STEVENS&BOLTON

DIRECTORS' DUTES - THE STATUTORY REGIME

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SECTION 1 | BACKGROUND: THE FORMER COMMON LAW REGIME

Before the introduction of the statutory duties in the Companies Act 2006 (the "Act"), directors' general duties were based in common law; that is to say that they were developed by the courts through case law. These common law duties generally comprised:

fiduciary duties (such as the duty to act in good faith in the best interests of the company as a whole, to avoid a situation of conflict, not to make a secret profit, to exercise the director's powers for a proper purpose and not allow his discretion to be fettered); and

a duty to exercise skill and care.

The statutory duties introduced by the Act constituted a significant reform with the intention of making the law clearer and more accessible for directors, in turn helping to improve standards of corporate governance. They do not provide a complete list of all duties owed by a director. Other specific duties as set out in various pieces of legislation (including the Act) continue to apply e.g.: the duty to file certain information at Companies House. The Government also left some duties uncodified (such as the duty to consider the interests of creditors in times of threatened insolvency) with the intention that they will continue to be developed by the common law.

Further, whilst these statutory duties replaced the common law rules to which they relate, the Act expressly states that they shall be interpreted and applied in the same way as the former common law rules. Therefore, there is an ongoing need to have regard to the common law, as it may continue to be developed by the courts going forward.

SECTION 2 | THE STATUTORY DUTIES

The scope of each of the statutory duties and the consequences of breach

The seven statutory duties require a director:

1. **to act in accordance with the company's constitution and exercise powers only for the purposes for which they are conferred;**
2. **to promote the success of the company for the benefit of its members as a whole;**
3. **to exercise independent judgment;**
4. **to exercise reasonable care, skill and diligence;**
5. **to avoid conflicts of interest;**
6. **not to accept benefits from third parties; and**
7. **to declare an interest in a proposed transaction or arrangement with the company**.

1. Duty to act in accordance with the company's constitution and exercise powers only for the purposes for which they are conferred

The term "constitution" comprises the articles of association as well as certain resolutions or decisions by the members or classes of them. In relation to the requirement to exercise powers only for the purposes for which they are conferred, this must be ascertained in the context of the specific situation under consideration. Essentially it involves assessing whether any abuse of power is involved in what the directors are doing or proposing to do, in the sense of the act being authorised and within scope but being done for an improper reason. The test is subjective and the state of mind of the directors involved at the time and their underlying motives will all be relevant.

2. Duty to promote the success of the company for the benefit of its members as a whole

This statutory duty provides that the 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, and in doing so must have regard (amongst other matters) to a list of factors. These factors are:

- the likely consequences of any decision in the long term;
- the interests of the company 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 environment;
- the desirability of the company to maintain a reputation for high standards of business conduct; and
- the need to act fairly as between members of the company.

This list is non-exhaustive; each director must also consider any other relevant matters. It is not enough to pay lip service to the six factors. A director must actually turn his mind to each factor when making a decision although he need not give any particular weight to each and, in having regard to them, the duty to exercise reasonable skill, care and diligence will apply. In many cases, directors will therefore need to take action to comply with this aspect of the duty; however, they will not be required to do more than is required by the principle of good

faith and the duty to exercise reasonable care, skill and diligence. The overarching obligation is to promote the success of the company for the benefit of its members as a whole.

The potential practical effects of this duty and a checklist of steps that companies and their directors might consider taking are set out at in Section 4. Note that there may be particular issues in a group situation where a director sitting on the board of more than one company within the same group might face conflicting duties. In such cases, care must be taken to isolate the interests of the particular company at the time that the director is taking the decision. Although directors can have regard to the interests of other group companies, this is only if it is consistent with the primary duties owed to the company of which he is a director The company's interests may not be sacrificed for the greater good of the group.

3. Duty to exercise independent judgment

Directors should act independently and not allow their independent judgment to be compromised, whether by delegation or otherwise, unless permitted by the company's constitution. It should be noted that directors cannot delegate their duties unless authorised to do so by the company. Therefore, any delegation by the board to a single director or committee of directors should be authorised by the company's constitution.

The Act provides that this statutory duty will not be infringed where directors act in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by the directors or in a way authorised by the company's constitution.

Particular questions arise in the case of a nominee director appointed by a shareholder in order to promote the shareholder's interests. A nominee director owes the same duties as any other director. The fact that a director is nominated to his office by a shareholder does not, of itself, impose any duty on the director owed to a nominating shareholder. A nominee may take the interest of his appointor into account when taking decisions, but this must not derogate from his duty to exercise independent judgment and to promote the success of the company. A nominee director should also carefully consider his position in light of the rules relating to conflicts of interests, as mentioned further below.

4. Duty to exercise reasonable care, skill and diligence

The standard required here is the level of care, skill and diligence that would be exercised by a reasonably diligent person with:

- the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and
- the general knowledge, skill and experience that the director has.

This is a subjective standard and means that where a director has a higher level of specialist knowledge and experience, he will be expected to perform to that higher level.

5. General duty to avoid conflicts of interest

Under this duty, a director is required to avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. So this duty would cover, for example, where a director has an interest in a competing company. This duty extends to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity). The courts take a strict line on conflict duties, and bad faith on the part of the director concerned is not required. Note that this duty does not apply to conflicts concerning transactions or arrangements with the company, which are dealt with separately under the last duty below.)

The Act enables the directors to authorise these conflicts. In the case of a private company, the directors will be able to authorise a conflict so long as the company's constitution does not expressly prevent them from doing so. However, directors of public companies must be expressly authorised by the constitution. In either case, the authorisation is only effective if the interested director(s) is/are excluded from the vote and from counting as part of the quorum at the meeting in which authorisation is given.

In the context of joint venture companies, it may not be appropriate or practical for directors to authorise conflicts because the authorisation must be given without counting the votes of interested directors or allowing interested directors to count in the quorum. In a 50/50 joint venture, for example, it might be impossible to achieve a quorate board meeting on this basis because all directors are conflicted. For joint venture companies, shareholder authorisation of conflicts might be the only practical solution.

Multiple directorships present an area in which conflicts are very likely to occur and it is vital that they are managed properly from the outset to avoid a breach of duty. A director with multiple business interests may become aware of an opportunity that he would like to exploit independently of the company. He is under a duty to disclose such a conflict and seek fully informed consent from the company in such situations. This applies even if the opportunity is outside his particular area of expertise within the company and did not come to his attention because of it, and even if he thinks the company would not be interested in pursuing it.

As mentioned above, a nominee director is very likely to find himself in a situation of conflict by virtue of his potentially competing duties to the company and his appointor. It is therefore advisable for a nominee director to obtain authorisation of that conflict from the outset of his appointment. However, it should be noted that such approval does not enable the nominee director to derogate from his duties to the company and may still require him, should he find himself in a position of actual conflict at any stage, to take such further steps as may be necessary to safeguard the company's interests.

6. Duty not to accept benefits from a third party

This duty provides that a director of a company must not accept a benefit from a third party conferred by reason of (a) his being a director, or (b) his doing (or not doing) anything as a director. This includes non-financial as well as financial benefits. However, this duty only extends to benefits which can reasonably be regarded as likely to give rise to a conflict of interest.

The main difference compared to the above general duty to avoid conflicts is that approval on the acceptance of benefits has to come from the members; the directors cannot be empowered to authorise them.

There are some practical concerns as to precisely what benefits might be caught, given the potential difficulty in determining in certain instances when a benefit could reasonably be regarded as giving rise to a conflict.

7. Duty to declare interest in proposed transaction or arrangement

This duty requires a director who is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, to declare the nature and extent of that interest to the other directors.

Such disclosure extends to matters of which the directors ought reasonably to be aware and requires any disclosure that is made to be updated as and when necessary, at any time prior to the transaction being entered into, to ensure it remains accurate and complete.

Note, however, that a director is not required to declare an interest:

- if it cannot reasonably be regarded as likely to give rise to a conflict of interest; or
- if, or to the extent that, the other directors are already aware of it (and, for this purpose, they are treated as being aware of anything which they ought reasonably to be aware); or
- if, or to the extent that, it concerns the terms of his service agreement that have been or are to be considered at a board or committee meeting.

Once a director has made such disclosure, no further authorisation by either the members or the board is necessary. This is subject, however, to anything contrary in the company's articles.

There is also a separate duty, along similar lines, applying to situations where a director has an interest in a transaction or arrangement already entered into with the company.

The impact of the statutory duties on the company's articles of association

In the main, these duties are mandatory and cannot be diluted by the company's articles of association. The exception to this is in relation to certain types of conflicts where the rules allow a company to adopt alternative approaches.

Some older companies may still have provisions in their articles dealing with disclosure of conflict of interests based on the Companies Act 1985. The problem with this is that the articles of association now have to be interpreted in the light of the new statutory provisions relating to conflicts of interests, leading to potential inconsistencies between what the articles of association say and what the law says has to be done. It is advisable for companies which have not already done so to update the articles of association to reflect the Act.

In relation to the general duty to avoid conflicts (item 5 above), whilst private companies which have been formed on or after 1 October 2008 do not need express permission in their articles for their directors to be able to authorise conflicts, private companies incorporated before that date must have amended their articles, or passed an ordinary resolution, expressly to permit such director authorisation. In contrast, all public companies, regardless of when they were incorporated, must carry express authorisation in their articles.

To whom will directors owe these duties?

A director, as a general rule, owes his duties to the company as a whole, rather than to the shareholders, creditors, employees or any other stakeholder.

In particular, in relation to the duty to promote the success of the company (item 2 above), it should be noted that whilst directors are required to have regard to the interests of various groups (such as employees, creditors and customers), it does not change the position that this duty is owed only to the company itself.

To which types of director do these duties apply?

These duties apply to all those who occupy the position of director, by whatever name called. This includes "de facto" directors (those who act as directors, even though not properly appointed). The duties also apply to shadow directors (those in accordance with whose directions or instructions the directors are accustomed to act) “where and to the extent that they are capable of so applying”. It remains to be seen how the courts will interpret this provision but the starting point for shadow directors will be that the general duties apply to them unless they are not capable of applying.

Certain aspects of the duties relating to conflicts continue to apply to directors once they have ceased to hold office. In particular, a former director will not be able to exploit, after termination of his office, any property, information or opportunity of which he became aware before he ceased to be a director.

What are the consequences for breach of these duties?
The Act does not specifically specify the remedies but simply states that the remedies which were previously available for breach of the former corresponding common law rule are preserved. Depending upon the nature of the breach, this could include compensation, damages, an account of profits, restoration of property or rescission of a contract.

Will the company be able to ratify a breach of duty by a director?
The Act preserves the ability of the company (which existed previously under the common law) to ratify a breach of duty by a director. However there is an important limitation: any decision to ratify a breach of duty must be taken by the members without reliance on the votes of that director and any other member connected with him. This means that directors who are shareholders are not able to vote to ratify their own breach (although note that this restriction does not apply where all the members in any event unanimously consent to the ratification). This is significant to majority shareholder directors who may be at the mercy of their minority shareholders to secure a ratification. It is therefore important for those shareholder directors to ensure that, where shareholder approval is required, it is obtained in advance (in which case those directors' votes can be counted) rather than having subsequently to rely on ratification (where those votes must be discounted).

It is important to note that ratification is only effective if the company is solvent at the time of the ratification. If there is a possibility that the company is insolvent, the interests of creditors become important and a purported ratification by members will not be effective to relieve a director of liability for breach of duty.

SECTION 3 |THE STATUTORY DERIVATIVE CLAIM

Overview of the circumstances in which a shareholder is able to bring a claim against a director on behalf of the company and the process involved

Under the Act a shareholder is able to bring a statutory derivative claim in the name of the company against a director for breach of duty.

The statutory derivative claim

The Companies Act 2006 derivative claim is wider in scope than its former common law counterpart. In particular:

- a broader range of conduct is caught - covering any actual or proposed act or omission involving negligence, default, breach of duty (including the statutory duties) or breach of trust by a director;
- a claim may be brought against a director (including a former director) or "another person". Although "another person" is not defined in the Act it is understood that this is intended to capture only a very narrow category of third parties, such as those who knowingly assist in such breach or who are in knowing receipt of money or property (e.g.: receipt of property by another company which is controlled by the defaulting director, such that the other company can be said to be in knowing receipt of the property);
- under the former common law claim, a director needed personally to benefit if a claim was to be brought against him. Under the statutory derivative claim, personal benefit is no longer a pre-requisite to a claim; and
- there is no minimum shareholding requirement - any shareholder may bring a claim and it is not necessary that he was a shareholder at the time of the alleged breach.

The procedure for bringing a claim consists of a number of stages designed to weed out groundless claims. Importantly, having commenced a claim, the claimant must apply to court for permission to continue it. If the claimant cannot establish a prima facie case the court will dismiss the application and effectively terminate the claim. If the claimant establishes a prima facie case, the court will consider whether to grant or refuse permission to continue the claim. There are a number of criteria set out in the Act which the court must take into account.

In particular, the court must refuse permission if:

- the person seeking to promote the success of the company for the benefit of its members would not continue the claim; or
- the act or omission has been authorised or ratified by the company.

Otherwise, in deciding whether to grant permission, the court must take into account the following:

- whether the claimant is acting in good faith;
- the importance a person seeking to promote the success of the company would attach to continuing it;
- whether the act or omission could be, and in the circumstances would be likely to be, authorised or ratified by the company;
- whether the company has decided not to pursue the claimant; and
- whether a member could pursue a claim in his own right rather than on behalf of the company (e.g.: an unfair prejudice petition).

Due to the very limited scope of the common law derivative claim, in the past it was often the case that a real threat to a director of a claim for breach of duty arose either in the event of a company's insolvent liquidation (where a liquidator might choose to pursue such claim) or perhaps as a result of a shareholders' dispute. The statutory derivative claim raises the opportunity for any shareholder to bring a claim at any time on grounds of any alleged breach of duty.

Inevitably, the introduction of the statutory derivative action initially led to concerns of an increased likelihood of claims against directors especially when coupled with the new duties. Such concerns appear, to date, to be unfounded. Few cases have come before the courts since the statutory derivative action was introduced. In those that have, the courts have refused permission to continue the claim, either on the grounds that a person seeking to promote the success of the company (as per the statutory duty set out above) would not continue the claim, or that more appropriate relief could be given under an unfair prejudice petition.

SECTION 4 | THE PRACTICAL IMPLICATIONS OF THE STATUTORY DUTIES

Details of available published guidance and a checklist of actions

The Government's non-binding guidance on the statutory duties includes simple high-level guidance for directors as follows:

- Act in the company's best interests, taking everything you think relevant into account.
- Obey the company's constitution and decisions taken under it.
- Be honest, and remember that the company's property belongs to it and not to you or to its shareholders.
- Be diligent, careful and well informed about the company's affairs. If you have any special skills or experience, use them.
- Make sure the company keeps records of your decisions.
- Remember that you remain responsible for the work you give to others.
- Avoid situations where your interests conflict with those of the company. When in doubt disclose potential conflicts quickly.
- Seek external advice where necessary, particularly if the company is in financial difficulty.

The GC100 Group* also published its view on best practice guidelines for compliance with the statutory duties. The GC100 is of the view that directors should not be required, as a matter of course, to set out in the minutes an exhaustive account of their thought processes, whether with regard to "enlightened shareholder value" factors or any other factors that they consider relevant. If anything, making board minutes lengthier in this respect would be more likely to expose the directors to a greater risk of litigation, particularly in light of the statutory derivative claim. Directors should concentrate on the actual decision making itself, ensuring that they are as fully informed as possible.

The statutory duties will continue to be developed by the courts going forward and directors will need to monitor these developments so as to ensure that they can effectively comply with their statutory obligations. Other steps which prudent directors seeking to minimise their risk should consider include:

- reviewing internal corporate governance procedures (in particular, ensuring that there is adequate policy guidance on the acceptance of benefits and procedures in other situations of conflict); and
- putting in place indemnities in favour of the directors to the fullest extent permitted by law (in addition to D&O officers' liability policies), and ensuring that such indemnities fully cover any claims brought pursuant to the statutory derivative claim procedure.

* The GC100 was launched in March 2005 and now comprises of senior legal officers of more than 80 FTSE100 companies (more than 70 at the time of publication of its best practice guidance). Its main objectives are to provide a forum for practical business-focused input on key areas of reform affecting UK listed companies and to enable its members to share best practice.

KEY CONTACT

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