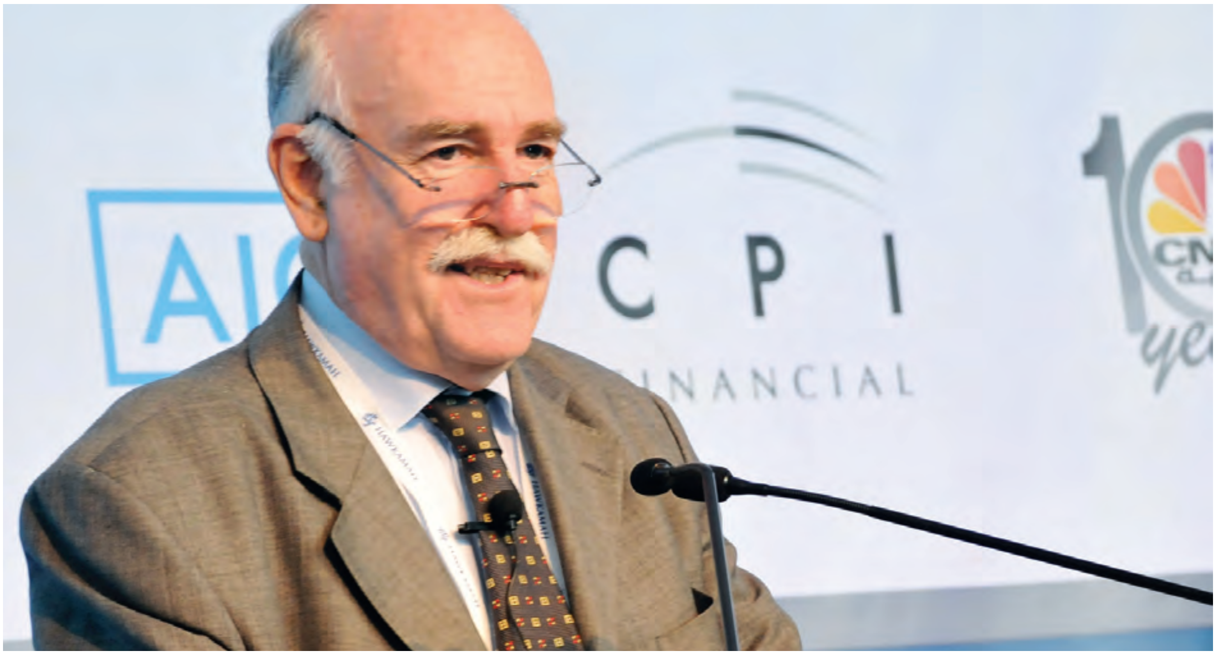
# GETTING THE COMPOSITION OF THE BOARD RIGHT

*The case of nominee directors*



A key issue in applied corporate governance concerns the composition and the duties of a board of directors in the presence of controlling shareholders and or powerful blockholders.[1] The debate about independent directors, how to define them and what should they do, must be seen in this context. Much less has it seems been written about another class of director which are contractually or otherwise bound (de facto or de jure) to particular shareholders: "nominee directors" which are permitted in a number of jurisdictions. While there is a demand by some investors for nominee directors to secure their interests operational or otherwise, in a company, they sit uncomfortably with company law and corporate governance approaches and can therefore be problematic. This paper aims to address these issues.

**Definition and role of nominee directors**

A nominee director is one who is an agent of a principal and therefore follows their instructions. This may be established by a contract or by other means such as being an employee of the principal. A director appointed by a major shareholder and with close relations with the same might, in many jurisdictions, be regarded as a nominee director. A nominee director might also be established by a shareholders agreement that specifies the number of board positions that each shareholder may appoint. In some cases, it may arise from an agreement with a creditor or even with the labour force. In other cases, the role of the principal is not just to nominate a director for approval by the general meeting of shareholders, but actually the right to appoint someone directly to the board.

1 For example see Ferrarini and Filippelli, "Independent directors and controlling shareholders around the world", ECGI Law Working Paper,258/2014, 2014



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Nominee directors serve the practical interests of investors in a number of different ways. Venture capitalists might have an agreement allowing them to place their employees on the board of an investment to make sure that sight is not lost of an exit strategy. A subsidiary of a company group or joint venture will often involve directors being appointed by the partners or the parent company which is also their employer. Their interests might therefore range from major commercial decisions to operational issues such as dividing markets, use of technology and transfer pricing (i.e. intra firm prices). These are all legitimate commercial demands to guarantee an investor's interests and the exercise of group control.

However, and more controversially, nominee directors are also used to ensure anonymity of the beneficial owner: the nominee director is usually not obliged to report whose interests they represent. Using nominee directors is also useful when establishing a company in a foreign jurisdiction which requires residents on the board, even from the moment of initial registration. But anonymity has a big role to play in hiding tax liabilities, facilitating money laundering and securing terrorist financing.[2] This article focuses on the corporate governance aspects including corporate law.

**How do they help or hinder corporate governance?**

It is axiomatic for corporate governance arrangements that the board of a company has a key oversight and control role to play and this is mostly reflected in company law and jurisprudence.[3] Thus company law often specifies fiduciary duties of board members towards the company, and especially a duty of loyalty.[4] Most important of all, boards are treated as a collective body with a duty to the company as a whole and not just one stakeholder such as a major shareholder or even a labour union. The duty of loyalty is here crucial for it requires directors to avoid conflicts of interest and to make independent judgements.

Nominee directors are clearly in a difficult position and have been described as being between the "devil and the deep blue sea" or "between a rock and a hard place". A nominee director following the instructions or interests of their principal may not be taking decisions in favour of the company as a whole. Being in breach of their fiduciary (or director) duties might make them liable for damages. An obvious solution might be for the director to recuse themselves from any decisions involving a conflict of interest. It might well be asked in this case, what is the purpose of having a nominee director and how long they might be so employed if they avoided the needs of their principal?

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2 The issue is often not nominee directors per se but the ability to conceal beneficial ownership through shell companies. The abuse of corporate vehicles is a major concern of the OECD and the G20. See The Abuse of Corporate Vehicles, OECD, 2001

3 Historically this was often not the case, as in the US up till around 1980 and in Germany with the supervisory board having limited powers up till the last 20 years.

4 The new UK company law goes further specifying the duty to promote the success of a company.

**Proposed solutions**

Most accept the legitimate need for nominee directors, but there are arguments by some that the contradiction with the law and jurisprudence needs to be settled more formally. One author [5] analyses the issues in common law jurisdictions by proposing a working taxonomy for categorisation of disparate judicial approaches on nominee directors in the common law world: an absolutist approach, a corporate primacy approach and an attenuated duty approach. However, once one starts by attenuating the law, it is a slippery slope.

She concludes that " while courts have acknowledged the reality of nominee directors giving some consideration to the interests of their appointers, in the absence of specific legislative intervention the preponderance of judicial opinion lies in favour of this only being possible where any action taken does not impinge on the interests of the company" (page 145).

A pragmatic solution might be to balance nominee directors with further "independent" directors. But this solution does entail loosening the duty of the board as a whole and will split the boards. Moreover, it still begs the question how the principal will achieve their objectives.

Some jurisdictions have dealt with the issue by establishing a fiduciary duty of major shareholders (i.e. those normally using nominee directors) towards other shareholders (i.e. Germany, Israel) in subsidiary companies. Thus instructions to nominee directors to take measures not in the interest of the company, would involve potential compensation to injured shareholders and perhaps to other stakeholders.

Some jurisdictions take a slightly different approach by providing courts and investors with the concept of "shadow directors" which would be liable for decisions not in the interest of the company. They thus lift the veil of the nominee director to hold the principle liable. Fine legal interpretations are necessary to enforce and interpret such a concept.[6]

One approach more in the civil law tradition addresses the issue of corporate control in company groups and is particularly important in dealing with the control of related party transactions, an important area for conflicts of interest.[7] It involves a controlled company documenting the losses suffered as a result of its relations with another controlling company. The board of the investee company accepts responsibility for net loses arising from the relationship (Italy, Germany, Portugal, and Turkey). In France and Belgium, a company can take decisions in the interests of another company if there is a close economic relationship between them (the so called Rozenblum doctrine)[8]. This would appear to give cover to nominee directors working for the interests of another company, albeit shifting liability toward the board of that company.[9]

5 D. Ahern, 2011, " Nominee directors duty to promote the success of the company: Commercial pragmatism and legal orthodoxy", *Law Quarterly Review*, 127

6 For a discussion see Nominee Directors in Australia: Guidelines, and Duties of Employees who are appointed or Nominated as a Director of a Company in Australia, Baker McKenzie

7 See Kirkpatrick et al, Related party transactions and minority shareholder rights, OECD, 2012

8 However, there must be close economic relations between the companies and the courts have established demanding criteria to prove the case. See op cit for discussion of Belgium and France.

9 Germany goes further than most others in defining two types of company group. The implicit group can result from contracts of one company with the management board of another, which results in operational control. Under German law, management boards have quite a deal of independence from the supervisory board that is excluded from day to day operational decisions.

One solution that is proposed especially in the US is to modify company law along contractarian lines. Company law is seen as setting broad principles that are applicable as default rules that can be overridden by the constitution of a company. Thus two or more shareholders could agree in the articles of association to appoint their own nominee directors to the board. There would thus be no conflict with corporate law. However, Prof Ahern argues persuasively that the contractarian approach is not suitable where there are many stakeholders. There is thus a case for company law not just establishing minimum default settings, which can be easily set aside, but something more mandatory.

**Conclusions**

The debate over independent directors to manage conflicts of interests on a board and to ensure board objectivity has raised a number of questions about the role of major shareholders. Outside of the US and the UK, most companies around the world have a major or controlling shareholder. However, attention also needs to be given to those cases where a director is bound either legally, or by way of employment status: nominee directors. There appears to be strong demand by investors for such directors both in civil law and common law jurisdictions.

Some methods that might be considered subject to the prevailing corporate law system include explicit consideration of company groups and introducing the concept of shadow directors into company law. Another route would be to establish more clearly a fiduciary duty of major shareholders towards other investors in group companies.

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