

DIRECTORS' DUTIES **AFTER THE** **COMPANIES ACT 2006**

Summary:

Directors' duties

The common law has imposed on all directors fiduciary duties and a duty of care and skill many of which are now codified by the Companies Act 2006 (2006 Act). Other statutes and regulations create additional offences and many of them impose strict liability.

Fiduciary duties

The *fiduciary duty* of the directors towards the company was traditionally a duty to act honestly and in good faith in the best interests of the company, and to use the powers granted to them for the purposes for which they were conferred. The duty included a duty to take proper care of the assets of the company; not to make a personal profit (unless permitted in the articles or approved or ratified by the company); to avoid conflicts with the

company and not to compete with the company.

Chapter 2 of Part 10 of the 2006 Act codifies certain of these duties. In summary, the seven general duties of directors under the 2006 Act are:

- To act within powers.
- To promote the success of the company.
- To exercise independent judgment.
- To exercise reasonable care, skill and diligence;
- To avoid conflicts of interest.
- Not to accept benefits from third parties.
- To declare an interest in a proposed transaction or arrangement.

The first four general duties came into force on 1 October 2007; the last three will come into force on 1 October 2008. On the relevant date, the statutory duty replaced, or will replace, the corresponding common law duty.

Other statutory obligations

Other statutory obligations of directors are contained in the Companies Acts and

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in other legislation. They include administrative duties (mainly found in the Companies Acts) such as the duty to keep the statutory books up to date and the duty to file annual returns. The liability for breach of these duties usually attaches to the company and to all defaulting officers of the company. Other legislation that imposes criminal and civil liability on directors includes the Insolvency Act 1986 (for example where a director continues to trade when he knew or ought to have known that there was no reasonable prospect of the company avoiding insolvent liquidation or if he knowingly continues to carry on business with the intention of defrauding creditors in the knowledge that there was no reasonable prospect of the creditors being paid by the company); health and safety regulations and environmental legislation (if it is shown that the director contributed to a breach through consent, connivance or neglect); the Company Directors Disqualification Act 1986 (if a director acts while disqualified); as well as competition and securities law.

Standard of skill and care

The older case law required a finding of more than mere negligence before a

director would be made liable to his or her company - "gross" or "culpable" negligence was required. Moreover, the standard of skill was a subjective one. More recently, courts held that the common law standard mirrored the tests laid down in section 214 of the Insolvency Act 1986, which includes an objective assessment of a director's conduct. That standard has now been codified in section 174 of the 2006 Act. Under section 174, a director must exercise the care, skill and diligence that would be exercised by a reasonably diligent person with both:

- 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 (the "objective" test).
- The general knowledge, skill and experience that the director actually has (the "subjective" test).

So, at a minimum, a director must display the knowledge, skill and experience set out in the objective test, but where a director has specialist knowledge, the higher subjective standard must be met. In applying the test regard must be had to the functions of the particular director, including his

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specific responsibilities and the circumstances of the company.

Directors who doubt their own ability to take on a particular role should make sure that in accepting the office they are not accepting responsibilities which they will be unable to discharge; delegation is by no means always a safe harbour.

Company Directors Disqualification Act 1986

The Company Directors Disqualification Act 1986 is also designed to raise standards. Any misconduct of a director may be relevant to the court in determining unfitness and periods of disqualification, not merely those criteria set out in the Act. Cases refer to a variety of forms of misconduct including breach of standards of commercial morality; gross incompetence or negligence; danger to the public; gross irresponsibility; and want of commercial probity. Case law has confirmed that a director may still be found unfit even though no breach of a formal legal duty has been established.

Directors' liability and commercial risk

The courts have not held that directors are guarantors of a company's success. The statutory obligation is that directors act in the way they consider - not what a court

may consider - would be most likely to promote the success of the company for the benefit of its members as a whole. Courts and policy makers alike have acknowledged that directors are in control of an entrepreneurial venture and that a degree of commercial risk-taking is a necessary part of earning a sufficient return on the capital. Further, it has long been accepted that directors are not liable for mere errors of judgment nor will a director be disqualified from holding office on the grounds of "ordinary commercial misjudgment". This understanding is not expected to change following the implementation of the 2006 Act.

While a court may relieve directors from liability if they acted honestly and reasonably it will only do so if, in its opinion, they ought fairly to be excused. Prudent directors, whether or not believed to be covered by indemnities or insurance, will take every reasonable step to prevent liability arising.

The holding of regular board and other management meetings and reviews, accompanied by clear minutes, have proved in practice to be the best evidence of the steps the directors took, and why.

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Liability to third parties

The fiduciary and general duties of directors are owed to the company, so shareholders or third parties will normally only have a cause of action against the company, not against individual directors. However, directors may also incur liabilities to shareholders and third parties where they act in a way which creates a personal obligation. This is not lightly implied, but could be assumed, for example, by an express representation by a director accepting a personal obligation to the shareholder or third party.

Indemnity for third party liability

Under section 232 of the 2006 Act, a company may not generally exempt a director from, or indemnify him against, liability in connection with any negligence, default, breach of duty or breach of trust by him in relation to the company. This means that a company cannot exempt a director from liability for breach of one or more of his duties to the company or limit his liability for such a breach.

This prohibition is subject to a relaxation which allows companies to provide a

qualifying third party indemnity provision (QTPIP), that is the company may:

- Indemnify its directors (and directors of an associated company) in respect of proceedings brought by third parties (covering both legal costs and the amount of any adverse judgment) except for the legal costs of unsuccessful defence of criminal proceedings, fines imposed in criminal proceedings and penalties imposed by regulatory bodies such as the FSA (*section 234, 2006 Act*). Companies may therefore indemnify directors against such third party actions as class actions or actions following mergers and acquisitions or share issues; and
- Pay directors' defence costs as they are incurred in respect of civil proceedings brought by the company itself or an associated company, or costs incurred in an application for relief under section 1157 of the 2006 Act (*above*), provided that the directors repay the costs if they are unsuccessful.

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D&O insurance

The DTI published guidance on this point and factors which companies should consider in deciding whether to indemnify directors, include:

- Whether it would be promote the success of the company for the benefit of its members as a whole for the company to agree to pay a director's defence costs as they are incurred even if the action were brought by the company itself.
- How the company might recover the costs if judgment was given against the director.
- How the company could verify the defence costs claimed when it was acting on the other side of the litigation.
- Whether to amend the articles of association to provide for the indemnification of the directors and other officers in ways which are permitted under the new provisions or to restrict the ability of the company to indemnify those officers.
- The extent of any QTPIP
- The effect of the rules on indemnification by an associated company.

Section 232(2) of the 2006 Act does not prevent a company purchasing and maintaining insurance for its directors, and those of an associated company, against any liability attaching to them in connection with any negligence, default, breach of duty or breach of trust by them in relation to the company.

Because directors face personal liability in certain circumstances despite the limited liability status of the company, a director should ensure that the company has taken out adequate directors' and officers' liability insurance (D&O insurance) to cover his potential exposure. Insurance cover is normally purchased by the company but may on occasion be purchased by individual directors.

Combined Code and Higgs review: non-executive directors

The Higgs review of "The role and effectiveness of non-executive directors in the UK" published a report in January 2003 (Higgs review). The Higgs review proposed significant revisions to the Combined Code on corporate governance (Code) and set out recommendations together with a

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suggested revised Code and a number of summaries and guidance notes for best practice. This note covers both the 2003 and 2006 versions of the Code.

Role of the board

The Higgs review noted that in the UK, the general legal duties owed to the company by executive and non-executive directors are the same. All directors are required to act in the best interests of the company. Each has a role in ensuring the probity of the business and contributing to the sustainable wealth creation by the company as a whole (*paragraph 4.4, Chapter 4, Higgs review*).

Role of the non-executive director

The 1998 version of the Code offered no guidance on the role of the non-executive director. The Higgs review noted that executive and non-executive directors have the same general legal duties to the company. However, as non-executive directors do not report to the chief executive and are not involved in the day-to-day running of the business, they can bring fresh perspective and contribute more objectively in supporting, as well as constructively challenging and monitoring, the management team. Higgs concluded that the role of the non-executive director

is therefore both to support executives in their leadership of the business and to monitor and supervise their conduct and proposed that a description of the role of the non-executive director be incorporated into the Code (*paragraphs 6.4 – 6.7, Chapter 6, Higgs review*). The Code includes the following description of the role of the non-executive director:

As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning” (*Supporting Principle to Main Principle A.1*).

Duties and liability of the non-executive director

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The Higgs review noted that the general duties of directors are owed to their company and that although the law does not apply different duties to executive and non-executive directors, it has been recognised that the knowledge, skill and experience expected will vary between directors with different roles and responsibilities (for example between the finance director or the sales director and a non-executive director) (*paragraph 14.5-14.6, Chapter 14, Higgs review*).

Guidance for non-executive directors proposed in the Higgs review has been included in the Code (*see Schedule B: Guidance on liability of non-executive directors: care, skill and diligence*) (Schedule B Guidance). The Schedule B Guidance makes clear that although non-executive directors and executive directors have as board members the same legal duties and objectives, their involvement is likely to be different. In particular, the time devoted to the company's affairs is likely to be significantly less for a non-executive director than for an executive director and the detailed knowledge and experience of a company's affairs that could reasonably be expected of a non-executive director will generally be less than for an executive director.

The Schedule B Guidance refers to elements of the Code that may be particularly relevant:

To enable directors fulfil their duties:

- The letter of appointment should set out their expected time commitment (*Code Provision A.4.4*).
- The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. The chairman is responsible for ensuring that the directors receive accurate, timely and clear information (*Code Principles A.5*).

Non-executive directors should themselves:

- Undertake appropriate induction and regularly update and refresh their skills, knowledge and familiarity with the company (*Code Principle A.5 and Provision A.5.1*).
- Seek appropriate clarification or amplification of information and, where necessary, take and follow appropriate professional advice (*Code Principle A.5 and Provision A.5.2*).

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- Where they have concerns about the running of the company or a proposed action, ensure that these are addressed by the board and, to the extent that they are not resolved, ensure that they are recorded in the board minutes (*Code Provision A.1.4*).
- Give a statement to the board if they have such unresolved concerns on resignation (*Code Provision A.1.4*).

D&O insurance. The Higgs review put forward the view that insurance is a basic protection for non-executive directors against suits by third parties. It recommended the inclusion in the Code of a reference to the need to provide appropriate D&O insurance. This is now included in the Code:

The company should arrange appropriate insurance cover in respect of legal action against its directors (*Code Provision A.1.5*).

Higgs recommended that companies should also supply details of their insurance cover to potential non-executive directors before they are appointed.

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