

Companies Act 2006 - Directors' Duties and Liabilities



This paper provides our initial commentary on several issues relating to directors' duties and liabilities. These are some of the key changes to company law, contained in the new Companies Act 2006 (2006 Act). These changes are likely to have an impact on almost every UK company. Many areas relating to the new legislation are likely to be ignored – this one is, we believe, ignored at your peril.

Introduction

The 2006 Act will, for the first time in the UK, codify the duties of directors. Concerns have already been expressed by many about the impact of these changes on companies and their boards. We provide our initial views below on how some of these changes might affect directors of private companies in carrying out their duties. The changes will with some variations also affect public companies. The main purpose of sending out this fairly detailed paper now is to begin to make you aware of these matters. Originally our understanding was that this part of the 2006 Act would not come into force until October 2008. However the Government announced recently that the implementation date will be October 2007, so companies and their advisors need to begin to understand these changes in the law.

The Current Law

Broadly, the so called "common law" duties of directors, which have been developed by the English courts over the last century or so, comprise the following:

1. To exercise skill and care;
2. To act in good faith in the best interests of the company;
3. To act within the powers conferred by the company's memorandum and articles of association (constitution) and to exercise the powers for proper purposes;
4. Not to fetter their discretion (which means they must not act in such a way as to bind themselves from acting freely in the future); and
5. Not to make a secret profit.

Transactions carried out by a company which have been entered into in breach of any of the these duties make such a transaction voidable. However, provided the terms of such a transaction would not amount to an action of serious detriment a minority (less than 50%) of the company's shareholders, the majority shareholders can ratify the transactional breach by ordinary resolution in general meeting.

Director's Duties and the 2006 Act

The provisions of the 2006 Act retain the common law position that directors will still owe their duties to the company itself and not to individual (or groups of) shareholders. However, the 2006 Act extends the new rights for shareholders to make recovery against directors for breach of duty. Such "derivative actions" will be the subject of a further paper on the 2006 Act.

Statutory General Duties

The 2006 Act codifies seven of the general duties of directors:

1. To act in accordance with the company's constitution;
2. To exercise powers only for the purposes for which they are conferred;
3. To promote the success of the company;
4. To exercise independent judgment;
5. To exercise reasonable care, skill and diligence;
6. To avoid conflicts of interest; and
7. Not to accept benefits from third parties.

The new legislation provides that although the statutory duties are based on (and have effect in place of) certain of the rules and principles currently laid down by common law, those duties should be interpreted in the same way as these existing rules and principles.

The Duty to Promote Success

In addition to the common law duties of directors (as listed above) the 2006 Act sets out a new requirement. Simply, it will be the duty of a director to act in a way that he considers, in good faith, would be most likely to promote the success of the company and consequently for the benefit of its members as a whole.

The 2006 Act sets out six specific factors to which directors must have regard during the decision making process to fulfil this duty-

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

This list of factors is not exhaustive. It is also subject to the relevant existing law requiring directors, in certain circumstances, for example in a potential insolvency situation, to consider or to act in the best interests of the creditors of the company.

In deciding whether a particular course of action is in the best interests of the company the directors must have regard to all six factors. There is no priority between them but the individual factors do not override the primary obligation to promote the success of the company. The aim is to "promote success" but not to the detriment of the other fiduciary duties when taking account of these considerations.

Our understanding of how this might work is (for example) that if a board is faced with a decision which will result in a significant loss of jobs and damage to the environment but it is most likely to promote the success of the company, then that it is the course they should follow. Consider also the possible conflict when on the one hand the board is trying to maximise profits – one way of measuring

success – but on the other hand in doing so seeks to negotiate very severe terms into its contracts with its suppliers to obtain the best financial result for the company. The 2006 Act gives no definition of what is meant by “success” although the DTI has stated that for commercial companies it will normally mean “long term increase in value”.

The decision as to what will promote the success of the company and what constitutes such success, is one for a director’s judgment acting in good faith. Strategy and tactics are for the directors and should not be subject to decisions by the courts, again subject to good faith. In certain other common law jurisdictions this is referred to as the “proper purpose” rule.

Directors must be able to prove that they have paid due regard to the six listed factors. The 2006 Act does not specify how directors are to do this but it is not likely to be sufficient for them simply to tick a box for each factor, as each one must be considered fully. The obvious method directors can use to do this will be by keeping detailed board minutes setting out their considerations and how decisions were reached.

According to the official explanatory notes to the 2006 Act the cumulative effect of the duties means that where more than one duty applies, the director must comply with each applicable duty, and the duties must be read in this context. So, for example, we believe the duty to promote the success of the company will not authorise a director to breach his duty to act within his powers, even if he considers that it would be most likely to promote the success of the company.

At the same time, the duty to promote success does not require a director to do more than the duties of good faith and to exercise reasonable care, skill and diligence would require. Nor would it be possible for a director acting in good faith to be held liable for a process failure which would not have affected his decision as to which course of action would best promote the success of the company. Our initial thought is that directors may become even more risk-averse, and thereby perhaps make their companies less competitive.

We have noted in several of our earlier papers the perceived conflicts between the laudable aims of the new legislation, including the ability to make it easier to run a company and to remove unnecessary burdens on directors, and the legislative provisions themselves. Given that most companies in the UK are small and often complain of being over-regulated we do wonder how the vast majority of these companies will deal with this complex area of the law. Will they comply or simply ignore it?

The Duty to Act Independently

A concern voiced during the consultation period for the 2006 Act was whether the duty to act independently means that directors will be unable to rely on the opinions of independent experts. It has since been confirmed by the explanatory notes accompanying the 2006 Act that directors will be able to continue to consult experts and to delegate decisions to committees of the board so long as such delegation is in accordance with the company’s constitution. However, this is on the condition that directors must exercise their own judgment when considering whether or not to follow third party advice on any particular matter. Although directors can consult experts on various matters, ultimately the decision-making powers and the responsibility remains with them.

Conflicts of Interest

Reflecting current common law, the 2006 Act requires that directors avoid situations in which they have or can have a direct or indirect interest that conflicts with that of the company. Existing law allows a conflict to be ratified/authorised by shareholder approval and this duty remains unaffected by the Act. As before, the duty does not apply to transactions and arrangements with the company. Instead, in this case, directors must declare their interests in the transaction or arrangement.

Both the general duty to avoid conflict and the separate duty of disclosure (as detailed above) benefit from two new “safe harbours”:

1. there will be no conflict where the situation ‘cannot reasonably be regarded as likely to give rise to a conflict’; and
2. where the board allows ratification by board resolution providing that firstly a quorum is met without counting the interested director(s) and secondly it is not invalidated by the company’s articles (in the case of public companies). The matter must be agreed without counting any vote cast by the interested director(s).

Further, the 2006 Act will now allow companies to deal with conflicts of interest in their articles of association.

Anything done in accordance with the articles will not be a breach of duty. It may be advisable for companies to make specific provisions for particular areas where conflicts are likely to arise. For private companies, where the articles are silent on the matter such authorisation will be the presumed position. Accordingly, authorisation will not be invalidated where it is not specifically expressed in the company's articles. This is not the case with quoted companies.

The Act also precludes a director from accepting a benefit from a third party unless the acceptance of the benefit cannot "reasonably be regarded" as likely to give rise to a conflict of interest. Yet another subjective test.

It is possible that the new provisions will cause the greatest difficulty for those directors who hold multiple directorships. However the DTI has suggested that a general authorisation by each board in relation to each other directorship held by one of its number will authorise conflicts that arise as a result.

At this stage it is not clear how the formulation relating to conflicts of interest changes the existing law, particularly in respect of board approval for potential conflicts. We believe it should be possible to deal with any differences in approach by making sure that proper authorisations are in place which recognise and permit potential conflicts of interest. Also, relevant changes should be made to the articles of association. This is an especially important point for public companies where such authorisation will not be presumed to be the default position.

Shadow and Former Directors

It is still unclear whether shadow directors owe some or all of the duties owed by "true" directors. In theory the codified duties will apply to all directors (even former directors who are appointed and resign following the implementation of the relevant sections of the 2006 Act). The 2006 Act recognises that shadow directors and former directors are not in the same position as actual directors and therefore the application will apply only to the extent that the corresponding common law rules and equitable principles apply.

Conclusion

It is more than likely that the codification of duties will create greater bureaucracy at board level at least at the outset and expose directors to greater potential liability. Smaller companies and those unused to considering these types of issues could be at substantial risk of breaching the new legislation. There is a danger that companies may feel fettered in their decision making by the new administrative burden introduced by the legislation, leading to failure rather than success. In addition there are concerns that the shift to giving more powers to shareholders could lead to an increased exposure to shareholder claims against directors. Many companies will no doubt be carefully considering the terms of their Directors and Officers insurance arrangements.

There are no additional duties for directors of public companies as such. However publicly-listed companies have always been subject to the much stricter rules of the FSA-regulated listing rules. For example, the first principle of the listing rules is that a listed company must take reasonable steps to enable its directors to understand their responsibilities and obligations as directors.

The codified duties described above are not a complete statement of the law in this area and the 2006 Act provides expressly that the duties are based on existing common law and equitable rules. Interpretation of the provisions of the 2006 Act will therefore take place in light of those rules. Working out exactly what is meant by the statute will still involve looking at existing court decisions.

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