Directors’ duties
Compliance with your Companies Act obligations
Staying on the right side of director’s duties

In the words of one judge “being a director is not an easy matter, and requires a responsible approach. The degree of regulation can catch even the most sophisticated of directors unawares and most directors do not have the requisite level of sophistication and skill to cope unaided with the extensive statutory framework to which they are subject, or the niceties of the company’s constitution. Many become directors of companies to take advantage of limited liability, so as to exploit their entrepreneurial skills and instincts, and may not be temperamentally suited to statutory control or constitutional restraint. There is a strong public interest in encouraging entrepreneurial activity. There is equally a strong public interest in combating abuse which limited liability too often engenders”.

Introduction

It has often been said that being a director is easy, but being a responsible one is not. Over the last few years directors’ duties have been in the spotlight and this article looks at some of the legal issues facing directors when carrying on their business and highlights some of the steps that directors can take to comply with their duties and to avoid incurring personal liability.

The rules governing the duties directors owe their companies have been codified in the Companies Act 2006 (the Act). The Act also introduced a new statutory right for shareholders to sue directors for breach of these duties in the company’s name in some circumstances (a ‘derivative action’).

This article sets out these duties and in also gives particular attention to two of the key principles; the duties to promote the success of the Company and to avoid conflicts.

Some have expressed concern about the possible impact of these changes on companies and their boards, but there are practical solutions to many of the issues that may arise, and these, and directors’ liabilities, are also addressed below.

So what are these director’s duties?

The Act sets out seven general duties:

- a duty to act in accordance with the company’s constitution, and to use powers only for the purposes for which they were conferred;
- a duty to promote the success of the company for the benefit of its members as a whole (this replaced the common law duty to act in good faith in the company’s interests);
- a duty to exercise independent judgment;
- a duty to exercise reasonable care, skill and diligence;
- a duty to avoid conflicts of interest (except where they arise out of a proposed transaction or arrangement with the company);
- a duty not to accept benefits from third parties; and
- a duty to declare to the company’s other directors any interest a director has in a proposed transaction or arrangement with the company.
Duty to promote success

One of the biggest differences between the common law regime and the statutory provisions is in the treatment of the directors’ duty of loyalty to their company. The common law requires directors to act in good faith, in the interests of their company. The statutory provisions oblige a director 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” (subject to certain exceptions, which require directors to consider, or act in the interests of, the company’s creditors, in insolvency situations).

This meaning of this statutory provision raises many questions, but the Act does give some assistance in setting out various non-exhaustive factors to be taken into account, namely the:

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

Although all of these factors must be considered in all decisions (whether formal or not) it will often be enough for the board to conclude that a particular factor is not relevant, and leave it at that. This new provision was intended to reflect what was already widely regarded as good practice amongst boards.

Duty to avoid conflicts

The key change in the conflicts provisions is to allow advance board authorisation where a director has an actual or potential conflict of interest or duty. The new rules make little practical difference to directors provided that they identify, disclose and, where necessary, seek authority for actual and potential conflicts and comply with any conditions the board imposes.

However it may be necessary for the company to operate more formal procedures for conflicts than it has in the past and the board has to consider whether to authorise an actual or possible conflict. There are rules for conflicts that arise in connection with a transaction or arrangement with the company, and separate rules for conflicts that arise in other cases (sometimes called ‘situational conflicts’).

A director is not under a duty to avoid interests in transactions or arrangements with the company. However, he must disclose any interest in a transaction or arrangement that the company is proposing to enter into or that has already been entered into, whether his interest is direct or indirect. Once declared, no authorisation is required and this is the same as the position before the Act. The old rules required a director to declare an interest in a transaction or arrangement with the company at a board meeting, or by a general notice that he was interested in a specified body corporate or firm or was connected with a specified person. The new provisions also allow the director to declare a particular interest by written notice to his fellow directors, rather than at a board meeting. As before, the nature and extent of the interest must be declared. In any case not involving a transaction or arrangement with the company, the new rules require a director to avoid a situation in which he has, or can have, a direct or indirect interest (or duty) that conflicts or possibly may conflict with the interests of the company, unless the board has already authorised the matter concerned.
In the case of a public company, the articles must contain express permission before the board can authorise conflicts. Private companies incorporated before 1 October 2008 must have passed a shareholder resolution to allow the board to authorise conflicts.

How can directors protect themselves?

Many companies have not needed to make significant changes to pre-Act procedures in relation to directors’ decision making, but nevertheless a company should review its procedures and, if it has not already done so, consider the following factors.

- Review the company’s policy with regard to taking minutes of meetings and how compliance is to be documented. The Association of General Counsel and Company Secretaries of the FTSE 100 has published a paper on directors’ duties that sets out its view on best practice guidelines for compliance by public companies’. In certain situations, where one of the above factors is particularly relevant, the board may wish to refer specifically in the minutes to such factor or document the discussion about it.

- Ensure that the directors (and those responsible for the production of board and other supporting papers, and HR, ethics and corporate governance issues) have had the requirements explained to them generally so that when they come to a particular decision they take the factors set out in section 2 into account; in particular all new directors should be briefe on their duties.

- In deciding whether to include a more detailed record of discussions on a particular matter in board minutes, the directors should also take into account any general policy they have adopted in relation to recordkeeping and potential litigation. An inconsistent approach may lead to concerns that the relevant factors were not properly taken into account if they are referred to on some occasions, but not on others.

- Fears have been expressed that the requirement for directors to exercise ‘independent judgment’ may prevent individual directors from relying on the judgment of others in areas in which they are not expert. The accepted view is that directors can continue to do this, and to delegate matters to committees, provided they exercise their own judgment in deciding whether to follow particular advice or to accept someone else’s judgment on a matter.

- Ensure that all delegated work is carried out by competent people.

- Ensure that where a director wants to take on a further directorship or other position this is considered and, if thought appropriate, authorised by the board, which should consider what should happen if an actual conflict arises in future and whether the authorisation should be subject to any conditions.

- Consider existing directorships and other positions.

- Review the company’s approach and any board guidance to benefits received from a third party.

- Advise all directors that if a specific conflict arises, particularly in sensitive areas (for example, if it relates to an important area of the company’s business or to a possible takeover), he should seek independent advice; if it is not possible to disclose the conflict and obtain approval, it may be necessary for the director to absent himself from relevant board discussions or, in some serious situations, to resign.

- Ensure that all interests in transactions or arrangements are notified as soon as the director becomes aware of them, as required in the Act (at a board meeting, by notice in writing to the other directors or by a general notice).

- Take steps to make sure that anyone connected with a director (in simple terms that is the director’s family (including spouse, civil partner (or in certain circumstances any partner) children and the directors parents); and in certain circumstances a company may also be
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connected with a director if the director is interested in, or has voting power over, 20% or more of the equity share capital of the company) is aware of the disclosure obligations and is asked to notify the director if a potential conflict arises

- Remind directors regularly of their notification obligations.
- Ensure that there is a regular flow of information, financial or otherwise to allow the directors to comply with their duties.
- The company’s annual accounts should be reviewed by all directors who should query anything which to them looks odd or unreasonable.
- Put in place appropriate Directors’ and Officers’ insurance.
- Ensure the directors understand the company's Articles of Association.
- Finally, where in doubt, take legal advice!

Liability

Taking commercial decisions are part of a director’s job, and from a legal point of view they should not be held accountable for mere errors of judgment. This principle has not been changed by the Act and while a Court may relieve directors from liability for breach of their duties if they acted honestly and reasonably it will only do so if, in its opinion, they ought fairly to be excused. It is in the director’s interest to act prudently, and to take all reasonable steps to prevent any liability arising, and taking into account those factors mentioned above should help achieve that objective.

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