

A Guide to Directors' Duties

Under the Companies Act 2006

The Companies Act 2006 ("the Act"), received Royal Assent on 8th November 2006. The Act was implemented over a 3 year period with various key implementation dates, the last of which was 1st October 2009.

In general, the aim of Government was to:

- simplify company law;
- to ensure businesses operate with greater integrity;
- to emphasis corporate social responsibility; and
- to make directors more accountable and responsible, primarily to the shareholders as a whole but also to a range of other stakeholders.

Directors' Duties

In relation to rules affecting directors, most of the key provisions came into force on the 1st October 2007 and 1st October 2008, however, other provisions relating to particulars of directors to be registered and directors' residential addresses (sub-sections 162-167 and 240 to 246) came into force on 1st October 2009.

One of the key changes for directors under the new Act is the codification of the various common law and equitable duties that govern the activities of the individuals who comprise of the Board. Breach of these duties means the transaction may be voidable, although still ratifiable by an ordinary resolution of the shareholders.

The key common law obligation is that directors must act in good faith in the best interest of the company, i.e. in the interest of the shareholders as a whole, except in times of insolvency, when the interests of the creditors must be given priority.

Other common law duties include the following:

- Duty to exercise skill and care;
- Duty to act within the powers conferred by the company's Memorandum and Articles of Association and to exercise powers for proper purposes;
- Duty not to fetter discretion;
- Duty to avoid conflicting interests and conflicting duties; and
- Duty not to make a secret profit.

The Act replaces these with a statutory statement of the main general duties owed to the Company. The seven new general duties are as follows:

- Duty to act within powers (Section 171);
- Duty to promote the success of the Company (Section 172);
- Duty to exercise independent judgement (Section 173);
- Duty to exercise reasonable care, skill and diligence (Section 174);
- Duty to avoid conflicts of interest (Section 175);
- Duty not to accept benefits from third parties (Section 176); and
- Duty to declare interest in proposed transactions or arrangements with the Company (Section 177).

The above is not a definitive list of all the duties that a director owes to a company, as there are a number of other responsibilities relating to the delivery of accounts and issues relating to insolvency, which are covered by other sections of the Act or by other legislation.

It is clear that for the most part, the codified duties reflect directly the previous position at common law and for that reason have not caused a great degree of comment during the consultation of the Act. However, one of the most significant aspects of the new regime is new wording set out in Section 172 of the Act and the widely quoted concept of “enlightened shareholder value”.

Section 172 - Duty to promote success of company

There is some doubt as to the implications of the new Section 172 duty to “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”. This has to be understood in the context of the newly introduced concept of “enlightened shareholder value” which the directors need to have regard to.

Section 172(1) states that, in exercising those duties, directors must have regard to (amongst other matters) the following six factors:

1. The likely consequences of the decision in the long term;
2. The interests of the company’s employees;
3. The need to foster the company’s business relationships with suppliers, customers and others;
4. The impact of the company’s operations on the community and the environment;
5. The desirability of the company maintaining a reputation for high standards of business conduct; and
6. The need to act fairly as between members of the company.

The theory behind expressing the duties in this way is that the Board should sit down and consider the interests of these various stakeholders before reaching a corporate decision.

Enlightened shareholder value

The term enlightened shareholder value is not used in the Act. It was a phrase adopted by the Company Law Review and repeated in the various readings of the Bill through parliament. For example:

“For the first time, the Bill includes a statutory statement of directors’ general duties. It provides a code of conduct that sets out how directors are expected to behave. That enshrines in statute what the Law Review called “enlightened shareholder value”. It recognises that directors will be more likely to achieve long term sustainable success for the benefit of their shareholders if their companies pay attention to a wider range of matters..... Directors will be required to promote the success of the company in the collective best interest of the shareholders, but in doing so, they will have to have regard to a wider range of factors, including the interests of employees and the environment”. Alistair Darling, Commons Second Reading, 6th June 2006, column 125.

This sort of language is consistent with growing pressure for businesses to incorporate corporate social responsibility (“CSR”) objectives into their plans. Whilst at one time companies and firms had a certain freedom to choose the extent to which they broadened their objectives beyond financial profit, global social change has increasingly called on regulators to force the businesses they govern to specifically take account of a wider range of stakeholders that the business may interact with or affect.

Consequences of the new regime

These codified duties are going to be interpreted on the basis of court judgment and therefore, in many situations, it is likely there will be continuity with the pre October 2007 common law position. Similarly, the consequences of breach are unchanged. Nevertheless, there is no real guidance on the weight attached to the factors listed under Section 172 and it may be a lengthy wait until there is sufficient judicial authority on what some of the new language means.

We would urge all directors of companies (of all sizes) to familiarise themselves with the new codified duties and should if possible read guidance provided by institutions such as The Institute of Directors.

In practical terms we simply advise directors to continue to act in good faith and have as wide a perspective as possible when making material board decisions. For smaller companies it would be wise for their directors to list the factors stated in Section 172 in their board meeting minutes in order to remind themselves of the wider considerations and various stakeholders they need to be considering when making board decisions.

The seven general duties in more detail

1. General duty to act within powers

Directors must act within their powers and in accordance with the company's constitution. More specifically they must "only exercise powers for the purposes of which they are conferred".

2. Duty to promote success of company

Directors must act in a way in which they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. In so doing, they must have regard to the 6 points set out above. However, if insolvency approaches, the directors must have regard to the interest of the company's creditors.

Enforceability of these duties is by the company through either the board, the members in general meeting or, if the company is in liquidation through the liquidator. Director's duties are enforceable by the company and not by individual members, creditors or anyone else (*Foss v Hardbottle*).

Therefore, the theory behind expressing the duties in this way is that the board should sit down and consider the interests of these various stakeholders before reaching a corporate decision. Whether this is going to prove to be the reality remains to be seen.

3. Duty to exercise independent judgement

Directors must exercise independent judgement. This is said to codify the current principle of law whereby directors must exercise their powers independently, without subordinating their powers to the will of others.

While the duty does not confer on a director a power to delegate, there is nothing to prevent the company's constitution permitting delegation.

4. Duty to exercise reasonable care, skill and diligence

Directors must exercise reasonable care, skill and diligence. This means that they must show the skill which they actually have or that which might reasonably be expected of such a director whichever is the higher. This confirms that the standard expected of directors is in line with that for wrongful trading under Section 214 of the Insolvency Act 1986. Example, a 30 years qualified accountant must show the care, skill and diligence of a 30 years qualified chartered accountant whereas those directors who might not be considered to be amongst the sharpest knives in the drawer, cannot hide behind their subjective stupidity; they must show the care, skill and diligence that a sensible observer would expect of such a director of such a company.

5. Duty to avoid conflicts of interest

Directors must act in such a way as to avoid a situation in which he has or could have an interest which conflicts with the interest of the company. In particular, this applies to the exploitation of any property, information or opportunity available to the company. It applies whether the company could or not take advantage of such property, information or opportunity.

Potential conflict situations must be authorised by the board.

Whenever authorisation is sought of the board, the interested director must not count in the quorum.

6. Duty not to accept benefits from third parties

A director must not accept a benefit from a third party conferred by reason of his being a director or his doing or not doing anything as a director. The duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. Quite at which point it can be said that a benefit cannot reasonably be regarded as likely to give rise to a conflict of interest is questionable. Query should it be measured by the objective value of the benefit or the subjective personal wealth of the director concerned?

7. Duty to declare interest in proposed transaction

If a director is in any way, whether directly or indirectly, interested in a proposed transaction or arrangement with the company, he must declare the nature and extent of that interest to the other directors. Such declaration must be made before the company enters into the transaction or arrangement. There is a de-minimus applied to this and a director need not declare an interest if it is not such as could reasonably be regarded as likely to give rise to a conflict of interest.

Subject to the company's articles of association, conflicted directors may participate in decision making.

Under the draft model articles of association, the directors must in most circumstances disregard the views of an interested director when taking a majority decision on a matter relating to such transaction with the company.

CALL NOW to speak to a member of the Company & Commercial team.

We would be happy to discuss your particular situation and offer specific guidance to help you navigate this transition more effectively and efficiently.

Disclaimer

These notes have been prepared by **Curwens Solicitors** as general guidance only and cannot be taken as legal advice. **Curwens Solicitors** will not be liable for any loss, direct or consequential, suffered by anyone acting or omitting to act as a result of the contents of these notes.

Enfield:
020 8363 4444
enfield@curwens.co.uk

Cheshunt:
01992 631 461
cheshunt@curwens.co.uk

Hoddesdon:
01992 463 727
hoddesdon@curwens.co.uk

Royston:
01763 241 261
royston@curwens.co.uk