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Directors' duties

under the Companies Act 2006

September 2007

Contents

The statutory duties: overview	3
Duty to exercise reasonable care, skill and diligence	3
Duty to promote the success of the company	3
Duty to act within powers	4
Duty to exercise independent judgement	5
Duty to avoid conflicts of interest	5
Duties not to accept benefits from third parties	5
Duties to declare any interest of the director in transaction or arrangement	6
Derivative actions	6
Practical steps	7
Appendix: General duties of a Director	**8**

For the first time, the principal duties owed by directors to their company have been set out in statute, in the new Companies Act 2006.

The statutory duties will replace the common law duties of directors on which they are based, and are coming into force on 1 October 2007 (except those relating to conflicts of interest, which will come into force on 1 October 2008). Apart from deliberate innovations, some changes of scope and application may arise simply from the way the newly formulated duties are interpreted by the courts.

The new Act also modernises and changes the rules by which shareholders can bring actions in the name of the company, known as derivative actions, and this may make it easier for shareholders to sue directors. The new rules on derivative actions will also come into force on 1 October 2007.

The statutory duties do not include all the duties and rules to which directors are subject. Other duties, such as the duty to creditors on insolvency and the various specific duties contained in companies legislation (like the duty to prepare accounts) and under health and safety legislation, will continue to apply alongside the new statutory duties. They are beyond the scope of this paper, which contains a brief summary of the new statutory duties and rules on derivative actions, and recommends some practical steps that directors can take.

The statutory duties: overview

The new Act contains seven general duties of directors:

- a duty to exercise reasonable care, skill and diligence
- a duty to promote the success of the company
- a duty to act within their powers
- a duty to exercise independent judgement
- a duty to avoid conflicts of interest
- a duty not to accept benefits from third parties
- a duty to declare any interest in a proposed transaction or arrangement

The full text of the statutory duties is reproduced in the Appendix on pages 8 to 10.

Like the common law duties they replace, the statutory duties are owed by a director to the company and not to any individual shareholder.

Duty to exercise reasonable care, skill and diligence

(section 174)

The duty set out in section 174 adopts the combined objective/subjective test prescribed in the Insolvency Act 1986 for judging whether directors are liable for wrongful trading.

- Under the *objective* limb, the director's performance is assessed against what a reasonably diligent and experienced person in the same role might reasonably have been expected to do in the same circumstances. So, for example, a sales director will not be expected to have the general skills of a typical finance director and vice versa; but no director can with impunity fall below the objective standard for his role.
- The *subjective* limb requires the director to exercise the general knowledge, skill and experience that he actually has, if that is greater than the objective standard.

In other words, directors have to achieve at least the level of skill of a reasonable person in their position but, if they are more skilled, they will be judged by their own higher standard. The courts have in fact used this test for many years to assess compliance with a director's common law duty of skill and care.

Unlike the other statutory duties, this duty is not of a fiduciary nature. This means, for example, that the company's remedy for breach is essentially an action for damages, whereas there are additional remedies for breach of fiduciary duty, such as making the director account to the company. Nevertheless, the duties will sometimes interact: for example, a failure to exercise the proper standard of care, skill and diligence may constitute – or at least indicate – a breach of the duty to promote the success of the company.

Duty to promote the success of the company (section 172)

The duty set out in section 172 replaces the common law duty of loyalty, often phrased as the duty to act in good faith in the best interests of the company. The new duty requires a director to act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a collective body: not just the majority shareholders, or any particular shareholder or section of shareholders. In doing so the director must have regard (amongst other matters) to six specified factors:

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

The concept of promoting the success of the company, and the non-exhaustive list of factors, have been the most controversial aspect of the new Act. The Government has described section 172 as a radical departure in articulating the connection between what is good for a company and what is good for society at large. This is said to reflect a cultural change in the way that companies conduct their business – that it is now recognised that pursuing the interests of shareholders and embracing the wider responsibilities flagged in the list of factors are complementary purposes, not contradictory ones. The Government also claims that section 172 should resolve any confusion in the mind of directors as to what the interests of the company are; there is no excuse, for example, for thinking that acting in the interests of the company's members necessarily precludes acting in the interests of those who depend on the company, like its employees and its supply chain.

Directors are nevertheless concerned that the list of factors in particular may make them more vulnerable to action by a liquidator in the event of insolvency, or to a derivative action by shareholders under the new, more comprehensive, regime. We think that directors should bear the following points in mind:

- It is important that all directors are aware of the list of factors, and recognise that these are not the only factors to consider. For example, they will need to look at the company's constitution (there may be limits on their powers, such as borrowing restrictions), shareholder decisions and anything else that they consider relevant in helping them to judge whether they are promoting the success of the company for the benefit of the members as a whole. Perhaps there will be foreign legal restrictions relevant to the company's activities.
- To a large extent, these matters are ones that any responsible Board would weigh up as part of its decision-making. Indeed, the new section can be seen as a means of improving the *processes* of Boards, rather than imposing an additional substantive burden.
- The Government says that the obligation to have regard to the factors means giving them proper consideration, and not merely paying lip service to them: directors must exercise the same level of skill, care and diligence as they would in carrying out any other function.
- The decisions taken by a director and the weight given to the factors are a matter for his good faith judgement. It is therefore fundamentally a subjective matter, although some degree of objectivity is imported by the need to exercise reasonable skill, care and diligence. While judges have consistently been reluctant to interfere with business judgements, there comes a point when the court would be prepared to say that no director could reasonably have reached such a decision in good faith.
- Not all the factors will always be relevant, and sometimes one factor may be irreconcilable with another one: investing in new technology, for example, may be better for the environment but cause job losses. The obligation is not to ensure that the company achieves a positive score on each factor, but to think about them when deciding what course will best promote the company's success. Where factors conflict with each other, or with what the directors consider to be the promotion of the company's success, it is legitimate to discount a particular factor or give it less weight – as long as it has been thought about, if it is relevant, with whatever attention is due and feasible in the particular circumstances.
- It is possible to see the list of factors as permissive, making it easier for a Board to justify decisions that are influenced by particular factors, even if that means not achieving the maximum profit for shareholders.

What does promoting the success of the company mean? The new Act does not say. The Government says that success means what the members collectively want the company to achieve: for a commercial company, usually long-term increase in value, but for others, such as charities and community interest companies, attainment of the objectives for which the company has been established. As with the common law duties, it will not always be straightforward: in contested takeovers, for example, a financially attractive offer to shareholders might come on terms that jeopardise the company's prospects (and its continued role in the wider community) after those shareholders have gone.

Duty to act within powers

(section 171)

The duty set out in section 171 codifies the common law duty to act in accordance with the Company's constitution and to use powers for a proper purpose. The company's constitution has an extended meaning, and includes any resolution or other decision come to in accordance with the constitution – for example, ordinary resolutions as well as special resolutions, and even Board resolutions.

Under the new Act companies formed on or after 1 October 2008 will automatically have unlimited capacity (unless they opt for restrictions in the articles), and the objects clause of an existing company will be deemed to be part of its articles of association.

Duty to exercise independent judgement (section 173)

The duty to exercise independent judgement replaces the common law duty of a director not to fetter his discretion. The Government says that the duty does not mean that a director has to form his judgement independently from anyone or anything. He will continue to be able to rely on the judgement of others in areas where he is not expert. Nor does it mean that the director has to be independent himself: he can have an interest in the matter. But his judgement must be his own judgement (and not, for example, that of the person who secured his appointment to the Board).

Directors may be in breach of duty if they fail to take appropriate advice – for example, legal advice – but they cannot abdicate their role by slavishly relying on it, and obtaining outside advice does not absolve directors from exercising their judgement on the basis of such advice.

A director is relieved of this duty if the company has contracted to fetter his discretion – and almost any contract will limit a director's discretion in some way – or if the company's constitution allows it.

Duty to avoid conflicts of interest (section 175)

The duty set out in section 175 codifies the common law rules on conflicts of interest with some important modifications. A director must avoid situations in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the company's interests. This applies in particular to multiple directorships and to the exploitation of property, information or a business opportunity (even if the company is not itself in a position to take advantage of it). The statutory duty provides that there will be no breach if the matter is validly authorised by the company.

Under the common law, only the shareholders can authorise a director's conflict of interest. Under the new Act, authorisation by non-conflicted directors is permitted in a private company provided the company's articles do not invalidate the authorisation, and in public companies provided the company's articles specifically allow it. Shareholder approval will still be required if all the directors are or may be conflicted. It is not enough for the director to settle in his own mind that there is no problem: there has to be a process for the company, through its members or directors, to make the decision without relying on the votes of the director seeking the authorisation or of any other interested director. The Government says that the duty is a heavy one and is intended to be so. The duty does not, however, arise if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest. If the matter falls outside the ambit of the company's business, a real conflict of interest is unlikely.

The duty catches the interests of persons connected with the director (for example, family members, connected companies, etc), but this category is extended to include a director's civil partner and adult children and step-children, the director's parents, a person who lives with the director as partner in an enduring family relationship, and any children or step-children under 18 of such a person who are not also the director's children or step-children. This extended definition flows into the provisions that determine whether a director is connected with, or controls, a body corporate.

The duty does not apply to a conflict of interest arising in relation to a transaction or arrangement between a director and the company, in which case a director must declare his interest in much the same way as before (see page 6. *Duty to declare any interest of the director in a proposed transaction or arrangement*).

This duty does not come into force until 1 October 2008, and until then the common law duty applies. Once section 175 is in force transitional arrangements will require companies already in existence on 1 October 2008 (private as well as public) to seek the approval of their members if they want to permit independent director authorisation of such conflicts.

Duty not to accept benefits from third parties (section 176)

The duty set out in section 176 replaces the common law duty not to make a secret profit. The duty applies only to benefits conferred on the director because he is a director, and will not be breached if accepting the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. Benefits from associated companies are excluded. Otherwise, all third party benefits – of any description, whether financial or not - must be authorised by the company's shareholders.

This duty does not come into force until 1 October 2008.

Duty to declare any interest of the director in a proposed transaction or arrangement

(section 177)

The common law position is that, where a transaction is proposed between a director and his company so that the director's duties to the company may be in conflict with his personal interests, shareholders must approve the transaction. This is usually modified by a company's articles, requiring directors merely to disclose their interests to the rest of the board instead of obtaining shareholder consent.

The duty in section 177 reflects the position in the Companies Act 1985 and in the articles of most companies, with some slight modifications. A director must disclose the nature and extent of his interest (which is likely to include the interests of persons connected with the director) before the company enters into the proposed transaction, and the notification must be updated if it becomes inaccurate or incomplete. If the director duly complies, the transaction is not liable to be set aside on equitable or common law grounds.

No disclosure is required if the interest cannot reasonably be regarded as likely to give rise to a conflict of interest. Nor is disclosure necessary if the other directors are already aware (or ought reasonably to have been aware) of the director's interest.

This duty does not come into force until 1 October 2008, and until then the common law position, as modified by the Companies Act 1985 and a company's articles, applies. This includes, in particular, section 317 of the Companies Act 1985, which contains a similar duty to declare an interest in a proposed transaction. Once section 177 is in force transitional arrangements will preserve whatever provisions companies in existence before 1 October 2008 already had for dealing with such conflicts.

The provisions of section 177 are complemented by the provisions of section 182, which require a director to declare the nature and extent of his interest in any *existing* (as opposed to prospective) transaction in which the company is interested. This would therefore apply where, for example, a person is appointed to a Board in circumstances where he has an interest in such a transaction. By contrast with section 177, failure to comply with this duty is a criminal offence, and compliance does not prevent the transaction from being set aside on equitable or common law grounds.

Derivative actions

As a general rule, if a wrong is done to a company, only the company itself (and not a shareholder) can bring an action for damages or some other remedy. In practice, the directors must decide whether or not to bring a claim. Clearly, if the wrong was done by the directors themselves, or a majority of them, no claim is likely to be made. The courts have therefore developed an exception to the rule, allowing shareholders to bring an action on behalf, and for the benefit, of the company (a derivative action) in certain very limited circumstances where it can be shown that the act in issue amounts to a "fraud on the minority" and that the wrongdoers are in control of the company. Derivative actions can only be brought at the discretion of the court and no claim can be brought where a majority of independent shareholders do not wish the action to proceed.

The new Act introduces a statutory version of the derivative action to replace the existing common law rules. A derivative claim will only be allowed – against a director or another person (or both) – in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director (whether arising before or after the claimant became a shareholder). The common law rules do not permit derivative actions based on a director's negligence unless he himself benefited from it, so the new regime is potentially much wider. There is no need to show that the act in issue amounts to fraud on the minority or that wrongdoers are in control of the company, or (in the case of a claim against a director for breach of duty), that the director personally benefited from the breach. But the court must dismiss the claim if it is satisfied that:

- a (hypothetical) director acting so as to promote the success of the company for the benefit of its members as a whole would not continue the claim; or
- where the act or omission is yet to occur, it has been authorised by shareholders or, where it has already occurred, it was authorised beforehand by shareholders or has subsequently been ratified by them (disregarding any votes cast by the directors concerned, if they are shareholders, or by any shareholder connected with them).

In deciding whether to give permission, the court must take various matters into account, including whether the

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shareholder is acting in good faith; the importance of the claim to the company; whether the company has decided not to bring the claim; and whether the shareholder could bring a claim in his own right, rather than on behalf of the company. The court is also required to have particular regard to the views of any disinterested shareholders: for example, if the company produces evidence that a majority of those shareholders do not favour pursuing the claim, this is likely to weigh heavily with the court. To get a derivative claim struck out, a company will want to show that, essentially, the Board's decision not to pursue a claim against a director is a reasonable one in the circumstances. It will help if the Board can show that it has taken independent legal advice and, preferably, that the decision has the support of the majority of disinterested shareholders.

Practical steps

Not all companies are the same, and approaches to the new Act may vary accordingly. In this section, we set out some practical steps that all directors should consider in light of the general duties contained in the new Act.

- It is essential that directors are aware of their duties, and in particular the changes introduced by the new Act. Training should be organised to give directors an understanding of the new duties – and in particular, to instil the factors they must have regard to when considering how to promote the success of the company. It will be a fundamental element of discharging a director's duties that he is aware of the factors even though, in individual instances, some or all of them may not be relevant to the decision in question. There should be a focus on training when new directors are first appointed.
- How well would the Board's procedures stand up if compliance with the Act were checked today? What changes need to be made in the way decisions are taken?
- Where directors receive briefing papers, studies, presentations and similar background material prepared by others, the individuals preparing those papers should also be aware of the directors' duties, and the matters directors may need to take into account. In that way, the board papers themselves are more likely to address all factors that are relevant for the directors in making a formal decision, and it becomes less likely that a decision could be made without proper consideration of a relevant factor.
- The duties apply to everything that a director does, not just his participation in formal board meetings. Many decisions are taken by individual directors in the course of their day-to-day work, particularly if they are executives. Directors should try to ensure that they set a suitable strategy for the company, which has been properly considered in light of the duty to promote the success of the company. This may be best done by holding periodic strategy review sessions, at which the duty to promote the success of the company (and the specific matters set out in section 172) are considered along with other relevant factors.
- The Government has said that there is no requirement on directors to keep records in any circumstances in which they would not have had to do so before. We do not consider it necessary that board minutes should record that the directors specifically considered the six factors listed in section 172 when reaching a decision. Instead, we believe that companies may continue to document their decisions in the same way as they currently do. What is important is the substantive decision-making process that the directors go through, not the way in which this is recorded in the minutes. There may be certain instances where more detailed minutes are appropriate as a way of evidencing the directors' consideration of certain specific issues – for example, in contemplating redundancies, a consideration of the impact of that proposal on the interests of the company's employees and possibly the local community. This is consistent with the approach that is typically taken when a company faces a risk of insolvency: board meetings are often lengthy, with detailed minutes being prepared, in order to ensure that the company can demonstrate that the interests of creditors were properly considered.
- The new duties, and in particular the duty to have regard to the statutory factors, is not intended to prevent a company from making quick decisions. Where an urgent decision is necessary, the requirements of section 172 should not be read as preventing a decision being made until (for example) formal reports have been commissioned – it is simply the case that the directors must do their best in the time that is available.
- It may be sensible to review the company's D&O policy and consider whether this should be complemented by an appropriate indemnity in favour of the directors from the company.

Appendix: General duties of a Director

170. Scope and nature of general duties

(1) The general duties specified in sections 171 to 177 are owed by a director of a company to the company.

(2) A person who ceases to be a director continues to be subject:

(a) to the duty in section 175 (duty to avoid conflicts of interest) as regards the exploitation of any property, information or opportunity of which he became aware at a time when he was a director, and

(b) to the duty in section 176 (duty not to accept benefits from third parties) as regards things done or omitted by him before he ceased to be a director.

To that extent those duties apply to a former director as to a director, subject to any necessary adaptations.

(3) The general duties are based on certain common law rules and equitable principles as they apply in relation to directors and have effect in place of those rules and principles as regards the duties owed to a company by a director.

(4) The general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties.

(5) The general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles so apply.

171. Duty to act within powers

A director of a company must:

(a) act in accordance with the company's constitution, and

(b) only exercise powers for the purposes for which they are conferred.

172. Duty to promote the success of the company

(1) A director of a company 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 have regard (amongst other matters) to:

(a) the likely consequences of any decision in the long term

(b) the interests of the company's employees

(c) the need to foster the company's business relationships with suppliers, customers and others

(d) the impact of the company's operations on the community and the environment

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

173. Duty to exercise independent judgment

(1) A director of a company must exercise independent judgment.

(2) This duty is not infringed by his acting:

(a) in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by its directors, or

(b) in a way authorised by the company's constitution.

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174. Duty to exercise reasonable care, skill and diligence

(1) A director of a company must exercise reasonable care, skill and diligence.

(2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with:

(a) 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

(b) the general knowledge, skill and experience that the director has.

175. Duty to avoid conflicts of interest

(1) A director of a company must 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.

(2) This applies in particular 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).

(3) This duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company.

(4) The duty is not infringed:

(a) if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest; or

(b) if the matter has been authorised by the directors.

(5) Authorisation may be given by the directors:

(a) where the company is a private company and nothing in the company's constitution invalidates such authorisation, by the matter being proposed to and authorised by the directors; or

(b) where the company is a public company and its constitution includes provision enabling the directors to authorise the matter, by the matter being proposed to and authorised by them in accordance with the constitution.

(6) The authorisation is effective only if:

(a) any requirement as to the quorum at the meeting at which the matter is considered is met without counting the director in question or any other interested director, and

(b) the matter was agreed to without their voting or would have been agreed to if their votes had not been counted.

(7) Any reference in this section to a conflict of interest includes a conflict of interest and duty and a conflict of duties.

176. Duty not to accept benefits from third parties

(1) 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 director.

(2) A "third party" means a person other than the company, an associated body corporate or a person acting on behalf of the company or an associated body corporate.

(3) Benefits received by a director from a person by whom his services (as a director or otherwise) are provided to the company are not regarded as conferred by a third party.

(4) This duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.

(5) Any reference in this section to a conflict of interest includes a conflict of interest and duty and a conflict of duties.

177. Duty to declare interest in proposed transaction or arrangement

(1) If a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, he must declare the nature and extent of that interest to the other directors.

(2) The declaration may (but need not) be made:

(a) at a meeting of the directors, or

(b) by notice to the directors in accordance with:
(i) section 184 (notice in writing), or
(ii) section 185 (general notice).

(3) If a declaration of interest under this section proves to be, or becomes, inaccurate or incomplete, a further declaration must be made.

(4) Any declaration required by this section must be made before the company enters into the transaction or arrangement.

(5) This section does not require a declaration of an interest of which the director is not aware or

where the director is not aware of the transaction or arrangement in question.

For this purpose a director is treated as being aware of matters of which he ought reasonably to be aware.

(6) A director need not declare an interest:

(a) if it cannot reasonably be regarded as likely to give rise to a conflict of interest

(b) if, or to the extent that, the other directors are already aware of it (and for this purpose the other directors are treated as aware of anything of which they ought reasonably to be aware); or

(c) if, or to the extent that, it concerns terms of his service contract that have been or are to be considered:

(i) by a meeting of the directors, or

(ii) by a committee of the directors appointed for the purpose under the company's constitution.

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