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ARTICLE

Directors' Duties under the Companies Act 2006

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Introduction

One of the most significant and controversial areas of the Companies Act 2006 (the '2006 Act') is the introduction of a codified statutory statement of duties for directors, replacing the previous mixture of common law and equitable rules. The majority of these duties came into force in October 2007, with the provisions in relation to directors' conflicts of interest coming into force in October 2008.

There has been a significant volume of discussion on the new codified duties, and the extent to which the position has changed with the implementation of the 2006 Act. This has led to confusion on the part of directors as to the extent to which they need to arrange their procedures and considerations when making decisions on behalf of the Company. There has also been concern that the new provisions could lead to greater shareholder action against directors. It should be noted that there are additional statutory duties on directors, such as the preparation of accounts, which are outside the scope of this article.

Position prior to the 2006 Act

Prior to October 2007, a director's duties to the company were set in case law, and comprised of a duty to exercise due skill and care; a duty to act in good faith in the best interests of the company; a duty to act within his powers and to exercise those powers for a proper purpose; a duty not to fetter his discretion; a duty to avoid conflicts of interest; and a duty not to make a secret profit. All of the duties other than the duty of due skill and care (which is a common law duty based in the law of agency) were fiduciary in nature and a breach could be ratified by the shareholders in general meeting provided that this would not amount to a fraud on any minority shareholders.

Statutory duties under the 2006 Act

There are seven codified duties of directors set out in the 2006 Act as follows:

(a) duty to act within the powers conferred by the Company's constitution and only to exercise powers for the purposes for which they are conferred (section 171);

(b) duty to act in a way which is most likely to promote the success of the company (section 172);

(c) duty to exercise independent judgment (section 173);

(d) duty to exercise reasonable skill, care and diligence (section 174);

(e) duty to avoid conflicts of interest (section 175);

(f) duty not to accept benefits from third parties (section 176); and

(g) duty to declare interest in proposed transactions or arrangements (section 177).

It is clear that a number of these duties are similar, if not identical, to the previously existing duties. Indeed, the 2006 Act states at section 170(3) that 'the general duties are based on certain common law rules and equitable principles and have effect in place of those rules and principles as regards the duties owed to a company by a director'. The 2006 Act goes on to state at section 170(4) that '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'. This suggests that the new duties are only partially codified, as the interpretation and application will be subject to the cases from which the pre-existing rules and principles derive. This has led to criticism that the duties are no clearer than they were prior to the 2006 Act coming into force, and that the addition of codification as an extra layer on top of the common law rules and equitable principles, rather than in replacement of them, has in fact made the situation more complex.

It is clear from section 170(1) that these duties are owed to the company directly, rather than to the shareholders, which echoes the previously existing principle in *Re a Company (No 004415 of 1996) [1997] 1 BCLC 479*. It is not clear whether the interpretation statement described above in section 170(4) will mean that the principle that, in exceptional circumstances, a duty

may be owed directly to the shareholders (*Peskin v Anderson [2001] 1 BCLC 372*) will continue to apply. It has, however, always been the case that even if the duties were not owed directly to a minority shareholder, such a shareholder could be entitled to bring an action against a director on behalf of the company under the rule in *Foss v Harbottle (1843) 2 Hare 461*.

Under the 2006 Act, a new enhanced right is given to shareholders to bring a derivative action on behalf of the company against a director (or another person). It is worth noting that the derivative action does not create a right of action in itself; it simply gives shareholders greater opportunity to bring a cause of action which the company already has. Such a cause of action must be in respect of an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company.

Each of the individual duties is considered in detail below.

Duty to act within the powers conferred by the Company's constitution and only to exercise powers for the purposes for which they are conferred

Although this is set out as a duty of directors, this provision in fact confirms that a court will not question the decisions made by a director, as long as those decisions have been made in accordance with his powers and for a proper, rather than collateral, purpose.

This duty is similar to the previously existing duty of a director to exercise his powers for a proper purpose, and the existing case law (which in accordance with section 170(4) is likely to be considered when interpreting the new statutory provisions) shows that a court will only interfere with the decision of a director if it is:

(a) not made honestly and in good faith (although it should be noted that dishonesty or bad faith is not a requirement for liability for breach of this duty);

(b) causing the company to act outside its corporate capacity or illegally;

(c) made outside the powers which have been delegated to him (even though it is within the powers of the company); or

(d) in breach of the so-called *Wednesbury* principle (that is, it is so unreasonable that no reasonable person in his position could have come to that decision (*Associated Provincial Picture Houses Ltd v Wednesbury Corporation [1948] 1 KB 223*), expressly applied to the decisions of directors in *Byng v London Life Association [1989] 1 All ER 561)*.

If a board is concerned that it could be considered that they acted for an improper purpose, it should ensure that full minutes showing their reasons and the factors which they took into account, including the arguments against the proposed course of action, are taken. This should ideally occur even in the case of one-man boards, particularly where the director is seeking a personal advantage (*Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald [1995] 1 BCLC 352*).

Duty to act in a way which is most likely to promote the success of the Company

This new duty is the most controversial part of the statutory statement of duties and has provoked significant discussion. It is intended to embody the previously existing common law duty that a director must act in the best interests of the company; however, the change in wording suggests that something different might be expected. In addition, the new duty sets out a non-exclusive list of factors to which the board is required to have regard as follows:

(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.

This has arisen out of the concept of 'enlightened shareholder value' proposed in the Company Law Review out of which the 2006 Act arose, under which directors must act in the way which will maximise the 'success' of the company. This list of factors makes it clear that 'success' is not something that can be easily defined. When this provision was discussed at the Lords Grand Committee, 'success' was referred to as what the members collectively hope to achieve. For a commercial company, it was acknowledged that this will normally mean a long-term increase in value, although it is essentially for the members to define their objectives. It does however clearly include some notions of corporate social responsibility which have not previously been enshrined in company law. The intention is to recognise that directors will be more likely to achieve long term sustainable success for the benefit of their shareholders if their companies pay attention to a wide range of factors, including the interests of employees and the environment.

The inclusion of a list of factors to be considered may lead to a temptation towards 'box ticking', and including in board minutes a confirmation that each of these factors has been considered in relation to every decision. However, the Commons Report on this provision

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makes it clear that the wording 'have regard to' does require this, but instead means 'give proper consideration to'. In addition, the GC100 has issued guidance stating that 'directors are not currently, and should not be, as a result of this legislative codification, forced to evidence their thought processes whether that is with regard to the stated factors or any other matter influencing their thinking'. This guidance also states that ' where the nature of the decision being taken by directors is such that it is supported by a formal process, that process need only specifically record consideration of those duties where the particular circumstances make it particularly necessary or relevant. The default position should be not to include these references.'

Although this new duty has caused significant discussion, it might be considered that the duties of directors have not in fact been substantially changed by this addition. Prior to the new provisions coming into force, directors had to act 'in the best interests of the company', which many directors will not consider to be significantly different to 'promoting the success of the company'. It has always been the case that there have been a number of often conflicting factors for directors to consider when deciding what is the optimal course of action for the company, and it is likely that in many cases well advised boards have been taking the factors listed in section 172 into account for some time. It should also be noted that in an insolvency situation, the interests of creditors supercede those of members, as was the position prior to the 2006 Act coming into force.

Duty to exercise independent judgment

Section 173 of the 2006 Act incorporates into statute the previously existing principle of law which states that directors must exercise independent judgment. This duty obliges directors to ensure that they positively exercise their powers independently. This means that in exercising his judgment on a matter, a director must make sure that outside opinions on the issue or instructions from any other person do not influence his decision in any way. This is to ensure that the director's final judgment remains his own, founded upon his personal understanding of the advantages and disadvantages of the matter. As Lord Goldsmith commented at the Lords Grand Committee in February 2006, 'the duty does not prevent a director from relying on the advice or work of others, but the final judgment must be his responsibility'.

This duty also prevents directors from subordinating their powers to the will of others and endeavours to prevent directors from restricting the future exercise of their discretion. This means that directors are prohibited from giving away or limiting their power to make decisions on behalf of the company which have been conferred upon them in their position as director. The duty of a director to exercise independent judgment does not, however, affect his power to delegate matters, provided that he always complies with any agreement duly entered into by the company, or in accordance with the company's constitution.

It is clear that the purpose of incorporating section 173 into the 2006 Act is to guarantee that directors remain responsible for the decisions made on behalf of a company, thereby ensuring that they always act in the best interests of the company. The duty highlights to directors that it is their responsibility in their position as fiduciary to remain in control of the decisions which are to be made for the company at all times and that they should not limit this power in any way.

Duty to exercise reasonable care, skill and diligence

Section 174 states that it is a director's duty to exercise reasonable care, skill and diligence in his role as a director. Under the previously existing duty of care, a subjective test had been applied, which only required directors to exercise the degree of skill which would reasonably be expected from a person with their knowledge and experience. Any analysis of breach simply involved an examination of the individual director's own expertise.

However, the new statutory duty extends this by applying both an objective and subjective test. A director must now exercise the care, skill and diligence that would be expected from a reasonably diligent person with both the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions of a director in relation to the company, and the general knowledge, skill and experience that the director concerned actually has. As a result, directors must now conform to the higher of a general objective standard, and a subjective standard based on their own actual knowledge, skill and experience.

Therefore, the standard of care, skill and diligence directors exercise in carrying out their work will have to reach a level generally recognised to be that expected of a competent director. If the individual director is more experienced in his field, then the subjective test will effectively increase the standard required of that particular director. Consequently, in a situation where a director possesses numerous qualifications, he will be expected to act in accordance with this higher standard.

Duty to avoid conflicts of interest

This section of the 2006 Act does not come into force until 1 October 2008, a year later than the other provisions on directors' duties. It has always been the case that directors have had a duty not to place themselves in a position where they are actually or potentially in

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conflict with the duties owed to their company. However, section 175 of the 2006 Act codifies this position, and changes the action required to allow a conflict situation to persist.

If a director is in a situation or position which actually causes or could potentially lead to a conflict of interest with the company, he is required to obtain approval from the other non-interested directors (here referred to as the 'independent board'). Where the company is a public company, a specific provision in its articles is required to permit the independent board to grant such approvals. There is no definition of a conflict of interest in the 2006 Act; however it is likely to be construed broadly by the courts, given that a conflict of interest may be direct or indirect, and that the duty is to avoid situations which create or could give rise to conflicts of interest. It is not necessary for a director to have any influence over a particular situation for that situation to require authorisation. This applies in particular to the exploitation of property, information or opportunity (whether or not the company could take advantage of the property, information or opportunity).

Where a situation cannot reasonably be regarded as likely to give rise to a conflict of interest, no authorisation is required. This provision is likely to apply to situations where the issue is *de minimis*, such as a very small shareholding in a competitor company. Given the difficulty of deciding when a situation falls into this category, directors should be advised to exercise caution and put all such situations forward for authorisation.

In some cases the interest of someone who is connected with a director will be treated as the indirect interest of the director and potentially lead to a conflict of interest. Whether such an interest creates a situation requiring authorisation will be a question of fact in each case. Under the 2006 Act, the definition of 'connected persons' has been broadened and includes family members (including spouses, civil partners, partners in an 'enduring family relationship', children, step children and parents), corporate entities with which a director is connected, trusts (and their trustees) of which the director or a family member is a beneficiary, and business partners.

The GC100 have produced guidance on the conflict procedures, which includes a list of situations which are likely to require authorisation. These include amongst other things acting as board representative of a major shareholder of the company; any advisory relationship (or interest in an advisory firm which has such a relationship) with the company or any of the company's competitors; and being in a position to take up an opportunity which has been offered to and declined by the Company.

Once the independent board has been notified of a conflict or potential conflict situation, it must decide whether or not authorisation should be granted. Each situation must be considered separately on its own particular facts. The independent board must take into account their general duties as directors when considering whether or not to approve a conflict or potential conflict situation. Where the independent board is asked to approve a potential conflicting position that brings clear benefits to the Company (for example access to industry or sector expertise) it will not usually be difficult for the independent board to decide that they are acting in the manner most likely to promote the success of the Company by authorising the conflict. Where the situation is less clear, the independent board needs to consider whether, on balance, it is most likely to promote the success of the Company to approve the conflict (which could have an effect on whether the director concerned can be retained or appointed). The independent board should also consider whether the matter they are approving would affect the relevant director's ability to act in accordance with his wider duties.

The independent board must consider how far the authorisation should go in relation to each matter it is asked to approve. For example, where a director seeks a sanction for his role as a non-executive director of another company, the independent board may decide to approve his continuing in the role, but may not want to sanction all of the consequences that flow from the role (such as in circumstances where the other company bids for the company or becomes a competitor of the company). Therefore, in sanctioning a matter the independent board needs to consider what consequences could flow from that matter and the stage at which the authorisation should no longer apply.

Duty not to accept benefits from third parties

Section 176 of the 2006 Act incorporates into statute the long established rule preventing directors from exploiting their positions for personal gain or receiving what were often referred to as 'secret profits'. This duty prohibits a director from accepting any benefit from a third party which is granted to him as a result of his being a director or his doing (or not doing) anything in his capacity as a director. However, this duty is only applicable if, by accepting the benefit, this is likely to create a conflict of interest. There is therefore a certain degree of overlap between this duty and that contained in section 175 which sets out the directors duty to avoid a conflict of interests.

Commentators have raised a number of concerns over the significance of the incorporation of this section, as it is uncertain whether directors now need prior approval from shareholders before accepting benefits such as corporate hospitality. Some directors may wish to protect themselves and ensure shareholder approval is granted before any corporate benefits are received, as a failure to do so where an acceptance of the benefit is held to be a breach of their duties could ultimately lead to their finding themselves liable for any loss the

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company suffers as a result of that breach. What is clear is that if a director does wish to accept a benefit from a third party, then this must be authorised by the shareholders rather than the board of directors.

This duty is qualified to a certain extent, in that there is no breach of the duty if the benefit granted by the third party cannot reasonably be considered likely to give rise to a conflict of interests. This may make many directors comfortable with maintaining their existing position on corporate hospitality and benefits. The duty also excludes from the scope of this section those who are not classified as 'third parties', including the company, its subsidiaries or its holding company. This will cover benefits granted to a director in his service contract.

Duty to declare interest in proposed transactions or arrangements

Section 177 of the 2006 Act states that it is a director's duty to declare the nature and extent of any interest he may, directly or indirectly, have in a transaction or arrangement with the company. If a director does have an interest in a proposed transaction then they are required to make a declaration of that interest prior to the arrangement being entered into. In order to validly declare such an interest, the director has the option of making the declaration to the company at a board meeting, by way of notice in writing under section 184 or by a general notice under section 185. This is similar to the previously existing position under the Companies Act 1985.

This duty imposes a continuing obligation on directors to ensure that they make further declarations of their interest, if necessary, in the event that it becomes clear that any previous declaration regarding a proposed transaction has become inaccurate or incomplete. It must be noted, however, that a further declaration is only required if the company has not yet entered into the transaction at the time the director becomes aware of this inaccuracy.

This duty initially appears to impose a large burden upon directors as they need not be a party to the transaction for the duty to disclose to apply. An interest of a third party in a contract with the company may create the need for the director to declare a direct or indirect interest he may have developed. However, there is no need for a declaration of a directors interest to be made in a proposed transaction if directors are not aware of any such interest. There is also no requirement for directors to make a declaration of an interest if it cannot reasonably be regarded as likely to give rise to a conflict of interest, or if the other directors of the company are already aware of that interest. There is no requirement to disclose an interest in relation to a directors service contract which has or will be considered at a meeting of the directors.

Conclusion

Although the introduction of a codified statement of duties has caused possibly more controversy and discussion than any other provision of the 2006 Act, it might be considered that the actual duties directors have to the company have, in essence, changed little, particularly given the statutory applicability of existing common law rules and equitable principles. The main change in practice is likely to be the new process for approving conflicts of interest. However, it will be interesting to see how the new derivative actions are utilised by shareholders (and the extent to which this is permitted by the courts) to enforce the duties of directors.

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