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Overview of Directors' Duties under the Companies Act 2006

Introduction - Pre-Companies Act 2006

Directors have historically been subject to duties under English company law. Until recently however, the vast majority of directors' duties were not set out in legislation but had evolved through case law. These duties included:

- a duty to act in good faith in the best interests of the company;
- a duty to exercise skill and care;
- a duty to avoid conflicting interests and duties; and
- a duty not to make a secret profit.
- The Companies Act 2006 ("the Act") was intended to simply 'codify' these duties – i.e. translate them into legislation largely unchanged. In the end however the Act has, by detailing duties more specifically, arguably changed the scope of directors' duties. Most controversially, it includes a new 'overriding duty' broadly equivalent to the old common law duty to act in good faith referred to at 1.1.1 above.

Overriding Duty (s.172)

This duty is set out in section 172 of the Act and 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"

This is very similar to the existing common law duty to act in the 'best interests' of the company. However the section also sets out a list of non-exhaustive factors which a director must consider while evaluating what would be likely to 'promote the success of the company':

- 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; and

- the need to act fairly as between the members of the company.

This was one of the most controversial aspects of the Act as it was feared that the new overriding duty and the ‘enlightened shareholder value’ concept it introduced would add significantly to the red tape company directors were subject to.

Duty of Skill and Care (s.174)

The duty of skill and care puts existing negligence law onto a statutory footing and provides that a director must act with the care, skill and diligence that would be exercised by a reasonably diligent person with *both* (i) the general knowledge, skill and experience to be expected of a director *and* (ii) the general knowledge, skill and experience that the director has.

In other words all directors will be held to the standard of the ‘reasonable director’ and will be assumed to have the knowledge, skill and experience to be expected of a director in that role. In addition, a director with additional or more specialised knowledge (e.g. accountancy qualifications) will be held to the standard of a reasonable director *with that knowledge*.

Duty to Declare Interests (s. 177 and s.182)

Directors must declare to their company’s board the ‘nature and extent’ of any interest they may have in any transaction or arrangement to which the company is or may be a party. There are two sections, s.177 dealing with a declaration before the transaction or arrangement is entered into and s.182 dealing with a declaration to a transaction or arrangement to which the company is already a party.

If they are aware of their interest a director **must** declare their interest before the arrangement is entered into under s.177. However if the director only becomes aware of their interest (or the interest only arises) after the company has entered into the arrangement then a director must declare as soon as possible under s.182.

Declarations under either section may be made either at a board meeting or by notice in writing or by a general notice. A director must update any declaration if it becomes inaccurate or incomplete (although if a company has already entered into a transaction or arrangement this may not be necessary).

There is no breach of these duties if a director is unaware of their interest or the transaction or arrangement to which the company is a party. In addition a director need not declare an interest if they are unaware of a possible conflict or if their interest cannot reasonably be regarded as giving rise to a conflict.

Duty to Avoid Conflicts (s. 175)

There is now a very wide statutory obligation to avoid conflicts of interest. A director must avoid any situation where they have or can have an interest that directly *or indirectly* conflicts with or *may conflict with* the company’s interests.

This duty specifically applies to a director exploiting any property, information or opportunity (whether or not the company could take advantage of that property, information or opportunity).

This duty does not apply to transactions or arrangements with the company (which are dealt with by sections 177 and 182) and there will be no breach if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest.

Any conflict may be authorised by a company's directors but the director(s) in question may not vote or be counted in the quorum at the relevant board meeting. If there are insufficient directors to pass a valid authorisation then the shareholders can (as with other breaches of duty) approve or ratify the breach of duty (see below) either using the statutory ratification procedure or by unanimous shareholder resolution.

Other Duties (s. 171, s. 173 and s. 176)

Directors are also under duties to act within their powers (s. 171) as conferred by the company's constitution and for their proper purpose – a director's powers and a company's purposes will in most cases be very widely drawn (but charitable and other not-for-profit companies may have more limited powers and objects).

A director must exercise independent judgement (s. 173) but this does not prevent a director from acting in accordance with an agreement to which the company is a party (i.e. the section recognises that directors will not have complete freedom to act in the company's interests as the company will be a party to various contractual obligations) and a director may act in accordance with a company's constitution (which may for instance allow for delegation).

A director may not accept a benefit (e.g. gifts or inducements) from third parties arising from his position as a director or which are intended to induce the director to act in a certain way (s. 176). There will be no breach if the gift or inducement cannot reasonably be regarded as giving rise to a conflict or if it amounts to payment for services provided to the company (e.g. payment from a personal services company). This duty is treated separately from conflicts of interest and breach of this duty may only be approved by shareholders.

Ratification or Shareholder Approval (s. 239)

Where a company is solvent, shareholders can ratify (approve) any negligence, default, breach of duty or breach of trust using a statutory procedure in section 239. Different considerations apply in an insolvency situation – see below.

A ratification resolution is an ordinary resolution which requires a simple majority of shareholders attending a meeting to pass. If a written resolution is circulated then a simple majority of all of the shareholders must sign that resolution. The votes of the director whose conduct is to be approved (if they are a shareholder) may not be counted nor will any votes from anyone connected with that director. Connected parties include close relations, connected companies and firms, connected trustees and partners.

If the rules preventing the director concerned and connected parties from voting mean that there are insufficient shareholders to form a quorum then any conduct can be ratified by unanimous shareholder resolution (s.239(6)(a)).

Assuming and Avoiding Personal Liability

A director's duties are owed to the company and not to third parties. There are however circumstances in which a director assumes personal liability to third parties expressly or impliedly.

A director can expressly assume personal liability by signing a personal guarantee of a company's obligations (usually to a landlord, bank or finance company). It is important to remember that a personal guarantee may apply to all obligations of the company to the party in whose favour the guarantee is granted and not just those which were considered at the time. For instance a personal guarantee may be given to a bank to secure a term loan which is repaid. That guarantee may continue to apply to overdrafts later obtained from the company from the same bank. In addition a personal guarantee will normally continue until it has been expressly terminated.

There are also situations where a director can assume personal liability by implication. The leading case is ***Williams and Another v Natural Life Health Foods Ltd. and Another, The Times, 9th January, 1997***. In that case a director of a franchisor company gave misleading advice to a franchisee of his company which was based on his own personal experience and may not have been connected with his position as a director. The Court of Appeal initially found that the director was personally liable to the customer who relied on the advice. However such situations are relatively rare and the House of Lords overturned that decision noting that personal liability would be imposed only in exceptional circumstances.

In the case of ***Contex Drouzhba Ltd v Wiseman and Anor [2006] EWHC 2708 (QB)*** a director who signed a contract was held to be making an implied representation about the company's solvency to a supplier which he knew to be untrue. The director was liable personally to the supplier for deceit.

Indemnities for Directors (s. 232, s. 234)

The Act allows for a company to provide a limited indemnity to a director in relation to the liability of that director to third parties. The indemnity can not cover criminal and regulatory fines or legal fees in the event of an unsuccessful criminal defence.

It is important to note that no indemnity can be given in relation to liability of a director to the company itself (which is a much more substantial risk), although a company can agree to pay a director's legal fees even for an action brought by the company (if the director is unsuccessful in his defence the fees would be repayable by him to the company).

Directors and Officers Insurance (s. 233)

Companies and directors may also take out 'Directors and Officers' insurance cover ("D&O Insurance"). D&O Insurance is insurance cover which is intended to protect directors in the event that claims are made against them in relation to the discharge of their duties. Careful attention should be paid to the exclusions and limitations on D&O Insurance – for instance some policies exclude claims made by the company against the director and this is likely to exclude almost all possible claims.

Duties in an Insolvency Situation

As set out above all duties are in general owed to the company itself and not to third parties (except where there has been some express or implied assumption of responsibility). The long-term interests of the shareholders, as a body, are regarded as being equivalent to the interests of the company when deciding questions of breach of duty.

However where there is an insolvency or a threat of an insolvency case law has specified that the interests of the company are to be regarded as broadly equivalent to the interests of the creditors of the company. Once a liquidator is appointed his authority replaces that of shareholders and directors and his obligation is to maximise returns to creditors. As such a director should act in the best interests of the creditors in an insolvency situation:

“In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude… it is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.”

Street CJ in Kinsela v Russell Kinsela Pty Ltd (in liq) (1986) 4 NSWLR 722 at 730 quoted in West Mercia Safetyware Ltd v Dodd [1988] B.C.L.C. 250.

Derivative Actions (s.260 – s.264)

Duties are owed by a director to their company and not to individual shareholders – shareholders do not have a direct right of action against directors for breach of duty. There may be cases where a company is unwilling or unable to commence an action against a current or former director. A derivative action or claim refers to court proceedings brought by shareholders in the name of the company against a director (or other third party) for breach of duty, breach of trust or negligence.

Derivative claims have existed for a long time but until the Companies Act 2006 the claim was a case law-based right of action. The derivative claims procedure is now specifically set out in the Act.

Directors should note that a claim may be brought by shareholders against directors who have long since ceased to be on the company’s board. A breach of duty now may lead to a derivative claim brought later by as yet unknown shareholders unless that breach is approved or ratified. We would advise that particular care is taken in relation to conflicts of interest (for instance where a director is a shareholder/ director of several companies) as conflicts are relatively easy to generate under the new Act and if they are not dealt with they may generate a substantial liability over a number of years.

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