

Legal Update

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Commercial Services

Companies Act 2006 - Directors' Duties

One of the most controversial aspects of the Companies Act 2006 ("the New Act") has been the codification of directors' duties. The main cause for concern in codifying these was that by setting down a list of duties in the New Act, it would increase bureaucracy, make the decision process more burdensome and potentially increase the directors' liability.

As the law currently stands, the duties directors owe to a company have largely evolved through case law, the main duties being as follows:

- duty to exercise skill and care;
- duty to act in good faith in the best interests of the company;
- duty to act within the powers conferred by the company's constitution and to exercise powers for proper purposes;
- duty not to fetter discretion;
- duty to avoid conflicting interests and conflicting duties;
- duty not to make a secret profit.

The New Act however includes a statutory statement of directors' duties that replaces many of the existing common law rules. The duties are owed solely to the company so only the company itself will be able to enforce them, although there are circumstances where shareholders can bring a derivative action (the New Act sets out a new statutory basis for such an action which may mean that they become more common) on behalf of the company with respect to a breach of duty that has not been authorised or ratified.

The relevant provisions are set out in sections 170 to 177 of the New Act. These provisions set out seven general duties as follows:

- 1 Duty to act within powers
- 2 Duty to promote the success of the company
- 3 Duty to exercise independent judgement
- 4 Duty to exercise reasonable care, skill and diligence
- 5 Duty to avoid conflicts of interest
- 6 Duty not to accept benefits from third parties
- 7 Duty to declare interest in proposed transaction or arrangement

1 Duty to act within powers

A director must act in accordance with the company's constitution (includes not only the articles but also, in certain circumstances, decisions of the members) and only exercise his powers for proper purposes.

2 Duty to promote the success of the company

A director must act in the way he himself considers, in good faith, would be most likely to promote the success of the company for the

benefit of its members as a whole. In doing so he must consider the following non-exhaustive list of factors (referred to below as “the section 172 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; and
- the need to act fairly as between members of the company.

This intends to codify the so called principle of “enlightened shareholder value”. This, along with the explicit references to the company’s employees, the community and the environment have generated the most press attention.

This duty is subject to any enactment or rule of law requiring directors in certain circumstances to consider or act in the interests of the creditors of the company (e.g. where the company is threatened by insolvency).

3 Duty to exercise independent judgement

Directors must exercise their powers independently, without subordinating their powers to the will of others, whether by delegation or otherwise (unless authorised by or under the company’s constitution to do so).

4 Duty to exercise reasonable care, skill and diligence

A director must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both the knowledge, skill and experience which may be

reasonably expected of a director in his position and any additional knowledge, skill and experience he has.

This test is therefore a blend of the subjective and the objective which reflects the approach taken by the courts in recent years.

5 Duty to avoid conflicts of interest

The main change here is the way in which a director can be authorised to act notwithstanding a conflict of interest. Under the current law a conflict can be approved by the members or in accordance with any procedure set out in the articles (in the case of private companies, articles commonly provide that a director can act notwithstanding a conflict, provided that he discloses the nature and scope of his interest to the other directors).

The new position is such that a conflict may be authorised either by the members or by the directors (in the latter case in a private company the directors may authorise unless the articles invalidate such authorisation, but in a public company the articles must specifically allow such a conflict to be authorised by the directors).

6 Duty not to accept benefits from third parties

A director cannot accept any benefit from a third party which is conferred by virtue of being a director or by virtue of doing or not doing anything as a director, unless there is no real possibility of a conflict of interest. The members can authorise a breach of this duty but the directors cannot.

7 Duty to declare interest in proposed transaction or arrangement

A director may be interested in whether or not he is a party to the transaction or arrangement and the interest may be direct or indirect. The declaration of interest need only be made to the other directors.

The New Act expressly states that these general duties are based on, and have effect in place of, the common law rules and equitable principles. However, the New Act also states that the general duties are interpreted and applied in the same way as and with regard to the corresponding common law rules and equitable principles. It is not simply the case that we can rely on the text of the new provisions, these must be read in the context of case law.

Finally, the statutory statement of directors duties is not exhaustive. For example some common law duties remain and there are other specific duties incorporated within the New Act - e.g. the duty to deliver accounts. It is also worth noting that there are no changes to the duties owed by directors to creditors and in particular to the wrongful and fraudulent trading provisions as set out in the Insolvency Act 1986.

A change of form but not of substance?

Although there are differences between the current and new position the intention of the New Act, by and large, is to codify the current position rather than introduce sweeping changes.

When the Company Law Review was first initiated there was a great deal of discussion around the question of whether a company's directors should owe any duties to its stakeholders and/or the wider community, or whether their duty should continue to merely act in the best interests of the company.

The concept of 'enlightened shareholder value' as discussed above, is the middle ground approach. In other words although directors are bound to consider various stakeholder issues, the overriding duty is still to promote the success of the company itself. This duty is still subjective and it is still owed solely to the company and not to the relevant stakeholders directly.

In practice

In practical terms the main difference is likely to be an increased need to record directors' decisions. Although the government has been keen to stress that there is no requirement for any additional paperwork or process as a result of changes in the New Act, the reality is that directors will be concerned to leave a paper trail to demonstrate that they have complied with their duties. This is particularly so as the government has not provided any view on the weight to be given to the various section 172 factors which the directors are to consider when promoting the success of the company. The key point will be proportionality and identifying the key decisions which could be subsequently challenged by a failure to consider these 'stakeholder' factors.

GC 100 (the Body of General Counsel of FTSE100 Companies) has recently published guidance as to their view of best practice for compliance by public companies with the new law. In summary, their recommendations are as follows:

- Companies should ensure that all directors are aware of their duties under the New Act.
- Where significant proposals are to be put to the board for decision they would expect such proposal (even under the current law) to be supported by a briefing paper prepared by management. This briefing paper should now include a consideration of any of the relevant section 172 factors. It is important that it is recognised that the purpose of the briefing paper is to assist the directors in reaching a decision through exercising their own judgement i.e. it does not constitute the decision itself or a record of the directors' views.

- Board minutes should clearly state the decision reached but they should not be used as the main medium for recording the extent to which each of the section 172 factors were discussed.
- Where decisions are to be taken by directors in circumstances other than at a formal board meeting it should be for the company to decide (in the circumstances), the best approach to be adopted. It is important that best practice recognises in the case of decisions where the preparation of a formal paper, or even a formal minute of the decision, is not appropriate that any lack of formal process should not lead to an inference that the section 172 factors have not been properly considered.

Commencement

As with the majority of the provisions in the New Act, those relating to directors' duties have not yet come into force although transitional arrangements are currently being worked on.

The Government has set out its plans for implementation of the New Act with the majority of provisions on directors' duties coming into force on 1 October 2007. The sections relating to directors' conflict of interest duties will not come into force until 1 October 2008.

Implementation of the New Act is set to be completed by 1 October 2008, with various sections coming into force in stages, on 1 October 2007, 6 April 2008 and 1 October 2008. **TLT** will be providing a detailed note on the implementation timetable for the New Act, although should you require more detailed information before then, please contact Chris Liddall.



If you would like more information in respect of directors' duties or any other provisions of the New Act, please contact Chris Liddall on 0117 917 7820 or cliddall@TLTsolicitors.com