with the content of the applicable constitutional documents and common law collectively describe a director's scope of duties. A person who carefully adheres to these duties when acting in his or her capacity as a director by being fully informed, unbiased, and by acting in good faith with the honest belief that such actions are in the best interests of the company, and with the skill and care, will minimize the risk of personal liability from being found to be in breach of his or her duties.

The Companies Act makes no distinction between executive directors, non-executive directors or alternate directors. The Companies Act also includes in the definition of director "… any person occupying the position of director by whatever named called." This is intended to cover *de facto* directors (i.e. persons who act as directors without having been properly appointed as directors). All of these persons are directors for the purposes of the Companies Act.

All directors of a company have a general duty to exercise care, skill and diligence in performing their duties. Coupled with this general duty are a director's fiduciary duties which must be observed at all times. These

fiduciary duties include the duty to: (i) act in honest and good faith in what the director *bona fide* considers to be in the best interest of the company, (ii) exercise his or her powers for the proper purpose, and (iii) avoid conflicts of interest unless the conflict has been adequately disclosed.

### TO WHOM ARE THE DUTIES OWED?

When solvent, every director owes these duties to the company itself, which, in practice, includes having regard to the interests of the general body of shareholders. If solvency becomes questionable the directors begin to owe a duty of care to creditors.

### DUTY OF SKILL AND CARE

In considering a potential Business Combination a director must exhibit in the performance of his duties a degree of skill that is reasonably expected from a person with his knowledge and experience. While the directors may properly delegate authority to others, it is a breach of their duty of care to wholly abdicate from exercising any supervision over the affairs of the company. However, section 97(5A) of the Companies Act specifically exonerates a director for breach of duty if "he relies in good faith upon: (a) financial statements of the company represented to him by another officer of the company; or (b) a report of an attorney, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him". This means that directors can safely rely on financial valuations and recommendations by professionals when considering whether a potential Business Combination is in the best interests of the Company, provided they properly consider the material being relied upon and make their own determinations thereon.

### DUTY TO ACT IN GOOD FAITH

Each director is under a duty to act in good faith in what the director considers is the best interests of the company and not for any collateral purpose. This means that directors must act with a conscious regard for their responsibilities as fiduciaries. Though good faith is determined objectively, the court's inquiry is confined to the director's subjective intent - i.e. directors must act *bona fide* in what they consider - not what a court may consider – is in the best interests of the company. A Bermuda court will not substitute its own view as to whether the potential Business Combination is in the best interest of the company.

Failure to exercise good faith not only allows claims to be brought against each director (by examining their intention, motive and beliefs) but also permits a challenge to be made of the particular decision taken by that director, or a transaction entered into by that company. However, Bermuda courts will generally accept that the directors have not breached this duty once it can be shown that they have conducted themselves as honest men of business and directors can demonstrate their good faith by documenting the purposes for, and reasoning behind, the Business Combination, or corporate benefit anticipated to be derived therefrom.

### A DUTY TO EXERCISE POWERS FOR A PROPER PURPOSE

Directors are under a duty to exercise their corporate powers only for the purpose which they were granted and not for any collateral or ulterior purpose. In context of a Bermuda company a "proper purpose" means a purpose which advances the interests of the company itself as a separate body corporate, as distinct from its shareholders. This duty permits courts to invalidate decisions taken by directors if their motivation is one which a court determines is beyond those which the power can be legitimately exercised. This duty can be breached even if the director has acted in good faith.

### CONFLICT OF INTEREST WITH THE COMPANY

The directors have a duty not to put themselves in a position in which their duties to the company conflict with their personal interests. Unless the conflict is adequately disclosed, any contract entered into by the company

in which a director has an interest may be voidable by the company and any profit made recoverable by the company.

A director should disclose at the first opportunity his interest in any material contract with the company (or its subsidiaries) or his material interest in any person which is a party to a material contract with the company (or its subsidiaries).

In Business Combinations, difficulties can arise where a director is appointed by a special class of shareholders. While the intention may be that such director represents the interest of the shareholders that have appointed him, he is nevertheless bound to exercise his judgment in the interests of the company as a whole. A director must therefore ensure that he (i) does not fetter his discretion by agreeing to act in accordance with the directions of a class of shareholders, and (ii) acts in good faith in the best interests of the company and not for any collateral purpose.

## FETTER THE DISCRETION

The debate as to whether a board of directors can or cannot bind themselves to recommending a Business Combination in light of the possibility of their company receiving a superior proposal, has not yet been considered by the Bermuda courts. As a general principle, directors must take care not to fetter their discretion during Business Combinations by agreeing to exercise their recommendation or vote in accordance with the directions of another director, their appointing shareholders or some third party and must always act in the best interests of the company. Conversely, there is Australian and English case law to suggest that directors would not be fettering their discretion where they have entered into a contract for the company on a bona fide basis which requires the directors to act in a certain manner in order to give effect to that contract, provided that the decision to enter into the Business Combination is made in accordance with the directors' fiduciary duties. The required performance arising from the agreement is nothing more than the result of the directors properly exercising those fiduciary duties. These cases held that while directors must act bona fide in the best interests of their company, it does not necessarily follow that they are totally prohibited from contracting in such a manner as would constrain them in the future exercise of their powers.

Although it would appear that there is a strong argument that directors entering into contracts on a bona fide basis in the best interests of the company, resulting in the directors binding themselves to perform some future act, may not be construed as fettering their discretion, the uncertainty of how Bermuda courts would interpret these cases means that it is preferable for directors to avoid committing their companies to irrevocable voting agreements.

Another difficulty arises in cases where directors, who are also shareholders, enter into voting agreements. As a shareholder, that person is entitled under Bermuda law to enter into a binding agreement to (i) vote in favor of a merger transaction and (ii) waive his or her appraisal and dissenter rights. However, as noted above, that person as a director is under a general duty not to fetter his or her discretion. Accordingly, such voting agreements must make clear that shareholders who are also directors (i) enter into the agreement solely in his or her capacity as a shareholder and (ii) make no agreement in his or her capacity as a director.

## ACTIONS AGAINST DIRECTORS

The Bermudian courts look to English common law authorities for guidance on the interpretation of the duties of directors and standard of care which are highly persuasive and for all practical purposes considered binding. As stated above, Bermuda courts are reluctant to interfere with the business decisions of directors. The courts will only be inclined to second-guess the decisions of directors in situations where the directors have breached their fiduciary duties, acted negligently or, having taken into account all reasonable actions, made an unreasonable decision that no sensible board would have reached.

Pursuant to the Companies Act, Bermuda companies may include indemnification provisions in their bye-laws. These indemnification provisions tend to cover all liabilities, losses, damages or expenses (including but not limited to liabilities under contract, tort and statute) as well as any liabilities which the director incurs in defending any proceedings (criminal or civil) where relief is granted to him, where he is acquitted, or where judgement is given in his favour. However, the Companies Act prohibits a company from indemnifying a director in respect of any "fraud" or "dishonesty".

## CONCLUSION

Directors in Bermuda are subject to statutory and common law duties. The courts' reluctance to interfere with business decisions made by directors in relation to Business Combinations coupled with the indemnity provisions generally included in the bye-laws of Bermuda companies, allow directors of such companies to feel secure when considering and authorising Business Combinations, provided they make such decisions on a well-informed, unbiased basis while acting in good faith with the honest belief that such actions are in the best interests of their company.

This article has been written by:

**Bermuda**
**Gary Harris**
Associate
+1 441 298 3249
gcharris@applebyglobal.com

**Bermuda**
**Seth Darrell**
Associate
+1 441 298 3285
scdarrell@applebyglobal.com

**Bermuda**
**Kendall Evans**
Associate
+1 441 298 3590
kevans@applebyglobal.com

**Bermuda**
**Matthew Ebbs-Brewer**
Associate
+1 441 298 3226
mebrewer@applebyglobal.com