

DIRECTORS' DUTIES AND RESPONSIBILITIES



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GENERAL DUTIES OF DIRECTORS UNDER THE COMPANIES ACT 2006 (THE "2006 ACT") AND FIDUCIARY DUTIES

The fiduciary duties which directors owe to their respective companies have evolved over many years by a combination of case law and statute.

WHAT IS A DIRECTOR?

There is no true definition of a director. Section 250 of the 2006 Act provides that "director" includes any person occupying the position of director, irrespective of title.

Directors be seen as agents of the company; having the roles and duties prescribed by Common Law, the Articles of Association of the company and statute. Directors can be employees of the company and enter into service contracts governing their employment relationship. Companies themselves may be directors of other companies. In the absence of a precise definition of directors, useful similarities can be seen in the offices of agency, trusteeship or that of managing partner.

THE DIRECTOR AS AGENT

The analogy with agency is an appropriate one since directors may contract on behalf of the company without assuming any personal liability, unless they act outside their powers or expressly assume personal liability. Even if they act outwith their powers, they will still bind the company but may incur personal liability to shareholders. However, the powers of a director are much wider than those of a normal commercial agent.

THE DIRECTOR AS MANAGING PARTNER

Small companies where the directors are often the controlling shareholders are sometimes referred to as "quasi-partnerships", but the analogy is not an exact one. Although one director may bind the company, directors do not incur personal liability nor do they have the capacity to bind each other personally.

THE DIRECTOR AS TRUSTEE

Directors have a similar duty as trustees to hold the property and assets of the company for the purposes of the company. However, their role tends to be less restrictive than that of trustees who are bound by the terms of their trust. As they are managing a trading concern, they will take greater commercial risks than trustees.

The directors have a duty not to misappropriate or misapply any of the company's property or assets. A third party dealing with the company in good faith does not have to concern themselves with the restriction this may imply but the directors may incur personal liability to the shareholders for any breach.



THE DIRECTOR AS EMPLOYEE

The executive directors of the company are employed by the company and have duties which extend beyond the boardroom. However the 2006 Act does not draw any distinction between executive directors and non-executive directors and they share the same level of responsibility for their respective actions.

TYPES OF DIRECTOR:-

(a) Executive Director – generally a director engaged under a service (i.e. employment) contract and/ or having day-to-day involvement in managing the company's business affairs.

(b) Non-executive Director – usually engaged under a consultancy type arrangement. Non-executive directors frequently find themselves appointed to the board of a company to represent a particular interest. While the director may be appointed to the board by a particular shareholder or body of shareholders, he still owes a duty to the company rather than to the individual shareholder which appointed him.

(c) Shadow Directors – (Relevant sections s251, 2006 Act; s251, Insolvency Act 1986). This is a person in accordance with whose directions or instructions the directors are accustomed to act. This would not include professional advisers, but could include significant shareholders who have undue influence over the board, or disqualified directors who continue to direct the company by directing the actions of a validly- appointed director. This implied orle is particularly relevant in insolvency proceedings.

(d) de facto – this is an individual either held out by the company as a director or who claims or purports to act as a director although not validly appointed as such. To establish that someone is a de facto director, it is necessary to demonstrate that he undertook functions in relation to the company which could properly be discharged only by a director. i.e. binding the company to legal contracts.

(e) de jure – a director who is validly appointed to office.

(f) Alternate – someone who takes the place of a director at board meetings.

DIRECTORS' STATUTORY DUTIES

1. Duty to act within powers (section 171, 2006 Act)

A director must act in accordance with the company's constitution and must only exercise his powers for their proper purpose. This prohibition applies even if the director believes, in good faith, that his conduct will promote the success of the company for the benefit of the members as a whole. A company's constitution is widely defined to include:

- the company's Articles (and Memorandum if it has one);
- decisions taken in accordance with the Articles and other decisions taken by the members or a class of them if they can be regarded as decisions of the company; and
- any resolutions and agreements which affect the way a company is administered. Directors should familiarise themselves with the constitution of the company, in particular with any limitations on the powers of the company or the directors.

2. Duty to promote the success of the Company (section 172, 2006 Act)

A director must, in good faith, endeavour to promote the success of the company for the benefit of its members as a whole. In fulfilling this duty, he must have regard to the following factors:

- 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 that the company should maintain a reputation for high standards of business conduct;
- the need to act fairly between members of the company; and
- any other factor which is specific to the situation.

This is the primary all-embracing duty of a director. In determining whether a director has acted in good faith, the Courts will apply a subjective test. In other words, they will consider whether the director thought he had acted in the best interests of the company. The duty is owed primarily to the company and not to the individual shareholders, although the directors have a general duty to act in the interests of the shareholders generally.

3. Duty to exercise independent judgment (section 173, 2006 Act)

A director must always exercise independent judgment on the company's behalf. Generally, any agreement a director makes to fetter his own discretion, e.g. to agree to vote at board meetings in a particular way would breach this duty (even if voting in that way would not otherwise be a breach of the director's duties to the company). Some exceptions are permitted, for example, a subscription and shareholders' agreement may contain an agreement by the founders of a company, in their capacity as shareholders, to exercise their votes as directors or shareholders of the company to ensure that the company observes the matters set out in that agreement.

This duty will not prevent the directors from relying on professional advice, as long as the directors exercise their own independent judgment in deciding whether or not to follow the advice.

4. Duty to exercise reasonable care, skill and diligence (section 174, 2006 Act)

The directors have a general duty to exercise a reasonable standard of skill and care in carrying out their duties, but they are not liable for mere errors of judgement. Under section 174, 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 reasonably be expected of a person carrying out the functions carried out by the director in relation to the company (the "objective" test).
- The general knowledge, skill and experience that the director actually has (the "subjective" test).



A person should be sufficiently qualified or experienced to be able to fulfil the functions that might reasonably be expected of him as a director, and if the person is particularly highly qualified or experienced then he would be expected to exercise a higher degree of skill and expertise. This means that, where a director has professional qualifications, in law or accountancy for example, the standard of skill and expertise expected of him will be far higher than the objective standard. Directors must also exercise their duties diligently; keeping themselves informed about the company's affairs and, with their co-directors, supervising and controlling those affairs. This responsibility cannot be delegated to any party, but this does not prevent the directors from relying on the experience and expertise of their colleagues or, generally, from sensibly delegating or allocating tasks to others, provided that they do not attempt to divest themselves entirely of responsibility.

5. Duty to avoid conflicts of interest (s175, 2006 Act)

A director must avoid any situation which has or could have a direct or indirect interest that conflicts (or may possibly conflict) with the interests of the company.

Directors should avoid placing themselves in positions where there is a conflict (or a possible conflict) between the duties owed to the company and either personal interests, or other duties owed to a third party. Failure to observe this duty may lead to the director having to account to the company for any benefit received from the affected transaction, or for any loss which the company suffers as a result of the transaction. This duty to avoid conflicting interests extends to contracts with the company, use of information or opportunities and competing with the company.

This duty also extends to the exploitation of property, information or opportunity, whether or not the company itself could actually take advantage of the property, information or opportunity in question.

The duty to avoid conflicts of interest is not infringed if the situation cannot reasonably be regarded as likely to give rise to such a conflict, nor is it infringed if the matter has been authorised by the other directors.

In the case of a private company, authorisation may be given by the directors at a board meeting as long as the Articles of Association do not invalidate this. In the case of a public company, where the Articles of Association include provision for director authorisation, these must be followed.

What action is required?

If a director anticipates that an actual or potential conflict might arise, the action can be authorised in advance either by the shareholders or by the directors.

As well as giving authority for authorisation, there may be special provisions in the Articles which can set out:-

- Procedures for disclosure of potential conflicts by directors. For instance how, when and where the procedures will take place;
- Procedures by which the directors authorise a conflict;
- Express permission for the directors to have certain conflicting interests such as other directorships in noncompeting companies; and
- A waiver of the duty to disclose confidential information obtained from outside the company.



How long does authorisation last?

Provided the facts and circumstances surrounding a conflict do not change, the authorisation will last indefinitely. As authorisations need to be specific, new authorisation will be needed if the facts and circumstances change.

All potential conflicts of interest should be considered and a procedure should be put in place to monitor this.

Duty not to accept benefits from third parties (s176)

A director must not receive personal benefits by reason of his being a director or doing anything as 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. Duty to declare interest in a proposed transaction or arrangement (s177)

Declaration of the nature and extent of the interest must be made to the other directors of the company. The declaration must be intimated before the company enters into the proposed transaction or arrangement.

The director need not declare an interest if: (a) it cannot reasonably be regarded as likely to give rise to a conflict of interest; (b) the other directors are already aware of it; or (c) if it concerns terms of his service contract that have been considered by a meeting of the directors.

7. Duty to declare interest in an existing transaction or arrangement (s182)

Where a director of a company is in any way, directly or indirectly, interested in a transaction or arrangement that has been entered into by the company, he must declare the nature and extent of the interest to the other directors. Note that this duty to declare does not apply to the extent that the interest has been already been declared under section 177. In practical terms, this duty is most relevant where a company appoints a new director who has an existing interest in an ongoing transaction.

FIDUCIARY DUTIES

In addition to the above statutory duties, directors have the following fiduciary duties to their companies:

Duty not to make unauthorised profits

There is a broad principle that any profit acquired by a director through holding the office of director must be accounted for to the company. The director may keep the profit if he has made full disclosure and the retention of the profit has been sanctioned by the company in general meeting. The director is liable to account to the company for any profits which he makes in contravention of this general rule.

Duty of Confidentiality

Directors owe a duty of confidentiality to the company. This duty overlaps with the duties to promote the success of the company, to avoid conflicting interests and duties and not to make unauthorised profits.



Directors amass a significant amount of sensitive information relating to a company. For example, a director is entitled to receive notice of, and attend, board meetings and can also inspect and take copies of the records of the company (including minutes of meetings). However, it would be a breach of a director's duty to pass on any such company information to an appointing shareholder, or other interested party by whom the director has been appointed, where there is a conflict between the interests of the company and those of the appointing shareholder. To avoid such difficulties, it is good practice for the board of a company to agree in advance with any shareholder what categories of information can be passed to the shareholder by its nominated director.

OTHER IMPORTANT PROVISIONS OF THE 2006 ACT

The Companies Act 2006 contains some 1300 sections and 16 Schedules. It is the single largest piece of legislation ever enacted. In addition to the specific duties listed above, there are a large number of prohibitions imposed and offences created by the 2006 Act. An exhaustive summary is outwith the scope of this note but a few of the most significant provisions are listed below.

A general knowledge and understanding of these provisions could properly be regarded as part of the overall duties a director has to his company.

Loans to Directors

Loans to directors are prohibited under section 197 of the 2006 Act, although there are de minimis exceptions of £10,000. There are civil remedies for breach of these provisions in the case of a private company and criminal remedies in the case of a public company. In either case, a loan to a director may be treated by the Inland Revenue as a payment to him and taxed accordingly.

Substantial Property Transactions

Any substantial transaction for the purchase or sale of property involving a company and one of its directors requires shareholder approval under section 190 of the 2006 Act. A transaction is "substantial" if it: a) exceeds the higher of 10 per cent of the company's net asset value and £5,000; or b) exceeds £100,000. This provision does not apply to transactions between a company and its wholly-owned subsidiary.

Failure to offer Rights of Pre-emption

Under section 563 of the 2006 Act, where the directors fail to offer existing shareholders their statutory rights of pre-emption on a new issue of shares, they may be personally liable to shareholders who did not receive their entitlement. The right of pre-emption can be disapplied generally or waived with shareholder approval on a case by case basis.

Fraudulent Trading

Fraudulent trading, which means carrying on the business with intent to defraud creditors or for any other fraudulent purpose, is a criminal offence under section 993 of the 2006 Act.

Failure to keep and file Accounts and Annual Returns

In addition to the duty to keep accounting records under section 386 of the 2006 Act, failure to file a company's Annual Accounts or Annual Returns within the prescribed periods are both punishable by a fine under a scale set by the Registrar of Companies in order to discourage offenders (sections 451 – 453 of the 2006 Act).



OTHER IMPORTANT STATUTORY PROVISIONS

While it is essential for every responsible director to have a clear understanding of his duties and responsibilities under the 2006 Act, there is also a steadily increasing body of statutory regulation affecting the duties, responsibilities and the potential liabilities of directors. These duties have been brought into focus by the Insolvency Act, the Company Directors (Disqualification) Act and the high profile litigation which has followed in the wake of some corporate failures. The examples which follow are not exhaustive but serve to illustrate the range and complexity of this area of the law.

The Criminal Justice Act 1993

This Act makes it a criminal offence to deal in the publicly traded securities of a company on the basis of "inside" information. This offence carries a maximum prison sentence of seven years as well as a significant fine.

The Insolvency Act 1986

This Act introduced the concept of "wrongful trading", extended the concept of "fraudulent trading" and created new restrictions on the use of prohibited names to try and avoid the so-called "phoenix" syndrome.

The wrongful trading provisions apply to directors in circumstances where before the company went into liquidation, they "knew or ought reasonably to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation".

If the company continues to trade past that stage, they may be personally liable to contribute to the assets of the company on its winding up. The provisions of this section apply equally to Shadow Directors and Nonexecutive Directors.

The fraudulent trading provisions state that if in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court, on the application of the liquidator, may declare that any persons who are knowingly parties to the carrying on of the business in the manner above mentioned are to be liable to make such contribution (if any) to the company's assets as the Court thinks proper.

The final outcome of the two provisions is the same, but as the standard of proof is lower in the case of the wrongful trading provision a liquidator is more likely to rely on the wrongful trading provision.

The Act provides that any director of an insolvent company who sets up a "phoenix" company with a similar name may be personally liable for its debts, and setting up a "phoenix" company without leave of the liquidator or the Court is a criminal offence. The Act also contains provisions dealing with fraud in anticipation of a winding up, falsification of the company's records, material omissions from statements of affairs, false representations to creditors and power to require officers of the company to appear before the Court for examination. If the company is insolvent (or in danger of becoming so), a director's primary responsibility is to consider the interests of the company's creditors. This is a subjective duty and, provided that the director can demonstrate he has exercised his powers diligently and in good faith, it is unlikely that he would be found to be in breach of the statutory duties which cover this situation.



THE COMPANY DIRECTORS (DISQUALIFICATION) ACT 1986

- The grounds of disqualification are as follows:
- conviction of an indictable offence relating to a company – maximum period fifteen years;
- persistent breaches of companies legislation – maximum period five years;
- fraud in winding up – maximum period fifteen years;
- conviction of a summary offence relating to a company – maximum period of five years.

An application for a Disqualification Order under any of the foregoing headings may be made by the Secretary of State, the liquidator or the receiver or by any past or present member or creditor of the company.

The Court also has discretion to make a Disqualification Order where a director is ordered to make a contribution to the assets of the company on a winding up under the wrongful trading or fraudulent trading provisions. The Secretary of State may also instigate a Disqualification Order following the investigation of a company's affairs under the Companies Act.

There is, however, a much wider ground of disqualification open to a liquidator or receiver and that is disqualification on the grounds that the director is unfit to be a director. The liquidator or receiver of an insolvent company has a duty to report on the conduct of a director of insolvent companies to the Secretary of State and the Court has a duty to impose a Disqualification Order if the director was unfit.

The grounds of unfitness (which will be construed widely by the Courts) are:-

- any misfeasance or breach of fiduciary duty;
- any misapplication or misappropriation of company funds or money;
- entering into a fraudulent preference;
- failure to keep statutory records comprising register of directors, register of secretaries, members and charges;
- failure to keep accounts;
- the extent of the directors' responsibility for the company becoming insolvent or the failure of the company to supply goods and services which have been paid for in whole or in part;
- the extent of the directors' responsibility to call a creditors meeting; and
- the extent of the directors' responsibility in connection with the preparation of a statement of affairs or attending creditors' meetings.



MISCELLANEOUS

The Financial Services and Markets Act 2000 (and The Public Offers of Securities Regulations) 1995 (as amended)

These Regulations contain many provisions which affect the duties and responsibilities of directors, particularly those involved in financial services companies regulated by one of the Self Regulatory Organisations. In particular it is an offence for an unauthorised person to carry on investment business or to issue false and misleading statements or unauthorised investment advertisements.

Documents relating to public offerings of securities must contain a statement to the effect that the directors accept responsibility for the content of the information. It is for this reason that public offer documents are analysed in minute detail prior to publication and that every single statement of fact and opinion is independently verified so that the directors can be satisfied that they have not knowingly made any false or misleading statements.

Where the minimum subscription in a public offer is not taken up, the directors are personally liable to pay back persons who did subscribe.

These are the principal areas of statutory responsibility but there are other statutory provisions imposing personal liabilities on directors in relation to Health & Safety, the Environment, VAT and many other areas.

THE VALUE ADDED TAX ACT 1994

The VAT Act contains criminal sanctions for the fraudulent evasion of VAT.

CODES OF PRACTICE

To supplement the existing legislative framework, voluntary Codes of Practice have appeared in recent years. These do not have the force of the law but it is conceivable that the Courts will in future pay some heed to the standards laid down in these Codes in determining whether or not a director is unfit.



CONCLUSIONS AND RECOMMENDATIONS

- Be fully aware of the nature and extent of your duties and responsibilities as a director.
- Do not accept office until you are fully aware of the position of the company. Take a proper interest in the business and management of the company.
- Ensure that you always have complete, up-to-date and accurate financial information and keep a regular check on any discrepancy between forecast and actual results.
- Ensure that the business pays all its debts as they fall due.
- Ensure that full records are kept of all meetings of the directors recording the reasons for important decisions. If you are not in agreement with a decision of the directors which you feel is wrong, ensure that your dissent is properly recorded in the minutes.
- Ensure that the business maintains all necessary statutory records and files, its accounts and annual returns on time.
- Do not sign any personal guarantees without taking detailed advice as to the consequences.
- Take out insurance cover.
- As a last resort, be prepared to resign. If you feel compelled to resign over an issue which affects your responsibility as a director, ensure that the reason for your resignation is clearly set out in writing.
- If you do resign, ensure that the appropriate intimation is given to the Registrar of Companies.

If in doubt, take appropriate professional advice.

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