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DIRECTORS' DUTIES
COMPANIES ACT 2006

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DIRECTORS' DUTIES: COMPANIES ACT 2006 ("the Act")

The Companies Act 2006 ("the Act"), which received Royal Assent on 8 November 2006, is intended to benefit businesses by modernising and simplifying company law.

Alastair Darling, the then Secretary of State for the DTI (now BERR), commented that:

"The [Companies] Act [2006] will help ensure that Britain remains one of the best places in the world to set up and run a business. It makes sure that the regulatory burden on business is "light touch", promotes shareholder engagement and will help encourage a long term investment culture in the UK."

Current law

The current rules governing directors' duties and liabilities come from several sources. The general duties which a director owes to a company are governed by common law (and developed by case law). Additional rules are set out in the Companies Act 1985 and other legislation. At present, directors' fiduciary and common law duties include the following:-

- Duty to exercise skill and care;
- Duty to act in good faith and in the best interests of the company;
- 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.

Key changes

The new Act sets out a statutory statement of directors' duties, known as "general duties", the majority of which were implemented by October 2007. These changes will replace many existing common law and equitable rules, therefore it would be useful for all directors to familiarise themselves with the code (see sections 170-181 of the Act).

The Act does, however, state that regard must be had to the common law rules and equitable principles that already exist in interpreting and applying the general duties (section 170(4) of the Act).

The new codified duties will be owed to the company and only the company will be able to enforce them.

The codified duties will apply to all the directors of a company, including shadow directors, and in the case of certain duties (section 175, duty to avoid conflict of interest and section 176, duty not to accept benefits from third parties) even former directors of the company.

Significant changes

The most controversial changes under the Act are as follows:-

- The statutory requirement for directors to have a regard, among other things, to a list of six factors (see below) in exercising their general duty to promote the success of the company for the benefit of the members as a whole.
- Allowing independent directors to authorise a director's conflict of interest.

Directors' duties

- **Duty to act within powers (s.171)** – a director will be expected to act in accordance with the company's articles of association and to exercise their powers only for the purposes for which they are conferred.

Action: it would be advisable for all directors to review their powers under the company's articles of association.

- **Duty to promote the success of the company (s.172)** – a director is expected to act in a way which he considers, in good faith, would be most likely to promote the success of the company, for the benefit of shareholders as a whole. In doing so, a director will need to have regard to the following:

- (a) the likely long-term consequences of his decisions;
- (b) the interests of employees;
- (c) the need to foster the company's business relationships with suppliers, customers and others;
- (d) the impact of the company's operations on the community and the environment;
- (e) the desirability of the company maintaining a reputation for high standards of business conduct; and
- (f) the need to act fairly as between shareholders.

Action: while a director is always expected to act in good faith, he must also exercise reasonable skill, care and diligence in their decision making process (s. 174 below). The meaning of "success" is unclear and the Government has stated that "success" will usually mean "long-term increase in value" for commercial companies. Ultimately, it will be a matter of a director's business judgement as to what constitutes "success".

There is some concern amongst the business community that this particular duty might have the effect of increasing bureaucracy in companies, rendering the decision making process more arduous and potentially increasing the liabilities of directors.

The General Counsel 100 Group ("GC100") (a group for the general counsel and senior legal officers of FTSE 100 companies) is concerned that a practice will develop in this area of requiring directors to establish processes to prove that they have specifically considered each of the six factors by formally documenting each of these specific considerations in their decision making process. As a result of this concern, GC100 has produced a paper in an attempt to influence best practice in this area. The paper is not intended to be relied upon as legal advice; it merely represents the views of the GC100 as to how companies and their advisers can put the new law into practice.

The main piece of advice contained in the paper is that directors are not at the moment, and should not be, as a result of the Act, forced to evidence their thought processes, whether with regard to the stated factors or any other matter influencing their decision.

The paper sets out various practical steps which a company can take:-

- ensure that all directors receive a thorough briefing on the new duties introduced by the Act;
- on appointment, all new directors should be briefed upon their duties under the Act;
- the terms of appointment and description of the role of any director should specifically refer to their 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 their duties; and
- care will need to be taken to ensure the duties are not inadvertently extended to give new rights of action to third parties.

Best practice should be to record consideration of particular factors only where the circumstances make it particularly relevant or necessary. Since board minutes are a summary of what went on in a meeting, they should not become a medium for recording whether each factor was considered.

While the GC100 accept and approve the codification of the duties, it believes that many decisions have to be made within a time frame which does not often allow for the preparation of a formal paper; or for a formal minute of the decision. Ultimately the GC100 believes that a lack of formal process should not be taken as an inference that the factors have not been properly considered.

- **Duty to exercise independent judgement (s.173)** – it has been stated by the Government that this duty is “about directors having to make up their own judgements and not follow blindly the views of another without considering the interests of the company”.
- **Duty to exercise reasonable care, skill and diligence (s.174)** – the standard required of a director is that level of care, skill and diligence which would be exercised by a reasonably diligent person with (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the director’s functions; and (b) the general knowledge, skill and experience that the director has.

Action: this duty may have practical implications for a director, for example, training or improving certain processes within the business. A director should consider whether a shareholder would have higher expectations of him, over another, given the sort of person he is.

- **Duty to avoid conflicts of interests (s.175)** – a director must actively avoid situations in which he has (or could have had) an interest (direct or indirect)

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that conflicts (or may conflict) with the interests of the company. This applies in particular to the exploitation of property, information or opportunity.

From 2008, a “conflict” may in certain circumstances be authorised by the directors. Such directors’ authorisation may be given in a private company where the constitution does not invalidate the authorisation, or in a public company, where the constitution specifically allows the directors to authorise the matters proposed. Board authorisation is only effective if the required quorum is met without counting the director in question (or any other interested director).

Action: Review the memorandum and articles of association of the company and take advice where necessary as changes may be required.

- **Duty not to accept benefits from third parties (s.176)** – a director must not accept any benefit (including a bribe) from a third party which is conferred by them being a director or their doing (or not doing) anything as a director. This duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interests. Any benefits conferred by the company, its holding company or subsidiaries and benefits given under a director’s service contract are excluded.
- **Duty to declare interest in proposed transaction or arrangement with the company (s.177)** – a director 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. Such declaration must be made before the company enters into the transaction or arrangement. The declaration may (but need not) be made at a board meeting or by way of notice in writing (s.184) or a general notice (s.185). Where the declaration made becomes inaccurate or incomplete, a further declaration must be made.

No declaration is required where the director is not aware of his interest or where the director is not aware of the transaction or arrangement in question. Directors are therefore treated as being aware of matters of which they ought reasonably to be aware. A director need not make a declaration of interest if his interest cannot reasonably be regarded as likely to give rise to a conflict of interest, or if the directors are aware of it, or if it concerns the terms of his service contract which have been considered at a board meeting or board committee.

The DTI suggests that as the duty requires disclosure to be made to other directors, no disclosure is required where the company has only one director.

Action – directors should be encouraged to notify their interest as soon as a director becomes aware of them, in the manner described in the Act.

Breach

Breach of a duty may expose directors to civil and criminal liabilities, as well as the risk of disqualification. Directors in breach may find themselves under an obligation to pay damages or compensation, or to restore property or account for profits as appropriate.

Final word

The majority of the changes outlined above will come into force on 1 October 2007. It is essential that directors are aware of the changes to the law. Every director will need to be clear about what the duties say and what they will mean for them in practice. On a practical level, implementation of these directors' duties means that existing corporate practices and also, perhaps, the relevant company's constitutional documents will need to be reviewed in light of the changes.

Need to know more?

Ask us. Joelson Wilson's experienced team of lawyers undertake a wide range of corporate and commercial transactions for private limited companies and listed clients in both the UK and overseas, please contact:

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