

Directors' General Duties Handbook

Protecting your interests



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- ▶ Advice on shareholders' agreements

The Companies Act 2006 (the 2006 Act) clarified the rules governing the duties which directors owe to their companies. Though similar to the duties owed by directors before the 2006 Act, there are some significant changes. The duties set out in the 2006 Act are referred to as the General Duties of directors. The 2006 Act also introduced a statutory right for shareholders to sue directors in the name of the company.

The following guidance sets out the position under the 2005 Act and also aims to provide practical solutions to any issues which directors may face in the future.

Types of Director

There are several types of company director and it is not always clear cut as to who the directors of a company actually are. It is, therefore, worth setting out the different types at an early stage.

Executive Director: carries out executive functions and will usually be and employee of the company.

Non-executive Director: does not hold an executive office nor is an employee of the company. These directors will often just devote part of their time to the business of the company in some form of independent advisory role.

De Jure Director: a validly appointed director.

De Facto Director: acts as a director and is treated as such by the board of directors but has not been validly appointed.

Shadow Director: any person on whose instructions the board of directors (or majority of the board) are accustomed to act. For example, a majority shareholder who the board always obeys without exercising its own judgement will likely be a shadow director.

In short, anyone who manages the business of a company registered at Companies House, whether that is a trading company or merely a social club, is open to being called a director and with that label will come the responsibilities of being a director.

[Consider reviewing service contracts so that job descriptions accurately reflect the roles undertaken by directors. Service contracts should specifically refer to directors' duties.](#)

Who are directors' duties owed to and by?

Who are the General Duties owed to?

The General Duties are owed to the company and so only the company itself will be able to enforce them. In certain circumstances, however, the shareholders may be able to bring a derivative action on behalf of the company.

Who are General Duties owed by?

The General Duties apply to all company directors, which include anyone occupying the position of director by whatever title they may go.

The position in respect of shadow directors is slightly different in that the General Duties only apply to shadow directors to the extent that corresponding common law rules or equitable principles apply.

The General Duties

The 2006 Act sets out seven General Duties which directors owe to their companies. They are to:

1. Act within powers
2. Promote the success of the company
3. Exercise independent judgement
4. Exercise reasonable care, skill and diligence
5. Avoid conflicts of interest
6. Not accept benefits from third parties
7. Declare interests in proposed transactions or arrangements

It is entirely possible that more than one of these General Duties will apply to any particular set of circumstances which a director faces. The application of each General Duty must, therefore, be made in the context of each other General Duty which also applies. Further, there are many other laws (for example, health & safety) which a director must obey.

Compliance with the General Duties does not permit a director to breach any other law which is applicable to him. It is worth pointing out that a company may, through its articles of association, set more onerous requirements on its directors. The constitution cannot, however, dilute the General Duties and in particular the company cannot exempt a director from breach of duty.

Consider taking steps to ensure that all directors are fully aware of their duties as a director. The provision of training for new board members may be advisable.

1. Duty to act within powers

Directors must act in accordance with the company's constitution and must only exercise their powers for their proper purpose. A company's constitution is widely defined and will include:

- ▶ The company's articles of association
- ▶ Resolutions and agreements affecting the company's constitution such as special resolutions
- ▶ Any resolution or other decision pursuant to the company's constitution
- ▶ Any decision by the shareholders of the company (or class of shareholders) if they can be regarded as a decision of the company

Consider taking steps to ensure directors are familiar with the company's constitution.

2. Duty to promote the success of the company

This General Duty replaces the fiduciary duty to act in good faith in the interests of the company and also replaces the previous statutory duty to consider the interest of employees.

A director must: "Act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its [shareholders] as a whole."

And must have regard (amongst other matters) to:

- ▶ 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
- ▶ The need to act fairly as between shareholders of the company

This General Duty applies to all decisions which directors make and not just those made at a formal board meeting. In making a decision under this General duty, the directors must also exercise reasonable care, skill and diligence (see below) and so it may be necessary for the directors to take expert advice (remembering always that they must exercise independent judgement in whether to follow such advice).

There is no guidance in the 2006 Act as to which of the above factors carry the greatest importance. It is, therefore, for each director to exercise in good faith his judgement to resolve any conflict.

The General Duty is subject to any law which requires a director to consider the interests of the company's creditors. So, when a company is insolvent or faces insolvency, this duty will take on a different form.

There is, of course, room for discussion over what constitutes success for any given company. During the 2006 Act's passing through Parliament, the Government stated that success for commercial companies will usually mean a 'long-term increase in value'. The Courts have historically refrained from involving themselves in the commerciality of directors' decisions – a position that the government echoed in suggesting that what promotes success for any given company will be a matter for the good faith judgement of its directors.

Consider how the board records its decisions. In the event that litigation arises over a directors' decision, it will certainly benefit the directors if they can show that due regard was given to the prescribed list of factors. So, a board of directors should:

- ▶ Minute that the list of factors (and any other relevant factors) were taken into account in making the decision
- ▶ Minute any specific discussions had in respect of any particularly relevant factor
- ▶ In the case of significant or controversial decisions, have briefing papers prepared by the management in respect of each of the factors

3. Duty to exercise independent judgement

Directors must exercise the powers conferred on them by the company independently, without subordinating whose powers to the will of others.

The General Duty does not give directors a right to delegate their powers but on the other hand it does not restrict the power to delegate either. Any such delegation of directors' powers can only be made if authorised by the company's constitution. Of course, in delegating their powers, directors must exercise independent judgement and show reasonable care, skill and diligence.

The duty will not be infringed by directors doing something in accordance with an agreement which the company has entered into and which restricts directors' ability to exercise discretion, or in a way authorised by the articles of association.

Directors can (and at times should) take independent expert advice as long as the directors exercise their own judgement in whether to follow such advice. Such advice should be minuted to show that directors take such matters seriously.

[Consider taking independent professional advice where appropriate. An example would be if the company is in financial difficulty, at which point the advice of an insolvency practitioner would be particularly advisable.](#)

4. Duty to exercise reasonable care, skill and diligence

Directors must exercise the reasonable care, skill and judgement which a reasonably diligent person would exercise. The test has two elements:

- ▶ **Objective test** – the general knowledge, skill and experience which may reasonably be expected of a person carrying out the functions of the director
- ▶ **Subjective test** – the general knowledge, skill and experience that the director in question actually possesses.

The Objective Test sets out the minimum standard which all directors must meet. The Subjective test will, in certain circumstances, increase the minimum standard by requiring that a particular director with specific knowledge and skills in performing his duties.

In applying this test it is important to factor in the specific role which a director has in the company. For example, a finance director who was once a chartered accountant is under a higher duty with regards to the company's finances than, say, a marketing director who has no accountancy background.

[Consider taking steps to ensure that directors fully understand their roles in the company and whether training is needed on the standards which they each must meet to fulfil those roles.](#)

5. Duty to avoid conflicts of interest

For situations arising on or after 1 October 2008, the 2006 Act has replaced the no-conflict rule under the old law.

Directors must avoid situations in which they have, or could have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. This General Duty applies, in particular, to the exploitation of property, information or opportunity and whether or not the company may be able to exploit such things itself.

This General Duty does not apply to a conflict of interest arising from a 'transaction or arrangement with the company' as those circumstances are dealt with under the General Duty to disclose interests as set out below.

The General Duty to avoid conflicts on interests will not be infringed if:

- ▶ The situation cannot reasonably be regarded as likely to give rise to a conflict of interest
- ▶ If the matter has been authorised by the directors

For a private company formed before 1 October 2008, the board can only authorise a conflict if there is nothing in the company's constitution prohibiting them from doing so and if the shareholders have passed an ordinary resolution (i.e. with a majority of more than 50%) permitting such authorisations.

The General Duty to avoid conflicts of interest continues to apply following an individual ceasing to be a director in respect of the exploitation of any property, information or opportunity which he became aware of when he was a director.

It is likely that those directors sitting on more than one board will face the greatest difficulty in complying with this General Duty. Government ministers did suggest that board authorisation of another directorship would 'frank' any conflict which later arose. However, it is entirely possible that such a general disclosure will not be wide enough to cover a particular conflict; in particular, a director may not be able to disclose full particulars due to confidentiality owed to the other company.

It should be noted that compliance with this General Duty is in addition to the requirement that approval of the shareholders is required for long term directors' service contracts or transactions where a substantial non-cash company asset is transferred to a director.

[Consider whether any conflicts of interest exist. If so, these should \(if possible\) be authorised by the board. If the company was incorporated before 1 October 2008, review the company's articles of association to see if there are any restrictions on the board authorisation and seek an ordinary resolution of the shareholders allowing board authorisation.](#)

6. Duty not to accept benefits from third parties

Directors must not accept any benefit from a third party which is considered by reason of their being a director, or their doing (or not doing) anything as a director.

The General Duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. Further, benefits from the company, companies within the same group, or a person providing the services of the director to the company, are explicitly excluded.

The General Duty not to accept benefits from third parties is distinct from the General Duty to avoid conflicts of interests. The board is not permitted to authorise the acceptance of a benefit from a third party and so shareholder approval must be sought. For example, a company could allow directors to accept benefits up to a certain threshold so that they do not fall foul of the General Duty in accepting, say, reasonable corporate hospitality.

Directors should also be aware of their obligations under the Bribery Act 2010.

Consider whether the company's articles of association need amending to allow for directors to receive benefits below a certain threshold. Take advice on obligations under the Bribery Act 2010 where necessary.

7. Duty to declare interests in proposed transactions or arrangements

Directors must declare to their fellow directors the nature and extent of any direct or indirect interest in a transaction or arrangement with the company before the transaction or arrangement is entered into. There is no duty on directors to avoid being in such a conflict of interest.

The director in question does not need to be a party to the transaction or arrangement in question; for example, a transaction or arrangement with a company of which he is a director or shareholder, or with a family member, should also be disclosed.

Directors are under an ongoing duty to ensure that before the transaction or arrangement is entered into, their declarations under this General Duty are accurate and complete. No declaration is required when:

- ▶ The director is not aware of the interest (although a director is deemed to know of interest which he ought to know of)
- ▶ The director is not aware of the transaction or arrangement
- ▶ The interest cannot reasonably be regarded as likely to give rise to a conflict
- ▶ The other directors are already aware of the interest
- ▶ The interest is in respect of the terms of the director's service contract which have been (or are to be) considered by the board
- ▶ The company has only one director

There is no requirement that a declaration be made at a formal board meeting although it would be advisable that such a declaration is minuted. Alternatively, a director may give written notice of his interest to all of his fellow directors

Further, a director may make a general declaration that he has an interest in a body corporation or firm, or that he is connected with a specified person. Such a general declaration must be made at a board meeting or at least be raised at a board meeting after it is given.

There is also a duty to disclose interests in existing transactions or arrangements with the company. This is a distinct duty from this General Duty and carries criminal sanctions.

Consider whether any general conflicts of interest exist. If so, they should be declared to the board. Conflicts should be considered each time the board of directors meets and accurate records of those interests should be maintained.

Protecting directors from liability

Ratification: a company may ratify conduct by a director which amounts to negligence, default, breach of duty or

breach of trust in relation to the company. An ordinary resolution of the shareholders is required and this must be passed without having regard to the votes which the director in question may hold, or the votes of any shareholder connected with him (e.g. family members, companies of which the director in question is also a director, trustees of a trust of which the director (or a family member or body corporate of which he is connected) is a beneficiary, or a director's business partner).

Unanimous consent (whether formally or informally) of all the shareholders of the company will always be sufficient to authorise the act of the director (as long as it is an act capable of authorisation). Of course, some acts (such as criminal conduct) are never capable of ratification.

Relief by the Court: the Court has the power to relieve a director from liability for negligence, default, breach of duty or breach of trust in relation to the company if it considers that:

- ▶ The director acted honestly
- ▶ Taking into account all the circumstances, he ought fairly to be excused

Directors can apply to Court to pre-empt liability for a claim which they expect to be brought against them.

Indemnity and Insurance: a company cannot exempt a director from liability for negligence, default, breach of duty or breach of trust in relation to the company. The company may, however, indemnify directors against defence costs, or costs of an application to Court for relief, provided the directors repay the costs if they lose.

A company is allowed to purchase insurance for its directors (commonly called Directors' and Officers' Insurance) against liability which they may face for negligence, default, breach of duty or breach of trust in relation to the company which they are directors of. Companies should ensure that their insurance policies cover not only any damages which may be awarded but also the costs of the litigation itself.

Consider whether the board has previously made decisions which may be open to criticism and whether these should be ratified by the shareholders. Review current Directors' and Officers' Insurance policies. If you do not have Directors' and Officers' insurance in place consider whether it is necessary.

Derivative actions

The general rule is that directors' duties are only enforceable by the company itself, however, the 2006 Act introduces a new statutory right for shareholders to sue directors in the name of the company to recover losses resulting from a director's negligence, default, breach of duty or breach of trust. This statutory right is known as a derivative action.

Shareholders can now bring actions in a wider range of circumstances than was previously allowed and can even recover (again on behalf of the company) from third parties implicated in any breach.

Shareholders must first apply to Court for permission to make a claim, at which stage the Court must determine whether there is, on the face of it, a case to answer. If not, the Court must dismiss the action at this stage. This is done without the input of the directors in question.

If the claim survives the first stage, the Court then has to consider whether the claim should be allowed to proceed based on the evidence of all parties. The Court will take into account several factors at this stage, including the views of shareholders with no personal interest. It goes without saying, therefore, that if the board has such shareholders on its side, it will stand a better chance of defeating the claim at this stage.

Only if a claim has survived the first two stages will it proceed to a full trial of the facts.

The new procedure does, therefore, offer some protection to directors and should discourage speculative claims being brought against them.

Directors' liability to third parties

The general position is that directors are not liable to anyone other than the company or (as seen above) its shareholders. However, there are duties imposed specifically by statute where a director can be held responsible for third party liability. For example, directors may be personally liable for debts of the company where they allow the company to trade when they knew (or ought to have known) that there was no reasonable prospect of the company avoiding insolvent liquidation.

Consider taking professional advice on directors' obligations under specific laws. Remember, ignorance of the law is no defence.

The General Duties: Quick Guide

Before the Companies Act 2006, the rules on directors' duties were governed by case law which has evolved over many years.

These rules were added to by the Companies Act 1985 but have also been bolstered in specific areas (for example health & safety) by specific pieces of legislation.

The 2006 Act sets out seven General Duties of directors in a new statutory regime. They are to:

1. Act in accordance with the company's constitution and to exercise those powers for the purposes for which they were conferred
2. Act (in good faith) in a way most likely to promote the success of the company for the benefit of the shareholders. There are several individual factors which directors are now duty bound to consider

3. Exercise independent judgement. Directors are still able to take professional advice but must exercise independent judgement when acting upon such advice
4. Exercise reasonable care, skill and diligence
5. Avoid conflicts of interest
6. Not accept benefits from third parties
7. Declare to fellow directors any interest in a proposed transaction or arrangement with that company

Remember to...

Review service contracts so that descriptions accurately reflect the role undertaken by directors. Service contracts should specifically refer to director's duties.

Take steps to ensure that all directors are fully aware of their duties. The provision of training for new board members may be advisable. Also ensure directors are familiar with the company's constitution.

Minute board meetings to demonstrate the factors taken into account when making decisions.

Take independent professional advice where appropriate.

Take steps to ensure that directors fully understand their roles in the company and whether training is needed on the standards which they each must meet to fulfil those roles.

Get conflicts of interest authorised by the board (or shareholders if necessary). Conflicts should be considered each time the board of directors meets and accurate records of directors' interests should be maintained.

Review the company's articles of association as these may need amending in light of the 2006 Act.

Take advice on obligations under the Bribery Act 2010 where necessary.

Consider whether the board has previously made decisions which may be open to criticism and whether these should be ratified by the shareholders.

Review current Directors' and Officers' Insurance policies. If you do not have Directors' and Officers' insurance in place consider whether it is necessary.

Take professional advice on directors' obligations under specific laws if you are unsure. Remember ignorance of the law is no defence.

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