



Guide to Directors Duties

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1. Who is a Director?

The Companies Act 2006 (the "2006 Act") requires every private company to have one or more directors and says that "Director" includes "any person occupying the position of director, by whatever name called" and draws no distinction between an executive and non-executive director (see below).

A person can be treated as a de facto director even if he/she is not called a director provided he/she has a right to sit on the company's Board and participate in the company's affairs.

In practice, there are different types of director, but the essential two categories are those of executive director and non-executive director. Generally, the law imposes the same basic duties on all directors, regardless of the role they play.

1.1 "Executive Director"

This is a director who is normally involved in the day to day running of the company's business, or part of it. It is usually the case that an executive director is an employee of the company under a service contract. In addition to his/her duties and responsibilities imposed by law, an executive director may also have obligations imposed under the terms of the service agreement.

1.2 "Non-Executive Director"

A non-executive director is usually a director who participates at Board meetings and on Board committees and working groups, but who does not have day-to-day responsibility for the operations of the company, or any part of it. However, the law still requires that a non-executive director is as responsible for all decisions taken and powers exercised by the Board as any other director.

1.3 "Shadow Director"

Under the 2006 Act this term means "any person in accordance with whose directions or instructions the directors of a company are accustomed to act". It is a question of fact, depending on the circumstances in each case as to whether a person is a shadow director. An example is in relation to group companies, where directors of a subsidiary company may be accustomed to act in accordance with the directions or instructions of the holding company. The holding company may, therefore, be the "shadow director" of the subsidiary, even though it is a corporate entity.

1.4 "Alternate Directors"

It is also possible for there to be an "alternate director" where a director appoints an alternate to act in his place when, for example, he/she is going to be overseas for long periods of time.

1.5 "Nominee Director"

In addition, there can be "nominee directors". A "Nominee Director" is someone who is appointed to the Board on a nomination of a third party. This occurs where, for example, a joint venture is established under which a party may be entitled to appoint such a director, or where an investor in a company wishes to maintain control over his investment.

2. Who can be a Director?

There are no qualifications required to be a director, but certain persons are not permitted to be directors:

- (a) An undischarged bankrupt.
- (b) Anybody disqualified from acting as a director under the Company Directors Disqualification Act 1986. Under this Act, a person can be disqualified from acting as a director or being otherwise concerned in the promotion, formation or management of a company for between two and 15 years, if that person is held to be unfit to be concerned with the management of a company.
- (c) A body corporate (if it is the sole director).
- (d) An individual below the age of 16 (any directors below that age as at 1 October 2008 will automatically cease to be a director).

3. Directors' Duties

3.1 General

A director, in exercising his/her functions, may become responsible for and directly or indirectly accountable to the following persons:

3.1.1 The Company

A director's fiduciary relationship is with the company and his/her duties are owed generally to the company as distinct from its shareholders. Directors do not owe duties to subsidiary companies or other associated companies.

3.1.2 Prospective shareholders

The Director may owe a statutory duty to prospective shareholders for the contents of a prospectus or listing particulars under the provisions of the Financial Services Act 1986. For example, if subscribers suffer losses as a result of any untrue or misleading statement in the prospectus or listing particulars, a director may be personally liable to compensate the subscribers for such losses.

3.1.3 Minority shareholders

3.1.3.1 Under the common law, minority shareholders in a company may have a right to bring a "derivative" action in the name of the company, if they can show that the company's affairs have been conducted in a manner which constitutes a "fraud on the minority" where such claim arose due to an act or omission that occurred before 1 October 2007.

3.1.3.2 However, from 1 October 2007, the procedure under the common law was replaced by a much wider statutory provision based on any actual or proposed act or omission involving negligence, default, breach of trust and breach of duty occurring after 1 October 2007.

3.1.3.3 A derivative action may now be commenced in the name of the Company or by a shareholder. In respect of an action being brought by a shareholder, permission needs to be sought from the Court, which involves the member satisfying a "double barrelled" test. The first "barrel" includes the shareholder presenting a prima facie case to the Court (without requiring the defendant to produce any evidence to rebut the claim) with the second "barrel" consisting of a preliminary hearing where the Court will decide whether the action should proceed further.

3.1.4 Creditors

If a company is insolvent, the duty to act in the interests of the company may be superseded by a duty to act in the interests of the company's creditors as a general body.

3.1.5 Employees

The Act requires the directors to include the interests of the company's employees in general in carrying out their functions. However, this duty is owed to the company and not to the employees directly, and so the employee is not given any direct remedy against defaulting directors.

3.1.6 Regulatory bodies

Directors are also accountable to the relevant regulatory bodies. For example, the directors of a listed company are accountable to the London Stock Exchange and the Takeover Panel in the performance of duties imposed by the Listing Rules and the Takeover Code.

3.1.7 Customers and suppliers

A director could be personally liable on contracts made between the company and third parties in certain cases, such as liability for negligent misrepresentations made in the course of negotiating a contract, liability on contracts expressed to be signed by him/her on behalf of the company prior to its incorporation, and liability under any guarantees given for performance of a contract by a company. It is also possible for a director to be liable under consumer protection legislation for providing, for example, misleading information contrary to the Trade Descriptions Act 1968 to 1972.

3.1.8 Fellow directors

A director will not generally be liable for breach of duty by a fellow director, provided he/she has not

acted in a negligent manner. He/she can, however, may be liable for sanctioning such an act, or for failing to supervise the activities of a fellow director or officers in circumstances where he/she was under an obligation to do so.

3.1.9 **Government bodies**

Directors also have potential liabilities to governmental organisations such as the Inland Revenue and the Health & Safety Executive.

3.1.10 **Competitors**

Directors are liable to competitors if they do, cause, procure, direct or participate in a plan to commit acts which breach competitors' rights. This would include, for example, the breach of a competitor's intellectual property rights.

3.1.11 **Subsidiaries**

3.1.11.1 Directors can be called on to represent the interests of the company on the Boards of subsidiary and associate companies. In these circumstances it is necessary for them to consider individually the position of each company as an independent legal entity and not the group as a whole. Thus, a director of a subsidiary must exercise his/her powers and fulfil his/her duties to promote the success of that subsidiary alone.

3.1.11.2 This can raise a potential conflict of interest, which could become particularly difficult if the subsidiary or associate company is nearing insolvency. In these cases, the interests of the creditors of that company prevail over the interests of its parent.

3.1.11.3 For suggestions on how to deal with such conflict, please see section headed "Duty to avoid conflicts of interest".

3.2 **Common Law Duties**

The 2006 Act does not contain an exhaustive list of directors' duties and because of this the common law is still relevant. For example, the common law duty of confidentiality (e.g. a director cannot use confidential information of the Company other than for the benefit or purposes of the Company) and to consider the interests of creditors when a company becomes insolvent (e.g. ceasing to trade once there was no reasonable prospect of the Company avoiding insolvent liquidation) are still relevant.

4. **Duties arising from the Company's Constitution**

4.1 The powers of the company are set out in the Memorandum and Articles of Association. Directors must ensure that the company acts within these powers, otherwise they are in breach of duty.

4.2 The conduct of the company's operations will be delegated to its directors under the Articles of Association, and breach of these provisions will also constitute a breach of duty.

4.3 The provisions of the Articles will include such matters as borrowing powers, procedures for dividend payments, and for the disclosure of the interests of directors.

4.4 Although a director's duties may be increased and made more onerous under a company's Articles of Association, they cannot be diluted unless such dilution is specifically permitted under the 2006 Act.

5. **Statutory Duties**

5.1 Many obligations are placed upon directors by statutes, the most important of these being the 2006 Act. The 2006 Act is being implemented in four stages, the first on 1 October 2007, the second on April 2008, the third on 1 October 2008 and the fourth on 1 October 2009.

5.2 The 2006 Act imposes many obligations on directors designed to ensure fair dealings between them and the company. They also relate to the management of the company, and protection of its shareholders and creditors and enlightened shareholder value. There are both civil and criminal penalties for failure to comply with the 2006 Act's provisions.

5.3 Previously, directors' duties derived solely from the common law. The 2006 Act has changed this and, for the first time, directors' duties are now codified, in an attempt to provide clarity and certainty, although the common law is still relevant.

5.4 These codified duties are owed by the directors to the company and, subject to the right of a shareholder to

bring a derivative action, are only enforceable by the company itself. These duties extend to shadow directors and even in certain cases, to former directors of a company (although their application would be different).

5.5 From 1 October 2007, directors will owe the following statutory duties to a company:

Duty to promote the success of the company

This duty replaces the former fiduciary duty to "act in the best interests" of a company. In order to promote the success of a company, a director should, in good faith, consider the following matters (in no particular order of importance):

- The interests of the company's employees;
- The need to foster the company's business relationships with suppliers and customers;
- The impact of the company on the community and the environment;
- The need to act fairly between its members; and
- The likely consequences of any decision in the long term.

It is important to note that in addition to the above, the director must also consider his duty to act in the best interest of the company's creditors (for example, when a company is becoming or becomes insolvent) which is retained under section 214 of the Insolvency Act 1986.

Although the list of factors set out above is non-exhaustive, they are a good starting point, and directors should consider other matters which are specifically relevant to promoting the success of their company. In considering the above factors, directors should also ensure that they exercise reasonable care, skill and diligence.

This duty also introduces the concept of "enlightened shareholder value" which is linked to the "success" of a company. Although there is no statutory definition of "success", the government has stated that it should be interpreted as meaning "long-term increase in value" for companies in the commercial arena.

As a matter of good "housekeeping", companies may like to start to minute their detailed consideration of the above factors in their meetings, especially where the board are considering something of material importance.

Duty to act within powers

This duty simply codifies the previous fiduciary duty for a director to act in accordance with the company's constitution (broadly its Memorandum and Articles of Association and any decision of its members or a class of its members insofar as they can be regarded to be a decision of the company) and to only exercise powers for the purposes for which they are conferred.

Duty to exercise independent judgment

Again, this is a codification of a formerly equitable duty. It is important to note that this duty to exercise independent judgment does not thwart a director relying on advice from others, or from delegating tasks to other people, provided that a director exercises his independent judgment on whether to follow that advice.

Duty to exercise reasonable care, skill and diligence

This duty essentially codified the already established common law understanding of the duty of care owed by a director.

This duty states that a director must exercise the care, skill and diligence that would be exercised by a reasonably diligent person carrying out the functions of that director (i.e. an objective test) and imputes the general knowledge, skill and experience that the director in question actually has (i.e. a subjective test).

It therefore follows that the more specialist knowledge a director has, the higher the standard of knowledge, skill and experience imposed upon him. The specific responsibilities of the director and circumstances of the company will also be incorporated into this duty and the satisfaction of the above test.

Duty not to accept benefits from third parties – 1 October 2008

This duty again codifies the former fiduciary duty of a director not to exploit his office for personal benefit. Accordingly, this duty states that directors must not accept any benefit (including bribes) from a third party which is connected to the fact that he is an officer of the company or his doing or not doing something in his capacity as director.

Benefits granted to a director under the provisions of his service contract are automatically carved out of this duty, as are any benefits bestowed by the company (or its holding company or subsidiaries) or if the acceptance of the benefit could not be deemed to be likely to give rise to an issue of conflict for the director.

If the receipt of a certain benefit cannot reasonably be regarded as giving rise to a conflict, then this duty will not apply, however the 2006 Act does not provide any clarification on what this means exactly, and it is therefore recommended that a director proceed with caution.

This duty will continue in relation to matters which arose during the course of a directorship, even when that directorship has been resigned.

Board authorisation of benefits will not be permitted, although it will be possible for a director to accept benefits from third parties if this is approved by the members of the company.

Duty to declare interest in proposed transaction or arrangement with the company – 1 October 2008

Most directors will be familiar with the fact that one of their equitable duties is to declare their interest in a proposed transaction or arrangement with the company. The purpose of this duty is to protect the creditors and members of a company from, inter alia, transactions at an undervalue or preferences.

Commonly, this fiduciary duty is modified by the Articles of Association of a company, which may permit (subject to a director declaring his interest) a director to vote on and count in the quorum at a Meeting of the Board where the matter in question is being discussed.

In accordance with this new duty, a director must declare the nature and extent of his interest to his fellow directors, be it direct or indirect, and this declaration must still be made even if he is not directly involved but one of his "connected persons" is.

Care should be taken in this instance, as, from 1 October 2008, a director's "connected persons" will have a wider remit than that under the Companies Act 1985; for example, it will include a civil partner and the dependants of a person (whether of the same or different sex) with whom the director lives as a partner in an enduring family relationship and also the director's parents.

A director should also be aware that he will need to make a subsequent declaration if he becomes aware, or should have become aware, that his original declaration has become inaccurate or incomplete at any time prior to the company entering into the transaction or agreement.

A director should note that there are several "carve outs" to this duty: a director need not make a declaration if the director was not aware of the proposed transaction or agreement, or if he could not reasonably be expected to be aware of the interest, or if there is only one director of a company, or if the other directors are already aware of the circumstances, or if the interest is not likely to lead to a conflict, or if it relates to his own service contract.

Duty to avoid conflicts of interest – 1 October 2008

A director must not put himself in the situation where there is, or could be, a conflict between his duties as a director and any duties he owes to a third party and/or any personal interest which he may have.

In assessing whether there is a conflict, the director does not need to take into account any interests of his "connected persons", although this could still amount to a "conflict situation".

As with other duties, this duty will continue to have retrospective effect: i.e. it will be relevant to situation which arose during the course of a directorship, even when it has been resigned.

It is recognised that compliance with this duty could cause daily headaches for a director who is also a director of a joint venture or where a director sits on the Board of various companies within the same group.

However, from 1 October 2008, a company will be able to authorise a situation where a director may otherwise have a conflict of interest between a parent and a subsidiary in the following manners:

- 5.5.1 via shareholder resolution (on a case-by-case basis);
- 5.5.2 via board approval (again, on a case-by-case basis and excluding the vote of any interested director who will also not count for quorum purposes); and
- 5.5.3 via provisions contained with the Articles of Association.

Please note that in the case of a private company, board authorisation is permitted if the Articles of Association do not prohibit this. For public companies, however, there needs to be an express provision in the Articles of Association which permits the directors authorisation.

The issue of conflict will be particularly relevant in a situation where a director sits on the Boards of a group of companies or is on the Board of a company and its joint venture.

Such conflict should be specifically authorised in the Articles of Association stating that a director who has multiple directorships is not required to breach his common law duty of confidentiality and relay confidential information relating to one group company to another.

Please further note that private companies incorporated before 1 October 2008 can only use the board authorisation route if its members pass an ordinary resolution authorising it to do so.

5.6 Directors should be aware that in considering the above duties, the 2006 Act does not specify how clashes between the various statutory duties should be determined – the onus is instead on the directors to use their good faith judgment to reach a solution on the particular circumstances: there is no "one size fits all" approach.

5.7 The 2006 Act also imposes further statutory responsibilities in relation to the following areas:

5.7.1 The maintenance of proper accounting records, their annual audit, and presentation to the shareholders at the Annual General Meeting, together with their publication, as well as the preparation of an annual Directors' Report.

5.7.2 The maintenance of statutory registers relating to the following:

Charges; Shareholders; Minutes of General, Board and Management Meetings; Directors and Secretaries; Directors' Service Contracts.

5.7.3 The payment of dividends.

5.7.4 Disclosure of any director's material interests in contracts, transactions or arrangements with the company.

5.7.5 Loans to a director of a company or its holding company or a "connected person": loans to directors were generally prohibited under the Companies Act 1985 if they were in excess of certain thresholds, but they can now be authorised by a private company with shareholder approval if they exceed the new statutory thresholds. A private company may also now make a quasi loan, a loan or a quasi loan to a director's "connected person" or enter into a credit transaction without shareholder approval. A public company or a company associated with a public company must always obtain shareholder approval for quasi loans, loans or quasi loans to a director's "connected person" and credit transactions when they exceed the statutory thresholds.

5.7.6 Directors' service contracts: termination for loss of office is subject to shareholder approval; a company must also keep copies of all service contracts of its directors at its registered office for one year from the date of termination or expiry; and directors' contracts in excess of two years also require shareholder approval.

5.7.7 Substantial property transactions (a transaction whereby a director wishes to buy or sell an asset to or from the company and the asset has a value in excess of £5000) must always be authorised by the shareholders of a company. The only exception to this is when a company is in administration or in the process of being liquidated.

5.8 Health & Safety at Work Act 1974

The company is under a duty to safeguard, as far as is reasonably practicable, the health and welfare of its employees.

5.9 Environmental Legislation

Recent environmental legislation has introduced duties relating to environmental matters, the breach of which may make a director liable, if it is proved that an offence has been committed with his or her consent, connivance or neglect. The legislation covers all types of pollution including discharges to air, land and water, and the depositing, keeping or treating of waste without proper authorisation.

6. Directors' liability

It is a corollary of the duties of directors that there are extensive potential liabilities.

6.1 Statutory and Criminal Liability

The source of any criminal liability may be either on a director's own account or "vicariously" for the crimes of a company.

The criminal offences are punishable by fine, imprisonment or both, for which a director may be liable as principal, as a party to or for inciting, attempting or conspiring to commit the offence.

Other important examples of offences under related legislation include:

6.1.1 "Insider dealing"

Provisions relating to insider dealing under the Criminal Justice Act 1993 would normally apply to dealing in the securities of listed companies.

6.1.2 "Wrongful trading and fraudulent trading"

When a company has gone into insolvent liquidation, a director may be required to make a contribution to the assets of the company if the liquidator can prove that before the start of the winding up, that person knew or should have concluded ceasing to trade once there was no reasonable prospect of the company avoiding insolvent liquidation. This is intended to deter directors from continuing to trade where there is no reasonable prospect of the company avoiding insolvency. Thus, it imposes a personal civil liability on directors. The defence open to a director in these circumstances is that he/she took every step with a view to minimising the potential loss to the company's creditors that he/she should have taken. The onus is on the director to prove this defence and one of the judgements to be made when a company has gone into insolvent liquidation is whether the directors sufficiently monitored the company's financial position and whether, if they had done so, the company's insolvency would have been spotted earlier. Thus, it is essential that a company's position is monitored at all times.

If liability is established, the Court can order the director to make such contribution to the company's assets as the Court thinks proper. The Court can also make an Order to disqualify the director from being in any way concerned in the management of a company for at least two years.

"Fraudulent trading" relates to the carrying on of any business of a company with intent to defraud creditors or for any other fraudulent purposes. The liquidator may apply to the Court for a contribution from anyone who was knowingly a party to the carrying on of the business in that manner. Proof of intent to defraud is required. In this case, however, there is no defence available in the taking of steps to minimise loss to creditors. Fraudulent trading is punishable by up to seven years' imprisonment or an unlimited fine, or both.

6.1.3 Intellectual Property Legislation

A director's liability for any infringements of intellectual property rights which he commits or in which he participates whilst acting as a director, can arise, for example, by he/she directing the infringing act or taking part in drawing up a plan to carry out the infringing act. Copyright can be infringed by a director authorising a person to carry out an infringement of copyright. A director can be liable in civil law, when he/she may not know that the act infringes a third party's intellectual property rights. He/she could be criminally liable for infringement of copyright or trademark if he/she knows or has reason to believe that the act amounts to an infringement of such rights.

6.1.4 Competition legislation

A director may be liable for involvement in the operation of a restrictive practice under the provisions of the Competition Act 1998.

6.2 Disqualification

The Company Directors Disqualification Act 1986 enables the Court to disqualify a person from acting as a director for up to 15 years, where a director:

- 6.2.1 is convicted of a serious offence in connection with the promotion, formation, management or liquidation of a company; or

- 6.2.2 is responsible for persistent breaches of statutory requirements relating to the filing of returns, accounts or other documents with the Registrar of Companies; or
- 6.2.3 is convicted of fraudulent trading or any other fraud or breach of duty; or
- 6.2.4 has at least three convictions under the Act for failing to provide information.

6.3 **Civil liability**

A director may find him/herself subject to civil liability in a number of cases.

6.3.1 Breach of fiduciary duty

Where a director breaches his/her fiduciary duty or duties, the remedies remain the same as under the Companies Act 1985, for example, rescission of a contract where an interest was not declared, damages, accounting for profits made, an injunction or termination of a director's service contract.

6.3.2 Breach of common law duties of skill and care

Where a director is liable for breach of his/her duty of skill and care, he/she will be subject to a claim for damages for negligence.

6.3.3 Breach of constitutional duties

The directors are required to act in accordance with the Memorandum and Articles of Association of the company and, if they do not, they may find themselves liable to account to the company for any loss arising as a result of such breach.

6.3.4 General remedies of the company

These include:

- 6.3.4.1 the right to an injunction or declaration to prevent a proposed breach of duty by a director;
- 6.3.4.2 the right to obtain rescission of a transaction unless the third party involved in the transaction has no notice of the breach and has acted in good faith;
- 6.3.4.3 the right to remove the director at a shareholders' meeting;
- 6.3.4.4 the right to dismiss the director under the terms of his/her service agreement;
- 6.3.4.5 remedies of other parties: parties other than the company can claim compensatory damages for breaches of duties owed to them and injunctions preventing further breaches.

7. **Insurance and ratification**

7.1 **Insurance**

It has become common for directors to consider seeking some form of indemnity from the company against liability they may incur from accepting employment as a director.

The 2006 Act does not permit any contract to exist between the company under which the company indemnifies or exempts a director from liability for negligence, default, breach of duty or breach of trust relating to the company.

However, it is permissible for a company to purchase and maintain insurance for its directors and officers (and those of an associated company) in respect of their liabilities, and to indemnify the director or officer for any costs incurred in defending successfully any proceedings, civil or criminal (providing that these costs are repaid if the director does not successfully defend the claim) or in connection with any application in which relief is granted by the Court from liability for negligence, breach of duty or breach of trust in relation to the affairs of the company.

Now may be the time to consider reviewing any such policy to ensure adequate cover is in place should a derivative claim ever be brought.

7.2 **Ratification**

There are circumstances where it may be possible to obtain retrospective Shareholder ratification for the action of directors. Ratification can be effected by a simple majority of shareholders although any such ratification which concerns default, breach of duty or trust or negligence must discount any votes of the director in question or any of their "connected persons" such as a family member and even fellow directors. If ratification is approved, this will form an automatic bar to a derivative claim being brought.

However, certain acts cannot be ratified by a resolution of the shareholders, such as acts involving a fraud on the minority of the company's shareholders, fraudulent or dishonest acts, acts for which a special procedure under the company's Articles is required which has not been followed, and acts which are in breach of statute or general law.

8. 2006 Act – 1 October 2008 implementation

As discussed previously, there are further changes affecting directors that will be implemented on 1 October 2008. Broadly speaking, these relate to the following areas:

- further statutory duties to avoid conflicts of interest/duty to disclose interests (see earlier); and
- duty not to accept benefits from third parties (again, see earlier).

9. 2006 Act – 1 October 2009 implementation

Currently, if a director does not wish for his personal address to go on a company's file at Companies House, he must obtain a confidentiality order, which requires the director to show that he would be at serious risk of intimidation or violence should his personal address be revealed on the register.

From 1 October 2009 onwards, all directors will be entitled to give the company's registered address instead of their own personal address in respect of any new appointments.

Unfortunately, it will not be possible to "cleanse" the public record retrospectively, and therefore details of their residential addresses will remain on the public register in relation to any Forms 288a filed in the past.

There will also be a duty for companies to retain a register of the residential addresses of their directors, but again these will not be part of the public record.

10. The 2006 Act: Checklist

- Consideration should be given to updating a company's Articles of Association to reflect changes effected by the 2006 Act, not only in relation to directors' duties, but also across the whole corporate spectrum.
- Ensure all directors are aware of their new codified duties and how these differ from before.
- Review insurance policies to ensure adequate cover in the event of a derivative claim.
- Review company policies and procedures to ensure compliance with the 2006 Act.
- Review the Company's minutes of directors' meetings and consider how the duty to promote the success of the company should be approached and presented (e.g. in business reviews, external advice).

Contacts

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