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THE NEW SEVEN DUTIES OF DIRECTORS- a guide for directors

INTRODUCTION

The Companies Act 2006 ("the Act") has introduced a statutory statement of duties, which came into force in full on 1st October 2008, that replace many existing common law and equitable rules.

Failure of a director to comply with the statutory duties can have significant consequences – the relevant transaction may be voidable, shareholders could pursue directors through the courts or an action could be taken against a director for misfeasance (acting in breach of a fiduciary duty). Therefore, it is important that a director is familiar with these duties and understands what is expected of him or her when acting in this role.

GUIDANCE ON THE SEVEN DUTIES

A director now has seven general duties set out in the new statutory statement:

1. "Keep to the brief" - A duty to act within powers

A director must act in accordance with the company's constitution and must only exercise his powers for their proper purpose

2. "Think beyond what's best for the directors" - A duty to promote the success of the company for the benefit of the members as a whole

A director must act in a way that he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a whole. This is called 'enlightened shareholder value'. The list of factors the director should have regard to include, but are not limited to, the following:

- 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.

The meaning of the expression 'success for the benefit of the company's members as a whole' is not very clear. However, the Government has stated that the expression will usually mean 'long term increase in value' for commercial companies and that whether any particular reason will lead to a long term increase in value is one for the directors' good faith judgement. Thus ensuring business decisions, in good faith, are for directors and not subject to decision by the courts.

There is no guidance in the Act as to the weight to be given to each factor and how conflicts between factors should be resolved. Again, it will be up to the directors to exercise their good faith judgement to resolve any conflicts that may arise between the different factors.

3. "Be independent" - A duty to exercise independent judgment

Directors must exercise their powers without being influenced by others and must not restrict the exercise of their discretion. This duty is not infringed by a director acting in accordance with an agreement entered into by the company that restricts the future exercise of the directors' discretion or in a way authorised by the company's constitution. It does not confer on a director a power to delegate or prevent a director from exercising a power to delegate conferred by the company's constitution, provided it is exercised in accordance with the powers set out in the company's memorandum and articles of association.

4. "Do your job well" - A duty to exercise reasonable skill, care and diligence

The test has two elements:

- an objective element in that a director must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both the general knowledge, skill and experience that may be reasonably expected of a person carrying out the functions carried out by the director in relation to the company; and
- a subjective element, being the general knowledge, skill and experience that the director actually has.

Regard must be had to the functions of the particular director, including his specific responsibilities and the circumstances of the company (e.g. if a director is an accountant the subjective element will be higher than if he or she had no financial qualifications if the relevant matter relates to financial or accounting issues).

5. "Accept no bribes or inducements" - A duty not to accept benefits from third parties

A director must not accept any benefit from a third party which is conferred because of his being a director or his doing (or not doing) anything as a director. This duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.

6. “Avoid conflicts of interest” - A duty to avoid conflicts of interest

A director must avoid situations in which he (or she) has or can have a direct or indirect interest that conflicts with or may conflict with the company’s interests. This applies in particular to the exploitation of property, information or commercial opportunity. This duty does not apply to a conflict of interest arising out of a proposed transaction or arrangement with the company.

7. “Be open about where directors have interests” - A duty to declare to the company’s other directors any interest a director has in proposed transactions or arrangements with the company

A director must declare to the other directors the nature and extent of any interest direct or indirect in a proposed transaction or arrangement with the company. Note that the director need not be a party to the transaction for this to apply.

The codification of directors’ duties in the Act is not exhaustive and they do not cover all the duties that a director may owe to a company. For example, the duty to consider or act in the interests of the creditors and the duty of confidentiality owed by a director to the company. Companies may also provide more onerous duties in their articles of association but the articles may not dilute the statutory duties except to the extent expressly allowed by the Act.

What happens when directors fail to perform these duties?

Any breach of these duties means that a company can cancel the relevant transaction, although it will be possible to ratify any breach by an ordinary resolution of shareholders.

Shareholder Litigation threat means more directors may be pursued through the courts.

The codified duties outlined above are owed to the company and only the company will be able to enforce them. However, the Act introduces a new statutory right for shareholders to sue directors, in the company’s name, to recover on its behalf loss it has suffered as a result of the director’s negligence, default, breach of duty or breach of trust. This is called a ‘derivative action’ and is likely to make it easier for shareholders to take directors to court.

A process has been put in place to reduce the risk that the new provisions under the Act will lead to a significant increase in time consuming and expensive litigation in relation to claims against a director which are ultimately unsuccessful.

In order to bring a claim the shareholder will have to apply to the court for permission to make the claim and, if this is successful, the court will decide, based on the evidence of both sides, whether the

claim should be allowed to proceed. At this stage a range of factors will be taken into account, including the views of independent shareholders with no personal interest in the matter. Only if the claimant is successful will the claim progress to a full trial of the issues.

What directors should do now?

In light of these changes to the Act directors should:

- ∑ ensure that they understand the scope and nature of their role;
- ∑ ensure that the structure and terms of board committees give the appropriate consideration to the statutory duties, particularly concerning 'enlightened shareholder value' and ensure the procedure for minuting meetings and recording other corporate decisions is adequate;
- ∑ consider whether it is necessary to take professional advice in relation to the duties to be considered, particularly in relation to balancing the environmental and community impact factor;
- ∑ in order to limit the scope for derivative actions, when considering any particularly difficult or controversial board decisions consider whether those shareholders not personally interested in the decision could or would ratify the decision; and
- ∑ review company indemnification and insurance arrangements and consider if these need to be revised in light of the potentially increased risk of shareholder litigation.

If you have any queries in relation to this briefing note please contact either John North on 020 7842 1490 or at jdn@royds.com or Louise Engel on 020 7842 1493 or at lxe@royds.com.

The information contained in this note is intended as a general review of director duties and does not constitute legal advice. Detailed specialist advice should always be taken before taking or refraining from taking any action.

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