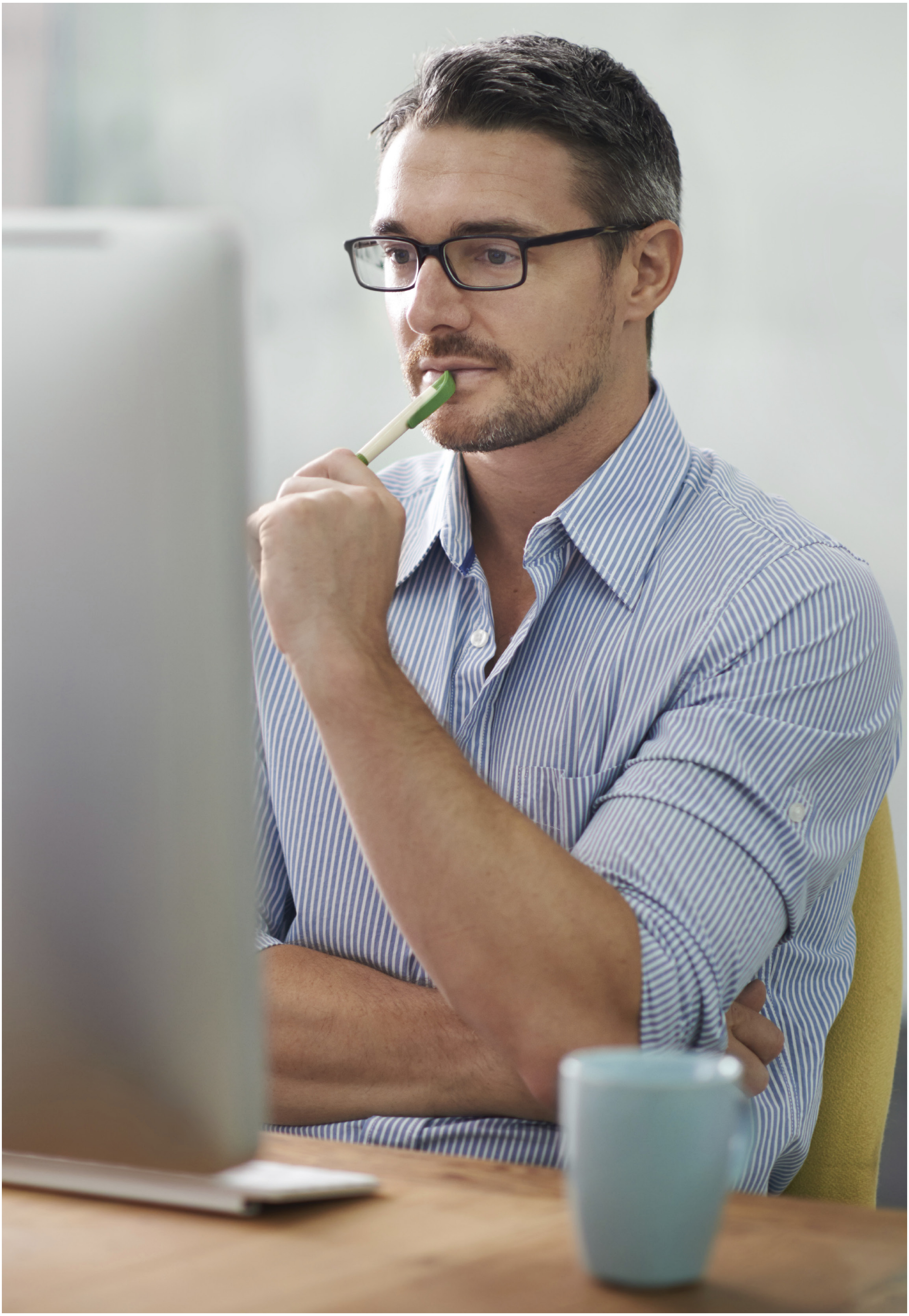
Directors' duties under the Companies Act 2006

An introduction

Hogan Lovells



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Introduction

The purpose of this note is to give new directors of UK companies an introduction to the main duties which they owe to their company under the Companies Act 2006. It is intended to be a quick reference guide written in everyday language rather than a comprehensive legal analysis.

Background

The constitution of a private company will normally state that the company's business will be managed by the directors. Most key decisions will be taken at a meeting of the board of directors or, where the constitution permits, by means of a directors' written resolution. It is not unusual, however, for the board to delegate some of its powers to committees or individual executive directors.

In carrying out their function of managing the company's business, the directors must comply with a number of duties which they owe to the company. Historically, directors' duties were set out in common law. As part of its wide-ranging reform of company law, however, the Companies Act 2006 codified the duties in statutory form, in some cases with significant changes.

The duties

The Companies Act 2006 sets out eight duties:

- duty to promote the success of the company
- duty to exercise reasonable care, skill and diligence
- duty to exercise independent judgment
- duty to act within powers
- duty to avoid conflicts of interest
- duty to declare interests in proposed transactions
- duty to declare interests in existing transactions
- duty not to accept benefits from third parties.

To a certain extent, compliance with these duties is a matter of common sense. It should go without saying, for example, that a director should exercise care, that he should seek to ensure the success of his company and that he should avoid conflicts of interest.

In practice, however, a common-sense approach has to be supplemented with a detailed understanding of the duties. For example, the Act does not simply require a director to promote the success of the company, but sets out a list of six factors which he must take into account when deciding whether a particular course of action would promote the success of the company. A director who honestly believes that he is acting in such a way as to promote the success of his company, but who has failed to consider the six factors, will be in breach of the duty. The duty to avoid conflicts of interest, too, is less straightforward than it first appears, for a director is, in fact, permitted to enter into a situation of conflict if he has the permission of the shareholders or, in certain circumstances, his fellow directors.

Duty to promote the success of the company

A director is required to act in the way which he considers will be most likely to promote the success of the company for the benefit of its members. In doing so, he must take into account, among other matters, the following six factors:

- the long-term consequences of the action
- the interests of the company's employees
- the company's business relationships with suppliers and customers
- the impact of the company's activities on the community and the environment
- the advantages to the company of having a reputation for high standards of business conduct
- the need to act fairly as between the company's shareholders.

The list is non-exhaustive, which means that a director may well wish or, indeed, need to take into account additional matters when deciding whether a particular course of action is likely to promote the success of the company.

The list is, however, mandatory. In other words, whatever other matters a director may take into account when making a decision, he must always consider those six factors.

It is important to note that the obligation is merely to take the listed factors into account. For example, it is possible for a director to take an action which would harm the environment without breaching the duty, provided that:

- he has considered the action's impact on the environment
- he has also taken into account the other listed factors, as well as any other relevant matters
- he has concluded, in good faith, that the action is most likely to promote the company's success.

As well as complying with the success duty, directors also need to consider how that compliance is recorded. The question of how this should be done was the subject of a great deal of debate during the course of the implementation of the Companies Act 2006. The generally accepted view is that the starting point should be that it is not appropriate simply to adopt a box-ticking approach, in which board minutes automatically record in respect of every resolution the fact that the directors considered all six mandatory factors in reaching their decision.

As far as large companies (including listed companies, most unlisted public companies and larger private companies) are concerned, there should normally be two aspects to the question of recording compliance:

- a discussion of the proposed action in light of the success duty should be included in the board papers prepared before the meeting and, where appropriate, in any management presentations delivered at the meeting. The discussion should normally address each of the mandatory factors which are relevant. The discussion should also consider any other relevant matters
- the board minutes should contain a brief reference to the fact that the directors believe that the proposed action will promote the success of the company. It will not normally be necessary for the minutes to record the fact that the directors have considered each of the six factors listed in the Companies Act 2006 (and any other relevant matters). If, however, the proposed action has serious implications as regards any of those factors (if, for example, it may have a significant impact on the environment or on employees), the minutes should record the directors' consideration of those factors.

Many companies, particularly smaller private companies, will not routinely prepare board papers, and so their main opportunity to record compliance will be in the board minutes. It will normally be sufficient, nevertheless, for the minutes to record only the fact that the directors concluded that the proposed action would promote the success of the company, and to refer to the mandatory factors only if the proposed action has serious implications in relation to one or more of them.

The Association of General Counsel and Company Secretaries of the FTSE 100, known as the GC100, issued best practice guidelines on recording compliance in February 2007 ('Companies Act (2006) - Directors' duties'). The guidelines are aimed at listed companies, but they will also be of interest as background reading on the success duty for directors of other companies. They are available on-line, at www.practicallaw.com (search for GC100).

Duty to exercise reasonable care, skill and diligence

A director has a duty to exercise reasonable care, skill and diligence.

This appears to be one of the more straightforward duties, but even here there is a point to be aware of which is not apparent from the wording of the duty. In assessing whether a director has exercised reasonable care, skill and diligence, two tests must be applied:

– did he exercise the care, skill and diligence which would be exercised by a reasonably diligent person with his general knowledge, skill and experience?
– did he exercise the care, skill and diligence which would be exercised by a reasonably diligent person with the general knowledge, skill and experience which may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company?

If the answer to either of these questions is ‘No’, the director is in breach of this duty.

This duty is, therefore, rather more onerous than it appears at first glance. In simple terms, not only must a director act with the level of care and skill which is to be expected of someone with his background, but he must also act with the level of care and skill which is to be expected of a hypothetical person carrying out his functions.

The difference between the two tests can be illustrated by the case of a finance director. Not only must he act with care and skill in light of his own experience, whatever that might be, but he must also act with care and skill in light of the experience which is to be expected of finance directors generally. An individual who is appointed to be a finance director, but who has no experience of financial matters, will find it very difficult to comply with this duty.

If a company appoints as an executive director an individual whose

background does not qualify him to fulfil his particular role, then arguably the company should bear at least some of the responsibility for his inability to do his job properly. The effect of this duty, however, is that it is the director who is culpable.

Prospective directors should therefore be quite certain, before they consent to their appointment, that they have the experience and expertise necessary to carry out the functions which will be expected of them.

Duty to exercise independent judgment

A director has a duty to exercise independent judgment.

This means simply that he must use his own judgment in performing his role as a director.

It does not prevent him from seeking professional advice, as long as he uses his own judgment to decide how to proceed in the light of that advice. Indeed, the government pointed out during the passage of the Companies Act 2006 through Parliament that in certain situations a director could be in breach of his duties if he fails to take advice.

The duty has particular relevance where, pursuant to a joint venture agreement, a director is appointed by one of the shareholders. In this situation, the director will need to ensure that he does not automatically follow the instructions of the appointing shareholder without employing his own judgment.

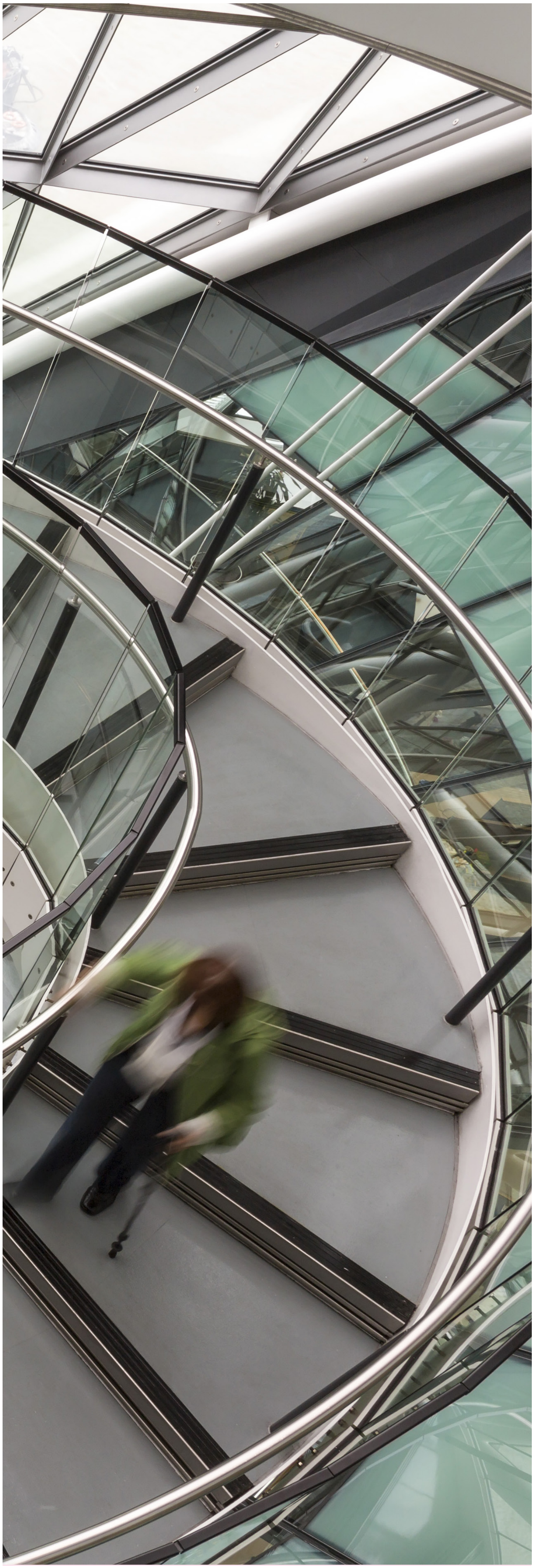
The duty does not prevent directors from delegating their powers, as long as the company's articles permit delegation, and as long as they exercise their own judgment in deciding to delegate.

Duty to act within powers

A director is required to act in accordance with the company's constitution and to exercise powers only for the purposes for which they are granted.

Under the first part of the duty, a director is required to act in accordance with the company's articles of association. He must, for example, abide by any provisions concerning the conduct of board meetings. Although companies no longer need to restrict their objects, if the company has opted to do so, he must not act in a way which is contrary to the company's objects. If the company's objects do not permit it to make investments in shares, for example, a director who approves such an investment will be in breach of this duty.

The second part of the duty is self-explanatory. As well as acting in accordance with the articles, a director must exercise his powers under the articles for the purpose for which they were given to him. For example, a director who allots shares pursuant to the articles with the primary intention not of raising capital but of diluting an existing shareholder's holding will be breaching this part of the duty.



Conflicts duties

The remaining duties all concern conflicts of interest. In broad terms, they provide as follows:

– a director must avoid a situation in which he has an interest which conflicts with the company's interests, unless the conflict has been authorised

– a director must declare to his fellow directors any interest which he has in a proposed or existing transaction or arrangement involving the company

– a director must not accept benefits from third parties.

Duty to avoid conflicts of interest

A director must avoid a situation in which he has, or could have, a direct or indirect interest which conflicts, or may conflict, with the company's interests.

This duty is extremely wide in scope. It is, in effect, a blanket prohibition preventing a director from entering into a situation in which his own interests may in any way conflict with the company's interests. It does not, however, apply to a conflict of interest arising in relation to a transaction or arrangement by the company.

A director can be caught by the prohibition in any number of ways. He may be caught, for example, if he owns a large stake in the company or if he is a customer of the company. He may be caught, too, if he is a director or shareholder of a competitor company, or indeed if his wife is a director or shareholder of a competitor company. There is no exhaustive list of the situations in which a director would fall foul of the prohibition, and so it is crucial that a director considers his own position, and that of those connected to him, very carefully, in order to ascertain whether he might be in danger of breaching this duty.

The duty is not as draconian as it sounds, however, because a conflict can be authorised either by the shareholders or, in certain circumstances, by the other directors. In addition, the duty is not infringed if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest.

For further information about this duty, please refer to our client note entitled 'Directors' conflicts of interest under the Companies Act 2006', which is available on our website (www.hoganlovells.com). Additional background reading on the duty, particularly in the context of listed companies, can be found in a GC100 paper entitled 'Companies Act 2006 - Directors' conflicts of interest' (18 January 2008), which is available on-line at www.practicallaw.com (search for GC100).

Duty to declare interests in proposed transactions

Duty to declare interests in existing transactions

A director must declare to the other directors any direct or indirect interest which he has in a proposed or existing transaction or arrangement with the company.

Here, again, a director will need to consider not only his own position, but also the position of those connected to him. A director whose wife is a large shareholder in a company with which his company is planning to enter into a contract, for example, will need to make a declaration.

Although the statutory duty is simply to declare the interest, the company's articles may well impose additional restrictions on a director with such an interest. In particular, they may prevent him from counting in the quorum at board meetings which are held to consider the transaction or arrangement and from voting on resolutions to which his interest is relevant.

The duty to declare interests in existing transactions is the only duty in relation to which a breach is a criminal offence. Whereas a director who breaches one of his other duties will normally find himself in difficulties only if the shareholders are unhappy about the breach, in the case of this duty an offence will be committed regardless of the shareholders' views.

Duty not to accept benefits from third parties

A director must not accept benefits from third parties.

This duty is designed to prevent directors from taking advantage of their position. For example, it prevents a director from accepting a sum of money from a third party which is hoping to win a contract with the company.

It is a wide prohibition, in that it is not confined to the acceptance of financial benefits, but covers benefits of any description. However, a director will not breach the duty if acceptance of the benefit is not likely to give rise to a conflict. Much will depend on the circumstances, of course, but the duty should not prevent a director from accepting limited corporate

Some final points

Consequences of breach

Directors owe their duties to the company. If, therefore, a director breaches his duties, it is the company which, as the aggrieved party, decides whether or not to take action against him.1 Since a company is controlled by its shareholders, this means that ultimately it is the shareholders who decide whether it is appropriate to take action. Shareholders are able, subject to certain specified requirements, to bring derivative actions against directors under the Companies Act 2006 for breach of their duties.

Relationship between the duties

The duties must not be considered in isolation.

A particular act may constitute a breach of more than one duty. A director who approves an action which is prohibited by the company's articles will be in breach of his duty to act in accordance with the company's constitution, and he is also likely to be in breach of his duty to exercise reasonable care and skill. Compliance with one duty does not ensure compliance with the others.

Executive and non-executive directors

Although listed companies are subject to a corporate governance code which addresses the balance of executive and non-executive directors on their boards, and although the two types of director will often perform very different functions within the company, English law does not in essence distinguish between executive and non-executive directors. As far as their duties are concerned, all directors of UK companies are subject to the same statutory duties under the Companies Act 2006.

Other duties and liabilities

The duties discussed in this note are the primary duties to which directors of all UK companies, whether private or public, listed or unlisted, are subject, and directors must therefore understand them properly. They are, however, only part of the picture, as directors are subject to numerous specific duties, both under general company law and under regulatory regimes governing areas such as:

- the environment
- health and safety matters
- competition (anti-trust) issues
- corporate insolvencies.

Directors of listed companies also have responsibilities in connection with the FCA's Listing Rules, Disclosure Rules and Transparency Rules and Prospectus Rules and the AIM Rules for Companies, possibly depending on the nature of the relevant listing.

Further information

If you would like further information on any aspect of directors' duties, please contact the person with whom you usually deal, or Andrew Pearson, Richard Ufland or Julie Stanbrook.

Andrew Pearson
Partner, London
T +44 20 7296 5139
andrew.pearson@hoganlovells.com

Richard Ufland
Partner, London
T +44 20 7296 5712
richard.ufland@hoganlovells.com

Julie Stanbrook
Counsel, London
T +44 20 7296 5841
julie.stanbrook@hoganlovells.com

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