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The Law and Directors' Responsibilities

The Companies Act 2006, for the first time, 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 guide 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

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 Act outlines seven statutory directors' duties:

Duty to act within their powers
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'.

A company director must now 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. Directors must exercise reasonable care, skill and diligence using their own general

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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 directors with significant experience must exercise the appropriate level of diligence in executing their duties, in line with their higher level of expertise.

There are three duties revolving around conflicts of interest:

Duty to avoid conflicts of interest

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 which arises 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

This duty extends the existing requirement for directors to disclose an interest in a proposed transaction. 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.

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

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omission (involving negligence), default or breach of duty or trust.

There are provisions in the regulations to safeguard against vexatious and malicious actions by disgruntled or activist shareholders and to avoid unnecessary injunctions.

Guidance for company directors

The following summary has been published by the Government:

1) **Act in the company's best interests, taking everything you think relevant into account.**

2) **Obey the company's constitution and decisions taken under it.**

3) **Be honest, and remember that the company's property belongs to it and not to you or to its shareholders.**

4) **Be diligent, careful and well informed about the company's affairs. If you have any special skills or experience, use them.**

5) **Make sure the company keeps records of your decisions.**

6) **Remember that you remain responsible for the work you give to others.**

7) **Avoid situations where your interests conflict with those of the company. When in doubt disclose potential conflicts quickly.**

8) **Seek external advice where necessary, particularly if the company is in financial difficulty.**

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