KEY FACTS
COMPANY LAW

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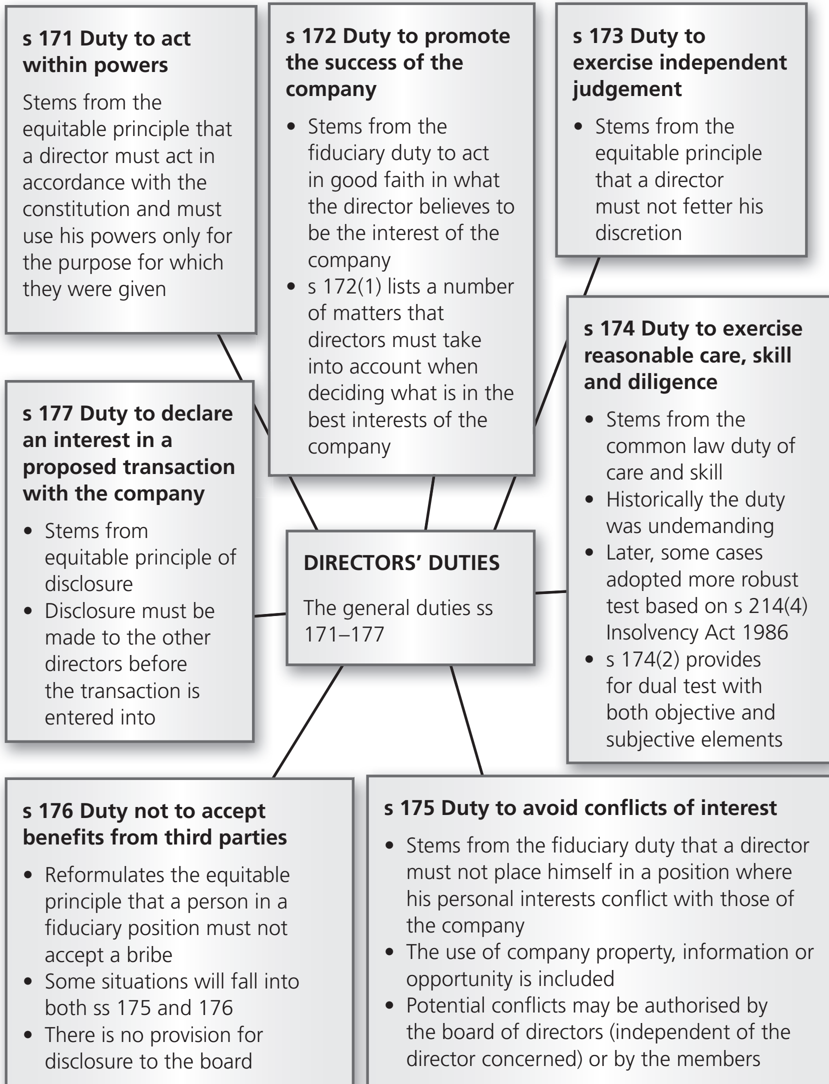
Directors' duties



12.1 Introduction

1. One of the most significant changes made by the Companies Act 2006 (CA 2006) is the codification of the duties owed to a company by its directors. Previously, the law on directors' duties was perceived as a complex web of common law, fiduciary and statutory rules and principles, some of which overlapped and which were sometimes not entirely consistent with one another.
2. The reform of the law was the subject of extensive review and consultation by the Law Commission and the Company Law Review Steering Group.
3. The general duties of directors are set out in Part 10, Chapter 2 CA 2006. In *Modern Company Law for a Competitive Economy: Final Report*, a legislative statement of directors' duties was recommended in order to:
   - achieve clarity and accessibility of the law;
   - correct perceived defects in the law, particularly relating to conflicts of interest;
   - address the question of the 'scope' of directors' duties.
4. The Act sets out seven general duties in ss 171–177. These are based on the equitable principles arising from the fiduciary relationship between a director and his or her company and on the common law of negligence.

s 171	Duty to act within powers
s 172	Duty to promote the success of the company for the benefit of its members as a whole
s 173	Duty to exercise independent judgement
s 174	Duty to exercise reasonable care, skill and diligence
s 175	Duty to avoid conflicts of interest
s 176	Duty not to accept benefits from third parties
S 177	Duty to declare any interest in proposed transactions

5. It is well established that directors owe duties to the company, not to individual shareholders or to shareholders collectively (*Percival v Wright* (1902); *Peskin v Anderson* (2000)). The Act now provides, under

s 170(1), that 'The general duties specified in sections 171 to 177 are owed by a director of a company to the company'. It follows that these duties can be enforced by the company only but note the new statutory derivative claim in Part 11 CA 2006: see Chapter 14 below.

6. Because of their position, directors owe a duty of loyalty to their company and it is this duty that underpins the fiduciary duties set out in the Act. These duties are owed by directors and *de facto* directors. A *de facto* director is a person who assumes the role of director and is held out as a director, but has never actually been appointed. It is not clear whether shadow directors owe a duty of loyalty to the company *(Ultraframe (UK) v Fielding* (2005)) and it is likely that the courts will decide each case on its own facts.
7. Section 178 provides that the consequences of breach of the general duties set out in ss 171–177 are the same as would apply if the corresponding common law rule or equitable principle applied.
8. The statutory duties of disclosure previously contained in Part X CA 1985 have been re-enacted in Part 10 Chapter 4 CA 2006.

12.2 The general duties

1. Section 170(4) CA 2006 provides: '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'. Thus the case law developed prior to the CA 2006 continues to be relevant.
2. This is intended to strike a balance between predictability of statute and the ability of the courts to develop principles through the doctrine of judicial precedent.

12.2.1 Duty to act within powers

1. Directors must act in accordance with the company's constitution and must only exercise their powers for purposes for which they are conferred: s 171.
2. The articles of association may limit the powers of directors. If a company has restricted objects its directors must not act outside those objects.

3. If powers are given to directors for a particular purpose they must not be used for some other purpose and directors must not use their powers to further their own personal interests (*Lee Panavision Ltd v Lee Lighting Ltd* (1992)).
4. A misuse of power will be a breach of duty even if the directors are acting in what they believe to be the best interests of the company.
5. A number of cases involve the allotment of shares. It is a breach of duty to allot shares to avoid a takeover (*Hogg v Cramphorn Ltd* (1967)) or to alter the weight of shareholder votes to influence the outcome of a takeover bid (*Howard Smith Ltd v Ampol Petroleum Ltd* (1974)).
6. It will sometimes be arguable that the act in question was carried out to achieve more than one purpose, only one of which may be a misuse of power. For example, in *Howard Smith Ltd v Ampol Petroleum Ltd* shares were allotted not only to alter the balance of voting power to avoid a takeover, but also to raise capital (a valid reason for the allotment of shares). In this kind of situation the courts will decide whether the improper purpose was the main or dominant purpose. In this case it was held that it was and the directors were in breach of their duty.
7. Acts in breach of the proper purpose rule can be ratified by shareholders (*Bamford v Bamford* (1970)).

12.2.2 Duty to promote the success of the company

1. This stems from the equitable principle that directors must act *bona fide* in what they consider to be the best interests of the company as a whole (*Re Smith & Fawcett Ltd* (1942) and see *Item Software (UK) Ltd v Fassihi* (2004)).
2. Section 172(1) provides: 'A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole . . . '.
3. The duty is subjective. The question is whether the directors honestly believed that their act or omission was in the best interest of the company at the time the decision was made. The court will not seek to make its own commercial judgment but will consider all the evidence to determine what the directors believed (see *Regentcrest v Cohen* (2001); *Item Software (UK) Ltd v Fassihi* (2004)).
4. Whether directors should consider wider constituencies (or stakeholders) than the company and its shareholders in managing the

company has long been a question for discussion by commentators. Now s 172(1) lists a number of matters that the directors must consider in making decisions:

(a) the likely consequences of the 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;
(f) the need to act fairly as between members of the company.

5. The section makes it clear that directors must act not only in the interests of the company as a separate entity, but must consider also the benefit of its members as a body. Furthermore, the list above is intended to ensure that the interests of other factors are taken into account as well in the board's decision-making.

6. Section 172(1)(b) replaces s 309 CA 1985, which provided that the directors must have regard to 'the interests of the Company's employees in general as well as the interests of members'.

7. Creditors are not specifically included above. However, s 172(3) provides that the duty imposed by s 172 is subject to any enactment or rule of law to consider the interests of creditors in certain circumstances. In general, directors do not owe duties to the company's creditors, but if a company is insolvent it has been held that directors must have regard to the interest of creditors (*West Mercia Safetywear Ltd v Dodd* (1988); *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd* (2002)).

12.2.3 Duty to exercise independent judgement

1. Section 173 provides that directors have a duty to exercise independent judgement and not to fetter their discretion. This may be considered part of their general duty to act *bona fida* and to promote the success of the company. However, it is well established that directors must not bind themselves to act in a particular way regardless of whether it would be in the best interests of the company. However, it is not a breach of duty for directors to enter into a binding contract which may have the effect of fettering their discretion at a later date, if they believe the agreement to be in the best interests of the company at the time that

the agreement is made (*Fulham Football Club v Cabra Estates plc* (1994); *Dawsons International plc v Coats Patons plc* (1989)).

2. Another situation where the duty to exercise independent judgement might arise is where a director is nominated by an 'outsider' for example by a holding company to sit on the board of a subsidiary. In such cases it has been held that the primary duty of the nominee is to the company of which he is a director, but that he may take account of the interests of the 'outsider' as long as this is not incompatible with his primary duty: *Re Neath Rugby Ltd* (2008).

12.2.4 Duty to exercise reasonable care, skill and diligence

1. Directors owe a duty of competence to the company, but historically the standard of care expected of them has been undemanding (*Re Brazilian Rubber Plantations and Estates Ltd* (1911)). Reasons for this approach included:
   - directors were sometimes appointed more because of their social standing than because they had particular skills or qualifications;
   - the courts did not wish to deter people from becoming company directors by imposing onerous duties of care and skill.
2. This duty was categorised into three propositions by Romer J in *Re City Equitable Fire Insurance Co* (1925):
   (a) A director was expected to show a degree of care and skill as may reasonably be expected from a person of his/her knowledge and experience. Note that the standard of care test was expressed in subjective terms, so a director was only expected to act with the degree of care and skill which he or she happened to possess and was not expected to have any particular qualifications or any experience of the company's area of business.
   (b) A director is not bound to give continuous attention to the affairs of the company (*Re Cardiff Savings Bank* (1892)).
   (c) Subject to normal business practice, directors may leave routine conduct of business affairs in the hands of management.
3. In later cases the courts have adopted a more robust approach (*Dorchester Finance v Stebbing* (1989); *Norman v Theodore Goddard* (1991); *Re d'Jan of London Ltd* (1994); *Re Simmon Box (Diamonds) Ltd* (2000) and *Base Metal Trading Ltd v Shamurin* (2004)).

4. The test that was applied in these more recent cases had an objective element, based on s 214(4) Insolvency Act 1986:
   - the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and
   - the general knowledge, skill and experience that that director has.
5. In *Barings plc (No 5)* (2000) negligence on the part of company directors was considered in the context of an application for disqualification under the Company Directors Disqualification Act 1986. It was held that:
   - directors have an obligation to acquire enough knowledge and understanding of the company's business to enable them to discharge their duties properly;
   - they may, subject to any restriction in the articles, delegate certain functions to others, but this does not absolve them from a duty to exercise proper supervision (see also *Re Queens Moat House plc (No 2)* (2005));
   - the extent of this duty will depend on the facts of the particular case.
6. Development of the law has been influenced by a number of factors including:
   (a) There is an expectation of a more professional approach to company directorship than existed in the first half of the twentieth century, for example directors should pay proper attention to the management of the company and if as part of the role they have a duty to perform a particular action they will be in breach for failing to do so: *Lexi Holdings Ltd plc v Luqman* (2009). However, a director who takes and acts upon appropriate legal advice will not be negligent: *Green v Walkling* (2007).
   (b) It is usual now to appoint appropriately qualified people to designated executive directorships, for example finance director.
   (c) Contracts of service for executive directors may contain clauses relating to care and skill, which may help to define the scope of the director's duty of care and skill.
7. However, it must be recognised that investing in a company carries some risk, managers may not be of the highest calibre and not every error of judgement will amount to negligence: *Re Elgindata Ltd* (1991).
8. Section 174 codifies the law by providing that a company director must exercise reasonable care, skill and diligence.

- Under s 174(2) the dual test, as set out in s 214 IA 1986, with both objective and subjective elements must be applied in deciding whether a director is in breach of this duty.
- The standard of care, skill and diligence is defined as that which would be exercised by a reasonably diligent person with:
  (a) '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, and
  (b) the general knowledge, skill and experience that the director has'.

12.2.5 Duty to avoid conflicts of interest

1. Directors owe a duty of loyalty to their company: see *Item Software (UK) Ltd v Fassihi* (2004) where Arden LJ emphasised the 'fundamental nature of the duty of loyalty'.
2. Section 175(1) CA 2006 provides: 'A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company'. The duty does not apply to a conflict arising from a transaction or arrangement with the company itself (s 175(3)).
3. The section is a statutory statement of the well established equitable principle stated in *Aberdeen Railway Company v Blaikie Bros* (1854): 'it is a rule of universal application that no one, having such (fiduciary) duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect'.
4. Section 175(2) brings the exploitation of any property, information or opportunity within the section and makes it clear that it is immaterial whether or not the company could take advantage of the property, information or opportunity.
5. A number of cases deal with exploitation by a director of a corporate opportunity. A corporate opportunity is regarded as a corporate asset, which directors may not use for their own benefit. This applies even if it would be impossible for the company itself to make use of the opportunity (*Industrial Development Consultants Ltd v Cooley* (1972)).
6. Furthermore, a director may still be in breach of fiduciary duties in circumstances where he or she resigns to take up the opportunity: *CMS Dolphin Ltd v Simonet* (2001); *Bhullar v Bhullar* (2003); *Foster Bryant*

Surveying Ltd v Bryant (2007). In *Bhullar* Jonathan Parker LJ said that the no-profit and no-conflict rules are universal and inflexible, and s 170(2)(a) now provides that a person who ceases to be a director continues to be subject 'to the duty in s 175 (duty to avoid conflicts of interest) as regards the exploitation of any property, information or opportunity of which he became aware at the time when he was a director'.

7. However, much will depend on the nature of the corporate opportunity and the timing of taking it up, for example in *Island Export Finance Ltd v Umunna* (1986), the court found in favour of the director. There are difficult judgements to be made between the duty not to exploit an opportunity on the one hand and the right of a director to take up opportunities after he or she has left the company on the other, and each case will be decided on its own facts.
8. There are a number of other instances that would fall within s 175, for example a director must not compete with his or her company (*Hivac v Park Royal* (1946)). Problems may also arise when a person holds directorships in competing companies: *Plus Group Ltd v Pyke* (2002) and see now also s 175(7).
9. It has long been recognised that a director may enter into a transaction in which he or she has a conflict of interest if he or she has the informed consent of shareholders in general meeting. In practice, articles of association often allow for disclosure to the board of directors instead. Under CA 2006, authorisation by the directors is now the default position in the case of a private company and in the case of a public company is sufficient if the constitution so provides (s 175(4) and (5)).
10. Authority of the board is effective only if the decision of the board is made independently of the director or directors in question (s 175(6)). Furthermore, the function of receiving disclosures cannot be delegated to a committee of the board (*Guinness plc v Saunders* (1990)).
11. The consequences of breach of the duty to avoid conflict of interest are:
    - a contract entered into in breach of the duty is voidable at the option of the company, subject to the rights of *bona fide* third parties, undue delays in rescinding the contract and affirmation of the contract by the company;
    - the director must account for any gains.

12.2.6 Duty not to accept benefits from third parties

1. Section 176(1) provides that a director of a company must not accept a benefit from a third party conferred by reason of his being a director or his doing (or not doing) anything as director.
2. The general duty set out in s 176 is an aspect of the no conflict principle. The section reformulates the principle of equity that a person in a fiduciary position must not accept a bribe. A benefit may take any form, financial or non-financial. However, s 176(4) provides that the duty is not infringed if acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.
3. There is some overlap between ss 175 and 176, and some situations will fall within both. An important difference between the two sections is that s 176 does not provide for disclosure to and authorisation by the board of directors and it seems that the acceptance of benefits can only be authorised by the members.

12.2.7 Duty to declare an interest in a proposed transaction with the company

1. Under s 177 a director must declare to the other directors the nature and extent of any interest he may have in a proposed transaction or arrangement with the company, whether his interest is direct or indirect.
2. The section covers proposed transactions and disclosure must be made before the transaction is entered into by the company (s 177(4)). Declarations of interest in existing transactions or arrangements are covered by the provisions in ss 182–187.
3. The disclosure under s 177 may be made by written notice, general notice or statement at a meeting of directors (s 177(2)).

12.3 Other statutory provisions regarding directors' interests

Companies Act 2006 Part 10 Chapter 4	Transactions with directors requiring approval of members
s 188	Directors' service contracts where the guaranteed term of employment is or may be longer than two years
ss 190–196	Directors' contracts with the company where the director acquires a substantial non-cash asset from the company or where the company acquires a substantial non-cash asset from the director
ss 197–214	Loans to directors

12.3.1 Directors' service contracts

1. The consent of members is required if a director's service contract includes a guaranteed term of employment of more than two years (s 188 CA 2006).
2. Section 189 provides that if the requirements set out in s 188 are breached the service contract is deemed to contain a term allowing the company to terminate it at any time by reasonable notice.

12.3.2 Substantial property transactions

1. Contracts between directors and the company itself fall outside the scope of s 177 discussed above.
2. Under ss 190–196 contracts under which a director or a connected person acquires a substantial non-cash asset from a company or its holding company require the approval of members. The same applies if a company or holding company acquires a substantial non-cash asset from a director or connected person.

3. A substantial asset is defined as one which:
   - exceeds 10% of the company's asset value and is more than £5,000, or
   - exceeds £100,000.
4. Exceptions are set out in ss 192–194.
5. Section 195 provides that a contract made in contravention of these requirements may be avoided by the company, and the director or connected person is liable to account to the company for any gain and to indemnify the company for any loss or damage resulting from the transaction.
6. Under s 196 it is provided that if within a reasonable period a transaction which was not approved is affirmed by members it will no longer be voidable.

12.3.3 Loans to directors: ss 197–214

1. Previously loans to directors were prohibited (s 330 CA 1985). Now, under s 197(1) and (2) CA 2006 a company may not make a loan, give a guarantee or provide security in connection with a loan to a director or a director of its holding company unless the transaction has been approved by a resolution of members.
2. A memorandum setting out the nature of the transaction, the amount of the loan and the purpose for which it is required and the extent of the company's liability under the transaction must be made available to all members.
3. For public companies there are more extensive provisions relating to quasi-loans (defined in s 199), loans and quasi-loans to persons connected with directors (ss 198–200) and credit transactions (s 201).
4. Any transaction which contravenes these provisions (to which there are exceptions) is voidable at the instance of the company (s 213), unless:
   - restitution is no longer possible;
   - the company has been indemnified for any loss or damage resulting from the transaction;
   - rights acquired by a third party in good faith, for value and without actual notice of the contravention would be affected by the avoidance.
5. Under s 214 such breach can be affirmed by members.

12.3.4 Exemption from liability

1. Any attempt to exempt a director from liability for breach of duty by a provision in the articles or other document is void (s 232 CA 2006).
2. By virtue of s 234 a company can insure its directors against liability incurred to a person other than the company for breach of duty, but not for liability to pay a fine in criminal proceedings.
3. Section 235 provides for pension scheme indemnity whereby a director may be indemnified against liability incurred in connection with the company's activities as trustee of the scheme.
4. In an action involving breach of duty, a court may relieve a director of liability, in whole or in part, if the director has acted honestly and it appears to the court that he or she should be excused in the light of all the circumstances (s 1157 CA 2006): see for example *Re Duomatic Ltd* (1969).