



The Companies Act 2006 received Royal Assent on 8 November 2006, and is being introduced in a series of stages. The legislation will replace all existing Company Law, except for the provisions relating to company investigations and community interest companies (CICs).

## New directors' duties Are you ready?

The new Act applies to companies of any size and type, and has seen the introduction of some significant changes to the legislation. Many of the changes are beneficial and the government appears to have achieved its aim of simplifying the law for private companies.

For the first time, the Companies Act sets out legislation relating to duties and responsibilities of company directors.

The inclusion of the duties was supposed to be a confirmation of established case law. However, the new Act includes important reforms which affect all directors in every company.

This briefing provides a summary of the requirements introduced by the Act together with the consequences of non compliance. The final section provides some practical action points for all directors.

### Directors' duties

The Act sets out the statement of general duties of Directors. This statement of duties codifies the existing 'common law' rules and equitable principles relating to the obligations of company directors. The existing common law had focused on the interests of shareholders. The new law extends this by highlighting the connection between what constitutes the good of the company and a consideration of its wider corporate social responsibilities.

In simple terms, the company comes first. Directors must act in the interests of the company and not in the interests of any other parties (including shareholders). Even sole director/shareholder companies must consider the implications by not putting their own interests above that of the company.

The aim of the codification of duties is to make the law more consistent and accessible. It should be noted that other existing duties will continue to apply alongside the new statutory duties.

The Act outlines seven new statutory director's duties, four of which took effect on 1 October 2007. The remaining three provisions will come into force on 1 October 2008.\*

### New duties from 1 October 2007

#### Duty to act within their powers

This states that a company director must act only in accordance with the company's constitution, and must only exercise powers for the purposes for which they were conferred.

#### Duty to promote the success of the company

This duty replaces the previous duty of directors to act 'in good faith and in the best interests of the company'.

The new principle states that a company director must act in such a way that he or she feels would be most likely to promote the success of the company (ie. its long-term increase in value), for the benefit of its members as a whole. However, the director must also consider a number of other factors, including:

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

#### Duty to exercise independent judgment

A director has an obligation to exercise independent judgment. This duty is not infringed by acting in accordance with an agreement entered into by the company which restricts the future exercise of discretion by its directors, or by acting in a way which is authorised by the company's constitution.

## Duty to exercise reasonable care, skill and diligence

This duty codifies the common law rule of duty of care and skill, and imposes both 'subjective' and 'objective' standards. A director must exercise reasonable care, skill and diligence using their own general knowledge, skill and experience (subjective), together with the care, skill and diligence which may reasonably be expected of a person who is carrying out the functions of a director (objective). So a director with significant experience must exercise the appropriate level of diligence in executing their duties, in line with their higher level of expertise.

## New duties from 1 October 2008\*

### Duty to avoid conflicts of interest

This dictates that a director must avoid a situation in which he or she has, or may have, a direct or indirect interest which conflicts, or could conflict, with the interests of the company.

This duty applies in particular to a transaction entered into between a director and a third party, in relation to the exploitation of any property, information or opportunity. It does not apply to a conflict of interest which arises in relation to a transaction or arrangement with the company itself.

This clarifies the previous conflict of interest provisions, and makes it easier for directors to enter into transactions with third parties by allowing directors not subject to any conflict on the board to authorise them, as long as certain requirements are met.

### Duty not to accept benefits from third parties

Building on the established principle that a director must not make a secret profit as a result of being a director, this duty states that a company director must not accept any benefit from a third party (whether monetary or otherwise) which has been conferred because of the fact that he or she is a director, or as a consequence of taking, or not taking, a particular action as a director.

This duty applies unless the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.

### Duty to declare interest in a proposed transaction or arrangement

Again there is an existing requirement for directors to disclose an interest in a proposed transaction. The new duty extends this further and requires that any company director who has either a direct or an indirect interest in a proposed transaction or arrangement with the company must declare the 'nature and extent' of that interest to the other directors, before the company enters into the transaction or arrangement.

The requirement to make a disclosure also applies where directors ought 'reasonably to be aware of' any such conflicting interest.

However, the requirement does not apply where the interest cannot reasonably be regarded as likely to give rise to a conflict of interest, or where other directors are already aware (or 'ought reasonably to be aware') of the interest.

Failure to comply with this duty is a criminal offence.

## Enforcement and Penalties

Although the common law duties have been extended and incorporated into Company Law, the Act states that they will be enforced in the same way as the common law. As a result there are no penalties in the Companies Act 2006 for failing to undertake the above duties correctly.

Enforcement is via an action against the director for breach of duty. Currently such an action can only be brought by:

- The company itself (ie the Board or the members in general meeting) deciding to commence proceedings; or
- A liquidator when the company is in liquidation.

Where the company is controlled by the directors these actions are unlikely.

However the Act has also introduced new legislation whereby an individual shareholder can take action against a director for breach of duty. This is known as a derivative action and can be taken for any act of omission (involving negligence), default or breach of duty or trust.

Following concerns that there could be a significant increase in shareholder actions, as a result of the modifications to the law, a series of provisions has been built into the regulations in order to safeguard against abuses of the new procedure. The most important of these is that the shareholder must apply to the court for permission to take such an action and until this is granted the company can continue to act on its decisions. The law states that a court cannot give such permission if a person acting in the best interests of the company would not pursue such an action.

It is considered that this will prevent vexatious and malicious actions by disgruntled or activist shareholders and avoid unnecessary injunctions.

## Action directors should consider

Clearly, while the intention of the new Act is to clarify and simplify the legislation, and is likely to have a number of benefits, particularly in the longer term, other areas of the rules remain potentially contentious and could lead to uncertainty.

For example, it may be difficult for directors to be certain whether particular benefits may be regarded as likely to give rise to a conflict of

interest. Similarly, it may not always be easy for directors to reconcile the various – potentially conflicting – factors which must be taken into account when reaching any major decisions, particularly in relation to the duty to promote the success of the company.

It is nevertheless essential for a director to show that they are aware of and have taken into account the relevant factors, and have exercised due care and diligence in giving them all fair consideration.

In order to comply with the legislation, all directors must take into account the company's constitution and any other relevant factors, such as shareholder decisions, in order that they can show that they are acting in the company's best interests when making a decision. In theory, such considerations should already form part of a responsible company's decision making processes.

Directors must also ensure that they are diligent and well informed regarding the company's affairs, and take care to avoid any situations where potential conflicts of interests could arise.

Adopting the following suggestions may help to protect directors from the risks of derivative claims and other legal action:

- Ensure that all existing company directors (and other appropriate staff) understand the new law by providing information and training as necessary
- Make sure that all new directors are similarly briefed regarding their duties
- Review the existing company constitution and decision making processes and policies, to bring them in line with the new requirements
- Consider a review of all directors' contracts and terms of reference in order that they encompass the new duties
- If not already in place consider taking out Directors and Officers insurance. Ensure existing policies are up to date, and take into account the new regulations should any legal action be raised
- Continually review the risk that Board decisions could be questioned in the future. Where significant decisions are taken consider the need to:
  - take detailed minutes indicating that all necessary factors were considered when making the decision
  - obtain expert external advice where required regarding impact on environment
  - take legal advice if there are significant doubts regarding the directors' duties in relation to a particular matter.

This information is intended for guidance purposes only, and you should always seek professional advice before taking any action. Please contact us for further information relating specifically to your business.

\* On 7 November 2007 the government announced that a final commencement timetable for the Act will be issued in December 2007 and that many 1 October 2008 provisions will be put back to 1 October 2009.