Executive, non-executive and independent directors of Luxembourg credit institutions - the impact of the status of a director

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The ILA Banking committee's mission is to promote the highest standards of directorship and governance best practices in Luxembourg financial institutions, provide their directors with the appropriate tools to meet these standards and best practices and prepare them for impending regulatory changes.

Luxembourg laws and regulations typically do not differentiate between the different statuses of board members. A director representing the Luxembourg state or another public body is the only statutory exception[i]. There is therefore no legal differentiation in Luxembourg between an executive director who is an employee of the entity, a non-executive director who is not and an independent director who is non-executive director with no link whatever with the entity that could entail a conflict of interest. The lack of differentiation or legal status of the different director statutes under Luxembourg law has traditionally made such differentiation empty of consequences and therefore not very important in practice.

However, with the CSSF circular 12/552, as amended (the Circular) which came into force on January 1, 2014 with respect to the section of the composition and qualification of boards of directors of credit institutions (hereafter "the banks") and investment firms and the increased European harmonization of corporate governance, the situation has changed and is likely to change even more dramatically in the next few years. We will hereafter briefly cover those areas in practice where the director status may have an impact now and in the future.

Executive versus non-executive directors

Given that there is no legal distinction between the statutes of executive and non-executive directors, both have the same legal duties, responsibilities and potential liabilities under Luxembourg law. This is for instance regularly evidenced in the fines imposed by the CSSF for regulatory violations, which are generally imposed identically across the board with no differentiation of status. This lack of distinction is somewhat problematic in practice as both classes of directors do not have the same access to information or involvement in the business, yet they have to show the same commitment to the entity they serve and have a good understanding of its structure and business. Also, it is clear that non-executive directors should feel less pressured by internal politics than executive directors who are financially dependent on the entity on which board they are sitting.

Finally, their underlying purpose differs: the additional cost of having (remunerated) non-executives on the board is usually linked to the expectation of the relevant entity to have them bring more independence and impartiality than an executive director could. They also have more liberty to act upon their convictions and bring in a combination of specific experience and/or knowledge that may not be easily found within the entity and personal qualities that allows the board to be a place of discussions and challenges.

There was a time where non-executive directors were appointed more as honorary directors, because they were trusted advisers, well-known in the industry or heavily networked and not principally because their profile in terms of competence and personality completed the board composition and encouraged an active and productive discussion around the board table. With the new "fit and proper" test applying to, among others, bank directors individually[ii] and the diversity and "collective fitness" requirements applying to the bank board collectively, we are now witnessing a clear willingness to break with a past practice.

This new turn will also mean that experts appointed to a board cannot satisfy themselves with merely advising other board members but have to be conscious of the fact that they are separate and individual board members who need to act and make decisions based on the same knowledge, skills and independence (of thinking) that are expected of the other directors.

Non-executive directors are specifically expected to allocate sufficient time to conduct their director mandate effectively[iii]. A minimum time commitment is often also mentioned in a director's engagement letter (if one is signed). The time commitment is however only indicative as directors will always be expected to have dedicated sufficient time to effectively fulfill their mandate. Such mandate implies that they shall have read and understood the information contained in the board pack and have acquired sufficient knowledge to fully understand the core information provided therein.

One other difference that could impact the treatment of different classes of directors is the remuneration. Executive directors are usually not remunerated for sitting on the board whereas non-executive directors typically would be. Under Luxembourg law, a mandate holder (such as a director) who is not remunerated for his/her mandate would typically benefit from a lower responsibility[iv]. This could theoretically have an impact on an executive's behavior.

In practice however, this does not seem to be the case as the main responsibility risk for bank directors (in terms of perception and, to this date, verified as far as Luxembourg market practice is concerned) is usually not to be sued by the bank or a third party but to be fined or otherwise sanctioned by the CSSF. In the latter case, remuneration would not make a difference as non-compliance is usually a "strict liability", which would result in the (administrative) sanction being applied by the CSSF across the board.

Non-executive versus independent directors

Independent directors have long been assimilated to non-executives in the Luxembourg market. Experts acting as non-executives directors often considered themselves to be "independent" directors eventhough they usually had business connections with the entity for which they were acting as directors. The Circular has now shed some clarity on the independent director concept: an independent director is a "director who does not have any conflict of interest which might impair his/her judgment because s/he is bound by a business - family or other5 - relationship with the institution, its controlling shareholder or the management of either"[v].

The Circular also mentions that the chairman of the board is in charge (and must therefore directly or indirectly promote, to the extent possible) of proposing the election of independent directors. Independent directors being especially mentioned and their appointment encouraged by the Circular, their "market share" is likely to increase with time. For now, they benefit from mere recommendations[vi] as opposed to "quotas" but this is expected to change in the near future. Other non-executives will remain relevant to a diversified and healthy bank board and will continue to benefit from the "no executives majority" rule applicable to banks[vii].

Employee representative directors

Employee representative directors are, according to Luxembourg law[viii] and in the absence of statutes, regulations or court cases expressly mitigating such principle, subject to the same standard liability as other directors. It is thus to be assumed that they should be treated as any other executive directors[ix]. This will mean in practice that they should ensure that they have the appropriate training to meet the high expectations deriving from bank directorship[x]. They are also subject to the duty of confidentiality as any other bank director and, because of their unique position, will want to clarify with the board what information (and when) they may or may not disclose to their fellow employees.

State and public body representative directors

A non-executive director representing the Luxembourg state or a Luxembourg public body has, unlike other directors, a very particular status. According to the law dated 25 July 1990, as amended, such a director is not liable for his/her actions taken during the directorship mandate but it is the state or public body that is liable in his/her place[xi]. Such director must report to the state or public entity and take voting instructions (which are however rarely given in practice).

This obviously means that these directors may not have the same pressure, from a risk and liability driven perspective, as other non-executive directors when it comes to their investment in the director mandate and their acting in the best interest of the bank. They could, at least from a legal and political perspective, have more of an interest in fulfilling the expectations that the state or public body will have attached to their mandate. All bank directors except state and public body representatives being subject to the same legal duties, responsibilities and potential liabilities, their director status differences thus matter elsewhere. While some statutes are growing in regulatory recognition and may be imposed to a larger number of Luxembourg banks in the near future, the same also have a cost impact in the form of their remunerations.

In Luxembourg, a bigger and more diversified non-executive directorship market and more transparency requirements are slowly dragging certain remunerations and the number of mandates per director down. At the same time, regulatory sanctions are being increased and becoming more common. A bank board membership is no longer mostly assimilated to an honorary position destined to a happy few, yet it has clearly not lost any of its appeal. It remains to be seen how the bank directorship market will evolve in Luxembourg but it can be expected that the changes will be more important than initially anticipated and be hoped that such market evolution will drive or at least properly accompany the changes to corporate governance expected by the CSSF and the European Union.

i) Law dated 25 July 1990, as amended concerning the status of a director representing the state or a public body in a Luxembourg public limited liability company.
ii) The Circular requires the assessment of the suitability of key function holders. See also the bill of law N°6660 dated 28 February 2014.
iii) Article 25 of the Circular. This also means that there will be a limited number of directorship mandates one can take on and devote sufficient time to fulfill his/her director duties. This view is reinforced by the Circular's requirement to disclose outside directorship mandates. See also the bill of law N°6660 dated 28 February 2014.
iv) Article 1992 of the Civil Code, "Le mandataire répond non seulement du dol, mais encore des fautes qu'il commet dans sa gestion. Néanmoins, la responsabilité relative aux fautes est appliquée moins rigoureusement à celui dont le mandat est gratuit qu'à celui qui reçoit un salaire."
It is however unclear under Luxembourg law whether an executive director will be considered to be without remuneration since he/she will be perceiving a salary from the entity not for his/her executive mandate but as its employee.
v) Article 31 of the Circular. See also, for guidance on criteria applied to define independence, "The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange" (2nd edition, October 2009, Appendix D – Independence criteria) and the practical checklists and examples set out in the "ILA bank directors 'guide" issued by the Banking Committee of the Institut Luxembourgeois des Administrateurs (ILA).
vi) In article 31 of the Circular, the CSSF recommends larger institutions to have one or several independent directors. We, at the ILA Banking Committee, recommend to have at least 2 independent directors to ensure that the independent directors are not isolated and their expressing challenging views does not become impracticable.
vii) Article 25 of the Circular.
viii) L-426-8 of the Labor Code.
ix) While these directors have in principle no management role, in the absence of clear guidance given by the legislator or the CSSF in this respect, it is to be assumed that at least for regulatory purposes, employee representatives directors may generally be considered to be executive directors. See however, the "no executives majority rule" stated in article 25 of the Circular for a possible different interpretation of the CSSF's views, which could also simply be linked to the statutorily set "quota" of employee representative having to be appointed directors: "In this respect, the board of directors cannot have among its members a majority of persons who take on an executive role within the institution (authorised managers or other employees of the institution, with the exception of staff representatives)".
x) It is unfortunate that employee representative directors rarely attend outside director training. It is sometimes forgotten that their status of employee-elected directors does not change the fact that they have to act in the interest of the bank and need to meet the usual expectations in terms of understanding of the bank structure, its business and strategies.
ILA (www.ila.lu) and IFBL (www.ifbl.lu) regularly have relevant sessions organised. For instance, the two-day workshop organized by the ILA Banking Committee end of September 2013 was specifically focused on bank directors and will occur at least once a year.
xi) «La personne morale de droit public assume les responsabilités qui incombent aux personnes désignées à sa demande en leur qualité d'administrateurs, sauf son recours contre elles en cas de faute personnelle grave.»