

## duties and responsibilities of directors

***As a director you are responsible for carrying on the company's business and for the exercise of the company's powers in accordance with its constitution. In other words, the powers of the company as a legal entity are delegated to you as a director. Primarily your responsibility is to the company, but responsibility is also owed to shareholders, fellow directors, employees and creditors.***

### **New statutory responsibilities of directors**

The law setting out directors' duties and responsibilities has recently changed. On 1 October 2007 a new set of codified directors' general duties was introduced by the Companies Act 2006 (CA 2006). Further statutory directors' duties on conflicts come into force on 1 October 2008.

The new law sets out the first statutory statement of general duties of directors for companies registered in England and Wales. The statement replaces some of the duties previously owed by directors, which had developed over time through case law, topped up by previous statutes. However, the old common law rules and equitable principles will remain relevant for some time as CA 2006 states that the new general duties will be interpreted and applied in the same way as, and taking into account, the old law.

### **Directors' general duties**

There are seven general duties owed by a director to his company under the CA 2006, four of which came into force on **1 October 2007**, namely the duties:

1. **to act within the director's powers** in accordance with the company's constitution and to exercise those powers only for the purposes for which they are conferred;
2. **to promote the success of the company** by acting in the way the director considers, in good faith, would be most likely to do so for the benefit of its members;
3. **to exercise independent judgement** but this duty is not infringed by any restrictions contained in any agreement entered into by the company or in the company's constitutional documents; and
4. **to exercise reasonable care, skill and diligence.**

The three other statutory duties that come into force on **1 October 2008** are the duties:

5. **to avoid conflicts of interest**, except where authorised by the board;
6. **to not accept benefits from third parties** conferred by reason of being a director, or doing (or not doing) anything as a director; and
7. **to declare any interest in proposed transactions or arrangements** with the company to the other directors.

There is no definitive guidance from the Government on the interpretation of the new duties, although in June 2007 the DTI (now BERR) issued a collection of ministerial statements on the meaning of the new directors' duties provisions, extracted from the parliamentary debates on the Bill. All of the new duties should be viewed as a statement of principles which will develop over time as they are interpreted by the courts (with, no doubt, frequent reference being made back to the pre-reform case law).

## **Duty to promote the success of the company**

There has been much discussion regarding the new duty to promote the success of the company for the benefit of its members, which aims to answer the question "*in whose interests should companies be run?*".

Previously, a director was required to act in the best interests of the company – interests that might not have been the same as those of the shareholders. Now the focus is on shareholders' interests. What does it mean to promote "success"? The ministerial statements highlight explanations given by Lord Goldsmith, who summarised it as meaning:

- for commercial companies – a long term increase in value; and
- for charities – the achievement of its objectives.

CA 2006 sets out a (non-exhaustive) list of six factors that directors must "have regard (amongst other matters)" to when reaching decisions, namely:

- the likely consequences of any decision in the long term;
- employees' interests;
- the need to foster business relationships with customers and suppliers;
- the impact of the company's operations on the community and the environment;
- the company's reputation for high standards of business conduct; and
- the need to act fairly between shareholders.

Directors must still think about the company's creditors too, particularly where insolvency is threatened, though this remains uncodified.

## **Duty of care, skill and diligence**

Prior to CA 2006, a substantial body of case law had built up in relation to a director's duty of skill and care. This case law, which will remain relevant at least for the time being in the interpretation of the new statutory duty, developed a number of principles, namely:

- **test of skill** – a director has to act as a reasonably diligent person with the general knowledge, skill and experience of a person carrying out his/her particular function with relation to the company as well as his/her own personal level of knowledge, skill and experience;
- **attendance at board meetings** – a director is not bound to devote his/her continuous attention to the business of the company but the size and nature of a company's operations determines the level of delegation that is appropriate;
- **conduct at board meetings** – a director is entitled to be given reasonable notice of board meetings; and
- **delegation** – a director can delegate those of his/her duties normally carried out by the directors to employees or agents of the company provided he/she ensures that the relevant person is suitably qualified. In the absence of authority from the company the directors have to act collectively as a board and have no general right to delegate their powers.

## **Conflicts of interest**

Directors are required to declare any direct or indirect interest that they have in any contract or proposed contract with the company. Whether a director, having declared an interest, can count in the quorum for the meeting and vote depends upon the articles of the company. The articles also usually state the quorum for board meetings and whether the chairman has a casting vote.

Until 1 October 2008, when the new statutory provisions go live, the current common law and equitable principles in relation to directors' conflicts of interest duties continue to apply:

- **Conflicts of interest and duty** – a director must not put himself/herself in a position where there is actual or potential conflict between his/her personal interests and his/her duties to the company. As a result, a director may not contract directly or indirectly with the company (except in the case of his/her personal director's service contract) unless the articles allow it or the shareholders have given their approval to the contract.
- **Duty not to make a secret profit** – a director must not make a personal profit from any opportunities that result from his/her position as a director even if he/she is acting honestly and for the good of the company. This applies whether the profit arises from a contract with the company or a third party.

## Penalties for breach

### Fiduciary duties and non-fiduciary duties

Of the seven new general duties listed above, all except the duty to exercise reasonable care, skill and diligence, are fiduciary duties. Fiduciary duties are duties of honesty and good faith borne from the relationship of trust and confidence between a company and its director. The distinction between fiduciary and non-fiduciary duties is important for determining the penalties that may be imposed on a director for breach of duty.

### Derivative claims

If a director breaches (or threatens to breach) any of his/her general duties, an action may be brought against him/her by the company or by a shareholder on the company's behalf. CA 2006 introduced a new statutory court procedure called a "derivative claim", from 1 October 2007, enabling a shareholder to bring a claim on the company's behalf against its directors for negligence, default, breach of duty or breach of trust. Claims for actual or proposed acts or omissions are allowed too.

### Sanctions

If a successful action is brought against a director for breach of duty, CA 2006 provides that the consequences of breach are the same as those that would apply if the corresponding common law rule or equitable principle applied. Therefore, the sanctions that may be imposed upon the director are civil penalties (except for failure to declare an interest in an existing transaction or arrangement, which is a criminal offence in relation to which the director may be liable for a fine).

Possible penalties for breach of any of the general duties that are fiduciary duties are:

- an injunction (to stop an ongoing breach or to prevent a threatened breach);
- the setting aside of the transaction;
- an obligation for the director to pay restitution and account to the company for any profits made or any other unjust enrichment;
- damages (ie, the director must compensate the company for any loss suffered); or
- an indemnity to the company for costs or expenses incurred.

As a non-fiduciary duty, the penalty for breach of the duty to exercise reasonable care, skill and diligence is damages.

### Joint or several liability?

Existing common law, which provides that the default of one director does not necessarily impose a liability on the others, will continue to be of relevance. A director is not generally liable for the acts of his/her fellow directors and is under no duty to supervise their conduct. However, a director who knows of the conduct in question and who participates in it to some degree (even if only slightly), or a director who fails to supervise or enquire when there are suspicious circumstances, could be liable to the company.

### Other responsibilities

Other significant issues for directors to consider relate to their conduct in connection with the following offences, which are unchanged by the new law on directors' duties:

- **Fraudulent trading** arises when, in the course of winding up a company, it is shown that the business has been carried on with intent to defraud creditors or for any fraudulent purpose. Directors participating in the fraud commit a criminal offence and can be made personally liable for the company's debts.
- **Wrongful trading** occurs if a company is in insolvent liquidation and at some time before the commencement of the winding up a director knew (or ought to have known) that there was no "reasonable prospect" of the company avoiding insolvent liquidation but then failed to take every step to minimise the potential loss to creditors. If a director is found to be liable for wrongful trading he/she can be required to make a contribution to the company's assets.

- **Misfeasance** (wrongful exercise of authority) proceedings can be brought against any director, manager or officer of a company if he/she has misapplied, retained or become accountable for any property of the company or has been guilty of any misfeasance or breach of trust. A director in breach of this duty must repay money misapplied or pay compensation.

## Transactions with directors requiring approval of shareholders

CA 2006 also introduced new procedures that apply from 1 October 2007 requiring shareholders' approval, subject to certain exceptions, for:

- directors' long-term service contracts (ie, where the guaranteed term of a director's employment is longer than two years);
- substantial property transactions (ie, sales and purchases between a director and his/her company);
- loans by a company to its directors; and
- payments to directors for loss of office.

## Further issues

- **Allotment of securities** – there is a limitation on the power of directors to allot shares. This limitation does not apply in relation to subscribers' shares.
- **Liability for contracts and wrongs of the company** – the principle of limited liability means that generally directors are not liable for the debts of the company, or for any of its other acts or omissions. Where a director enters into a contract on behalf of his/her company with proper authority to do so, he/she will not be liable to the other party since he/she is merely acting as the company's agent. However, a director may be personally liable to a third party and to the company if he/she had no actual authority to enter into the contract or if the contract is concluded before the company has actually been incorporated.
- **Power to bind the company** – if a director or a group of directors act outside their authority in entering into a transaction with a third party, their powers are deemed to be free of any limitations under the company's constitution and the transaction will be valid and binding on the company. This is intended to protect third parties dealing with the company in good faith.

- **Relief from liability** – a director who is guilty of a breach of duty or who exceeds his/her powers may still be relieved of liability in certain circumstances. There are three main ways this can happen:

- by a qualifying indemnity provision,
- by insurance; or
- by ratification by a resolution of the shareholders (votes in favour cast by the director, if also a shareholder, or any shareholder connected with him/her are disregarded). Certain breaches of duty such as fraud and dishonesty cannot be ratified.

- **Publicity and disclosure** – a number of provisions enable the public to identify a company's directors and to require directors to disclose certain information including their home address and any other UK directorships held (although changes expected to be introduced in October 2009 will limit the extent of this information and offer some protection to directors).

- **Register of directors** – every company must keep a register of directors.

## Shadow directors

It is possible for somebody who is not formally appointed as a director still to have certain duties and responsibilities of a board member if they are a "shadow director". This will apply to a person in accordance with whose directions or instructions the directors of the company are accustomed to act, except where this is only because the directors act on advice given by him/her in a professional capacity.

## De facto directors

In addition, a person who has not been formally appointed as a director, but who nonetheless claims to be a director, holds himself/herself out as being a director and deals with matters that could only be properly carried out by a director of the company, could be a "de facto" director with all the duties and responsibilities of a director.

## Former directors

Subject to any necessary adaptations, the new general duties to avoid conflicts of interest and to not accept benefits from third parties (set out earlier in this section as points five and six) will apply to former directors of a company as well as current directors when they come into force on 1 October 2008.

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