

DIRECTORS DUTIES AND LIABILITIES

UNDER THE COMPANIES ACT 2006

DISCLAIMER

This guidance note contains a general statement of the new provisions under the Companies Act 2006 and is made available on the basis that no liability is accepted for any errors of fact or opinion it may contain.

Professional advice should be obtained before applying the information in particular circumstances

INTRODUCTION

This briefing note has been prepared to provide directors with a summary of their duties under the Companies Act 2006 (2006 Act).

The duties owed by directors to their companies have evolved through case law. However, the 2006 Act introduced a statutory statement of directors' duties that replaced many of those common law and fiduciary duties.

In this briefing note, unless otherwise stated all references to sections are to sections of the 2006 Act.

It should be noted that this note only covers duties owed by a director to the company. Directors will, however, have many other duties, both under the 2006 Act, such as the duty to deliver accounts (*section 441*), and under a wide variety of other laws and regulations, such as insolvency and health and safety legislation.

GENERAL DUTIES OF DIRECTORS UNDER THE COMPANIES ACT 2006

1 Duty to promote the success of the company (section 172)

Section 172 provides that a director must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole (*section 172(1)*). In so doing, the director must have regard (among other matters) to:

- The likely consequences of any decision in the long term.
- The interests of the company's employees.
- The need to foster the company's business relationships with suppliers, customers and others.
- The impact of the company's operations on the community and the environment.
- The desirability of the company maintaining a reputation for high standards of business conduct.
- The need to act fairly as between the members of the company.

Where the company's purposes consist of or include purposes other than for the benefit of its members, the director must act in the way he considers, in good faith, would be most likely to achieve those purposes (*section 172(2)*). Companies are therefore free to adopt other purposes in their constitutions.

The duty is subject to any enactment or rule of law requiring directors in certain circumstances to consider or act in the interests of the creditors of the company (*section 172(3)*). Accordingly, the duty is displaced when the company is insolvent, and may be modified by an obligation to have regard to the interests of creditors as the company nears insolvency.

It should be noted that:

- The duty will apply to all decisions made by a director, not merely formal decisions made by the whole board.
- "Success" is not defined. The government has stated that "success" in this context will usually mean "long-term increase in value" for commercial companies, and that what will promote the success of the company, and what constitutes such success, will be for the director's good faith judgment - its view is that this will ensure that business decisions on, for example, strategy and tactics, are for the directors, and are not subject to decision by the courts, provided the directors were acting in good faith.
- The obligation to have regard to the listed factors is clearly subordinate to the overarching duty to promote the success of the company for the benefit of its members as a whole. However, the obligation to have regard to at least the listed factors, in carrying out the overarching duty, is mandatory.
- The list of factors is not exhaustive - directors should have regard to other matters relevant to the duty to promote the success of the company.
- In having regard to the listed factors, the duty to exercise reasonable care, skill and diligence (*section 174*) will apply (see further below, Duty to exercise reasonable care, skill and diligence (*section 174*)). In some cases, to satisfy the duty, it may be necessary to seek expert advice, for example in relation to the impact on the community or environment.

- One of the stated purposes of the annual business review is to help members assess how the directors have performed their duty under section 172 (*section 417(2)*). Stakeholders may examine the review to assess whether the directors have complied with the duty.

Section 172 has been the subject of a great deal of comment and debate. Concerns have included:

- Whether the distinction between a company as a corporate entity and its members will be maintained. The fiduciary duty to act in the best interests of the company has traditionally been interpreted by identifying the company with its shareholders, both present and future and requiring directors to balance short-term and long-term interests. So, in the case of a hostile bid which could damage the company's long-term interests, it has been generally accepted that directors could decline to recommend a bid, even if it would be in the best interests of the current shareholders.
- It is not clear that this will continue to be the case. The drafting of the section could mean that the interests of the company's present members take precedence. Until the meaning of the section is more settled, directors may wish to seek professional advice in circumstances where the interests of the company's present members conflict with those of the company as corporate entity.
- How, or if, directors should document their compliance with the section. Some commentators are of the view that directors will be in a much better position if, in the event litigation later arises, they can provide records, such as minutes of discussions, to prove that they paid due regard to the factors listed in section 172(1). However, the current prevailing view appears to be that:
 - It will be sufficient for the minutes to state that the directors have taken the factors into account in carrying out their duty (for example, *Standard document*, Skeleton board minutes: 1 October 2007).
 - If any factor is particularly relevant, whether or not in the specified list, the minutes should reflect points made during discussions (subject to company policies on record-keeping), but otherwise the discussion of each factor need not be minuted.
 - For significant or potentially controversial decisions, briefing papers prepared by management should address each listed factor, unless clearly irrelevant, along with other relevant matters.
 - Companies may wish to circulate a copy of section 172 with board papers.
- That the need to consider a prescribed list of factors, combined with the new derivative action provisions in the 2006 Act, will increase shareholder litigation. The government has expressed the view that there is no reason to expect that there will be a greater degree of litigation on the new duty than there is now on the duty to consider the interests of employees under section 309 of the 1985 Act (a little-litigated section). It should also be noted that any member seeking to bring a derivative action will face considerable procedural hurdles and that, when considering whether to give permission to continue a derivative claim, a court must look at any evidence before the court as to the views of the company's members with no personal interest in the matter (see further below, Action by the company). Accordingly, for potentially controversial decisions, boards might want to seek the views of independent shareholders.

All companies should ensure that the directors are aware of their duties under the 2006 Act. The GC100 has suggested that this could be done in all or some of the following ways:

- As a transitional move, boards should be given a thorough briefing on the new duties introduced by the 2006 Act.
- On appointment, all new directors should be briefed upon their duties under the 2006 Act.
- The terms of appointment and description of the role of any director should specifically refer to his duties.
- The terms of reference of any board or committee may also refer to those duties.
- Companies should review their existing policies in areas such as human resources, ethics, compliance and corporate responsibility against the background of the new duties.

Other steps may include:

- Ensuring management, those employees responsible for preparing board papers and presentations, and others involved in governance, are also given a thorough briefing on the new duties.
- Reviewing the company's policy on minutes of meetings and determining how compliance with section 172 will be documented (minutes, briefing papers and presentations etc).
- Concern has been expressed that directors may be exposed to risk if the board minutes deal with the section 172 matters inconsistently, for example by sometimes stating that the matters were taken into account, sometimes discussing each factor individually, and sometimes not referring to them at all. Such inconsistency could be construed as an indicator of whether, and to what extent, the board took the section 172 matters into account. Drafting and complying with a policy setting out the company's approach to section 172 might assist in rebutting such an assumption, however the policy would need to be carefully drafted and applied consistently, as failure to comply with it could also be adversely construed.

2 Duty to act within powers (section 171)

Section 171 codifies the equitable principle under which a director must act in accordance with the company's constitution and must only exercise his powers for their proper purpose.

A company's constitution for these purposes includes:

- The company's articles (and memorandum).
- Decisions taken in accordance with the articles.
- Other decisions taken by the members or a class of them, where treated by law as equivalent to decisions of the company.
- Any resolutions and agreements affecting a company's constitution.

The section does not clarify aspects of the duty to exercise powers for proper purposes, such as how those purposes are to be ascertained, or the extent to which an improper purpose may taint a decision. Such matters will fall to be determined in accordance with previous case law, under which courts have approached the duty by first

ascertaining the purpose for which the power was conferred, and then determining whether that was the director's substantial purpose when exercising the power. The liability is strict: if the director's substantial purpose was not the purpose for which the power was conferred, it will not matter if he exercised the power in good faith or in the belief that it would promote the success of the company for the benefit of the members as a whole.

3 Duty to exercise independent judgment (section 173)

Section 173 also codifies the existing law. It provides that a director must exercise independent judgment. The duty will not be infringed by a director acting in accordance with an agreement entered into by the company that restricts the future exercise of the directors' discretion or in a way authorised by the company's constitution. It follows that any powers of delegation should be set out in the articles.

The government has said that this duty will not prevent directors relying on advice, as long as the directors exercise their own judgment in deciding whether or not to follow the advice.

4 Duty to exercise reasonable care, skill and diligence (section 174)

Section 174 codifies the commonly accepted understanding of a director's duty of care, skill and diligence.

Under section 174, a director must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both:

- The general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company (the "objective" test).
- The general knowledge, skill and experience that the director actually has (the "subjective" test).

So, at a minimum, a director must display the knowledge, skill and experience set out in the objective test, but where a director has specialist knowledge, the higher subjective standard must be met. In applying the test regard must be had to the functions of the particular director, including his specific responsibilities and the circumstances of the company.

5 Duty to avoid conflicts of interest (section 175):

Under section 175, a director must avoid situations in which he has or can have a direct or indirect interest that conflicts with, or may conflict with, the company's interests. That applies, in particular, to the exploitation of property, information or opportunity, and whether or not the company could take advantage of the property, information or opportunity.

The section does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company, as that is covered by sections 177 and 182 (see below, Duty to declare interest in proposed transaction or arrangement with the company (section 177)).

The duty in section 175 will not be infringed:

- If the situation cannot reasonably be regarded as likely to give rise to a conflict of interest.

- In the case of a private company, if authorisation has been given by directors who are genuinely independent (in the sense that they have no direct or indirect interest in the transaction), unless the company's constitution prevents such authorisation.
- In the case of a public company, if authorisation has been given by the independent directors and the company's constitution expressly permits such authorisation.

Board authorisation will only be effective if the required quorum is met without counting the director in question or any other interested director and if the conflicted directors have not participated in the taking of the decision or if the decision would have been valid without the participation of the conflicted directors. (Board authorisation is not permitted in respect of the acceptance of benefits from third parties (*section 176*.)

The duty to avoid conflicts of interest will continue to apply after a person ceases to be a director as regards the exploitation of any property, information or opportunity of which he became aware when he was a director.

Concern has been expressed as to the application of section 175 in relation to directors who sit on more than one board. The government has suggested that board authorisation of another directorship would "frank" any conflict which later arose as a result, however a general authorisation may not be wide enough to cover the conflict in question, and a director may be unable to disclose particulars to the company when they arise, for example for reasons of confidentiality. In such circumstances, directors should seek independent legal advice.

Companies might wish to consider amending their articles to provide for such issues, for example, to provide that directors may hold additional directorships and need not disclose confidential information obtained through those other offices.

6 Duty not to accept benefits from third parties (section 176):

Section 176 codifies the fiduciary rule prohibiting the exploitation of the position of director for personal benefit.

Under the section, directors must not accept any benefit (including a bribe) from a third party which is conferred because of his being a director or his doing or not doing anything as a director.

The duty will not be infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. Benefits conferred by the company, its holding company or subsidiaries, and benefits received from a person who provides the director's services to the company, are excluded.

Any current ability of the members of a company to authorise the acceptance of benefits that would otherwise be a breach of this duty is preserved by section 180(4), and the company's articles may contain provisions for dealing with conflicts. Companies may wish to amend their constitutions to provide that where directors accept benefits under a specified value, they will not be in breach of their duty to the company, for example to ensure that the acceptance of a certain level of corporate hospitality will not cause a director to breach the section.

The duty will continue to apply after a person ceases to be a director in relation to things done or omitted by him before he ceased to be a director.

7 Duty to declare interest in proposed transaction or arrangement with the company (section 177):

Under section 177, directors must declare to the other directors the nature and extent of any interest, direct or indirect, in a proposed transaction or arrangement with the company. The director need not be a party to the transaction for the duty to apply. An interest of another person in a contract with the company may require the director to make a disclosure under this duty, if the other person's interest amounts to a direct or indirect interest on the part of the director.

The declaration must be made before the company enters into the transaction or arrangement.

Where a declaration of interest proves to be, or becomes inaccurate or incomplete, a further declaration must be made, if the company has not yet entered into the transaction or arrangement when the director becomes, or should reasonably have been, aware of the inaccuracy or incompleteness.

No declaration will be required:

- Where the director is not aware of his interest or where the director is not aware of the transaction or arrangement, but directors will be treated as being aware of matters of which they ought reasonably to be aware.
- If the interest cannot reasonably be regarded as likely to give rise to a conflict of interest, if the other directors are already aware of it, or if it concerns the terms of the director's service contract which have been (or are to be) considered at a board meeting or board committee.
- Where the company has only one director.

Section 177 only deals with proposed transactions or arrangements. Existing transactions and arrangements are covered by section 182 (not a "general duty" as defined by the 2006 Act), which provides that a director must declare the nature and extent of his direct or indirect interest in an existing transaction or arrangement entered into by the company, to the extent that the interest has not been declared under section 177.

SCOPE AND NATURE OF THE GENERAL DUTIES

1 Which directors?

The general duties will apply to all the directors of a company. "Director" is defined to include any person occupying the position of director, by whatever name called (*section 250*), which will include a de facto director (that is, a person who acts as a director without having been validly appointed). Whether the general duties will apply to a shadow director (that is, a person in accordance with whose directions or instructions the directors of the company are accustomed to act) will depend on his or her functions.

The Act makes no distinction between executive and non-executive directors.

2 Duties owed to the company

The codified duties are owed to the company (*section 170(1)*). Only the company will be able to enforce them, although in certain circumstances shareholders may be able to bring a derivative action on the company's behalf (see below, Action by the company).

3 Cumulative duties

Where more than one duty applies in a given case, the directors must comply with each applicable duty (*section 179*). For example, the duty to promote the success of the company will not authorise directors to breach their duty to act within their powers, even if they consider that action would be most likely to promote the success of the company. The general duties also do not require or authorise a director to breach any other law.

4 Relationship between the common law and equitable duties and the new general duties

The 2006 Act does not contain all the necessary details on directors' duties, and common law rules and equitable principles will need to be considered in interpreting and applying the general duties.

It should also be noted that the codification is not exhaustive. Directors will continue to owe certain equitable and common law duties to the company, such as:

- The duty of confidentiality.
- The duty to consider or act in the interests of creditors when the company is insolvent (see Duty to promote the success of the company (*section 172*), above).

CONSEQUENCES OF BREACH

1 Action by the company

As noted above, the codified duties are owed to the company and only the company will be able to enforce them, although in certain circumstances shareholders may be able to bring a derivative action on the company's behalf.

The circumstances in which derivative actions may be brought are extended by the 2006 Act, and such actions are expressly available for a breach of duty by directors (including any breach of the general duties in Chapter 2 of Part 10), even if the director has not benefited personally from the breach.

However, a member will face a number of procedural hurdles in bringing an action. For example, a court must refuse permission for a claimant to bring a derivative claim where it is satisfied that either:

- A person acting in accordance with the general duty to promote the success of the company (under section 172) would not seek to continue the claim.
- The act or omission giving rise to the cause of action has been authorised or ratified by the company (*section 263(2)*).

Further, section 263(3) prescribes factors that the court must particularly take into account when considering whether to give permission, which include:

- Whether the member is acting in good faith in seeking to continue the claim (the intention being to assist in preventing vexatious claims at an early stage).
- The importance that a person acting in accordance with the duty to promote the success of the company would attach to continuing the claim.
- Whether the company has decided not to pursue the claim.
- Any evidence before the court as to the views of members of the company who have no personal interest (direct or indirect) in the matter.

Directors should also bear in mind the following deterrents to bringing a derivative claim:

- Costs will usually be awarded against unsuccessful claimants.
- Even if a claim is successful, any damages will accrue to the company, not to the claimant.

2 Remedies

Under section 178, the consequences of a breach or threatened breach of the duties are the same as for breach of the corresponding common law or equitable principles.

The remedy for a breach of section 174 (Duty to exercise reasonable care, skill and diligence) will usually be damages. Remedies for breaches of other general duties may include:

- An injunction.
- Setting aside of the transaction, restitution and account of profits.
- Restoration of company property held by the director.
- Damages.
- Termination of the director's service contract.

3 Relief from liability

3.1 Ratification

Section 239 preserves the current law on ratification of acts of directors, but with a significant change. Any decision by a company to ratify conduct by a director amounting to negligence, default, breach of duty or breach of trust in relation to the company must be taken by the members without reliance on the votes in favour by the director or any connected person. A member connected with the director will include certain family members (*section 252*) and may include fellow directors (*section 239(5)(d)*).

Ratification will bar the bringing of a derivative claim. Even if the conduct has not been ratified, where a court is determining whether to permit a claimant to continue a derivative claim, it must consider whether the conduct could be, and is likely to be, ratified by the company.

3.2 Power of the court to grant relief

Section 1157 substantially restates section 727 of the 1985 Act and provides that where proceedings for negligence, default, breach of duty or breach of trust are brought against a director, the court may relieve him from liability if it considers both that:

- He has acted honestly and reasonably.
- Considering all the circumstances of the case, he ought fairly to be excused.

A director may also apply to the court for relief where he has reason to expect that a claim may be made against him.

INDEMNITY AND INSURANCE

1 Indemnity

Under section 232 (which broadly re-enacts section 309A of the 1985 Act), a company will not be able to exempt a director from any liability for negligence, default, breach of duty or breach of trust in relation to the company. (Liability under derivative claims, brought on behalf of the company, will be covered by this section.)

The company may, however, indemnify the director against defence costs, or costs incurred in an application for relief under section 1157 (above), provided that the director repays the costs if he is unsuccessful.

Directors should review the terms of any indemnity given to them by the company to determine whether such third party liabilities are covered.

2 Insurance

Section 233 permits a company to purchase insurance for its directors, and those of an associated company, against any liability attaching to them in connection with any negligence, default, breach of duty or breach of trust by them in relation to the company of which they are a director.

Directors should also review the terms of their D&O insurance to ensure that the defence of derivative claims under the 2006 Act is covered.

PRACTICAL STEPS

In summary, directors should:

- 1 Ensure that they are aware of their duties under the 2006 Act (see further, Duty to promote the success of the company).
- 2 Ensure management, those employees responsible for preparing board papers and presentations, the business review and others involved in governance, are also aware of the new duties of directors.
- 3 Review the company's policy on minutes of meetings and determine how section 172 will be complied with and documented (minutes, briefing papers, presentations, external advice, business review etc) (see further, Duty to promote the success of the company).
- 4 Review the terms of reference of board committees, in particular in view of the duty under section 172.
- 5 Review the company's policies generally in view of section 172.
- 6 Familiarise themselves with the constitution of the company, in particular any limitations on the powers of the company or the directors (see Duty to act within powers (section 171)).
- 7 Determine whether the articles of the company (whether public or private) should be amended to permit independent director authorisation of conflicts of interest (see Duty to avoid conflicts of interest).
- 8 Consider whether the articles should be amended to:
- 9 Include authorisation for directors to act in a way which would otherwise breach section 173, such as authority to delegate certain functions (see Duty to exercise independent judgment)
- 10 Provide for specific conflicts of interest, such as multiple directorships (see further, Duty to avoid conflicts of interest).
- 11 Remove redundant provisions arising from the change of law on conflicts on interest, such as provisions which provide that a director may enter into transactions or arrangements with the company in certain circumstances (see Duty to declare interest in proposed transaction or arrangement with the company).
- 12 Include, if appropriate, a requirement for member approval of certain transactions or arrangements that would otherwise only need to be authorised by directors under section 175 or declared to the board under section 177.
- 13 Include or retain restrictions on a director's participation in board discussions on matters to which sections 177 and 182 apply.
- 14 Provide that where directors accept certain benefits from third parties, such as benefits under a specified value, they will not be in breach of their duty to the company under section 176 (see Duty not to accept benefits from third parties).
- 15 Review their D&O insurance policies to ensure that the defence of derivative claims under the 2006 Act is covered, and ensure the terms of any indemnity from the company includes permitted third party liabilities (see Indemnity and insurance).