FRESHFIELDS BRUCKHAUS DERINGER

Companies Act 2006

Directors' duties

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Introduction

The rules governing the duties directors owe their companies have been codified in the Companies Act 2006 (the Act), which will come into force by October 2008. The Act also introduces a new statutory right for shareholders to sue directors in the company's name in some circumstances (known as the 'derivative action'). Concerns have been expressed about the impact of these changes on companies and their boards, but we believe there will be practical solutions to most of the issues that may arise.

We provide guidance below on how to meet many of the challenges of the new regime.

The new rules: a quick guide

At present, the rules governing directors come from several sources. The general duties they owe their company are governed by the common law and have been developed over many years in case law. The Companies Act 1985 (in particular, Part X) sets out additional rules. There are also other statutes that govern directors' behaviour in specific circumstances (such as health and safety). The Act now sets out a new statutory statement of directors' duties – described as their 'general duties' – in place of the common law and replaces (and to some extent rewrites) Part X Companies Act 1985.

Although the statement of general duties has been described by the government as a codification, it is not exactly the same as the existing law. The explanatory notes published with the original version of the Act describe two deliberate changes to the rules on directors' conflicts (both are described in more detail below). However, much of the language in which the general duties are framed is different from the language used by the common law and may lead to differences in approach when the new rules are applied in practice.

There are seven general duties in the new statutory statement as follows.

- A duty to act in accordance with the company's constitution, and to use powers only for the purposes for which they were conferred. This replaces existing, similar duties.
- A duty to promote the success of the company for the benefit of its members. This replaces the common law duty to act in good faith in the company's interests.
- A duty to exercise independent judgment. There is no exactly equivalent duty at common law. However, directors are currently under an obligation not to fetter their discretion to act or to take decisions – this aspect of the general duty replaces this obligation.
- A duty to exercise reasonable care, skill and diligence. This replaces the existing duty of care and skill.
- A duty to avoid conflicts of interest (except where they arise out of a proposed transaction or arrangement with the company – see below). At present, if a director allows his personal interests, or his duties to another person, to conflict with his duty to the company then, unless shareholders consent to the conflict: (i) the company can avoid any relevant contract and (ii) he must account to the company for any 'secret profit' he has made out of the arrangement. The new duty replaces this old rule.
- A duty not to accept benefits from third parties. There is no express duty to this effect at common law. It appears to derive from the current duties

to act in the company's interests and the rule dealing with conflicts of interest.

- A duty to declare to the company's other directors any interest a director has in a proposed transaction or arrangement with the company. At present, a conflict of interest arising out of a transaction or arrangement with the company is dealt with by the general rule on conflicts of interest, described above. In future, such a conflict will be covered by this new duty of disclosure.

Decision making and board proceedings

Promoting success

One of the most significant differences between the current regime and the new provisions is in the treatment of the directors' duty of loyalty to their company. The common law requires directors to act in good faith, in the interests of their company. The new provisions oblige a director to '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'.

This new formulation raises many questions, few of which have been answered by the government. In particular, it is not clear whether 'the company' will continue to have interests as an entity separate from its members or whether the interests of present members will always be paramount. Government spokesmen in the Lords and the Commons have referred to the directors' obligation under the new provisions as being to promote the success of the company for the benefit of members as a collective body. Lord Goldsmith (the government's spokesman on this part of the Act) also said that 'success', for a commercial company, will usually mean 'long term increase in value'. It is not clear how far it will be possible to rely on existing case law in interpreting these provisions. The Act provides that regard is to be had to the current common law rules in interpreting the new provisions: it may be that, although the new duty of loyalty is framed in very different terms from the current law, the courts will nonetheless apply it in a similar way.

We hope that, in most circumstances, the new rules will not require directors to decide particular questions differently from the way they would decide them at present. But in a few cases – for example, where a proposal will lead to a significant change in the company's membership or to the company ceasing to exist – the new rules may require a different approach. Particularly difficult questions are likely to arise in relation to competing, and hostile, bids for a company's shares. Under the current law, we take the view that directors can recommend the lower of two competing bids, or decline to recommend a bid, if they believe this course of action is in the long term interests of the company – even though it does not best serve the short term interests of its current members. It is not clear that they will be able to do this under the new law. Uncertainties will inevitably remain, at least until cases begin to come before the courts.

Factors to be considered

In deciding how to promote the success of the company, the directors are required to have regard 'amongst other matters' to:

- the likely long term consequences of their decisions;
- 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 maintaining a reputation for high standards of business conduct; and
- the need to act fairly as between members of the company.

The introduction of this list has caused some concern. However, it seems that although all the listed factors must be considered, in many cases it will be enough for the board briefly to conclude that a particular factor is not relevant, and move on. Helpfully, the government has made clear that the new provision is not intended to impose additional bureaucratic burdens on companies, and is intended to reflect what is already widely regarded as good practice. Most companies are unlikely to need to make significant changes to present procedures in relation to directors' decision making, provided that they do the following.

- Consider at least the factors listed above in reaching a decision. Given the government's assurance, in our view there is no reason why companies should significantly change their procedure for documenting decisions. So, we believe it should normally be adequate for the minutes to refer generally to 'the factors listed in section [ ] of the Companies Act 2006'. Where a factor (such as the environmental impact) is particularly relevant to a decision, companies may wish to continue to address this in board papers. In some circumstances, the board may also wish to refer specifically in the minutes to a particular factor or a discussion about it.
- Ensure that the directors (and those responsible for the production of board and other supporting papers) have had the new requirements explained to them generally so that when they come to a particular decision they take the factors set out in the Act into account.

In deciding whether to include a more detailed record of discussions on a particular matter in board minutes, the directors should also take into account any general policy they have adopted in relation to record keeping and potential litigation.

Independent judgment

Fears have been expressed that the new requirement for directors to exercise 'independent judgment' may prevent individual directors – particularly, non-executives – from relying on the judgment of others in areas in which they are not expert. The government confirmed in debate that directors will continue to be able to do this – and to delegate matters to committees – provided they exercise their own judgment in deciding whether to follow particular advice or to accept someone else's judgment on a matter.

Dealing with conflicts

Four separate provisions deal with conflicts of interest and their disclosure. These distinguish between: (i) interests in transactions and arrangements

with the company (which must be disclosed but need not be approved) and (ii) all other conflicts (which will normally require approval).

In relation to conflicts other than those arising in connection with a transaction or arrangement with the company, the Act contains a broad duty to avoid situations where a director has an interest that conflicts, or may conflict, with the company's interests. In particular, this applies to the exploitation of any property, information or opportunity – whether or not the company could have taken advantage of it and, it seems, whether or not the property, information or opportunity was available to the director because of his directorship. Two new safe harbours are provided: (i) where the situation 'cannot reasonably be regarded as likely to give rise to a conflict' and (ii) where the matter has been authorised by the directors. Board authorisation can be given only if:

- in the case of a private company, it is not invalidated by the company's articles;
- in the case of a public company, the articles expressly permit authorisation of conflicts by the board;
- any quorum requirement is met without counting the interested director(s); and
- the matter is agreed without counting any vote cast by the interested director(s).

Although not said expressly, it is likely that interests of anyone connected with a director will be taken into account in deciding whether or not a director has a conflict. The categories of 'connected person' have been broadened, and now include:

- family members (including spouse or civil partner, anyone with whom the director lives as a partner in 'an enduring family relationship', children and step children (both the director's own and his partner's) and the director's parents);
- bodies corporate to which the director is connected (detailed rules determine when this will be the case);
- trustees of a trust of which the director (or a family member or a body corporate with which he is connected) is a beneficiary; and
- a director's business partner.

The Act also precludes a director from accepting a benefit from a third party, unless the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.

It is likely that the new provisions will cause the greatest difficulty for directors who sit on more than one board. Government ministers suggested in parliament that a general authorisation by each board in relation to each other directorship held by one of its number will 'frank' any subsequent

conflicts that arise as a result, if directors' authority is wide enough to do this. If the authority is not wide enough, so that any such conflict must be expressly authorised as it arises, we can foresee some difficult situations arising for directors who are unable to disclose the circumstances of a particular conflict because they are subject to a duty of confidentiality to another company.

It is not clear to what extent the new formulation of the duty changes the existing law, particularly given the scope for board approval of potential conflicts. However, we anticipate that it will be possible to deal with any differences in approach through the articles of association (see below) and by taking practical steps, such as:

- ensuring that where a director wants to take on a new directorship this is considered and, if thought appropriate, authorised by the board, which should consider what should happen if an actual conflict arises in future;
- where a benefit has been received from a third party, requiring the director who received it to declare it at a board meeting – the board's view that its acceptance cannot reasonably be regarded as likely to give rise to a conflict should be minuted; and
- advising all directors that if a specific conflict arises, particularly in sensitive areas (for example, if it relates to an important area of the company's business or to a possible bid), he should seek independent advice – if it is not possible to disclose the conflict and obtain approval, it may be necessary for the director to absent himself from relevant board discussions or even to resign.

Disclosure of interests in transactions with the company

As far as interests in transactions or arrangements with the company are concerned, although a director is not under any obligation to avoid such an interest, where one arises it must be declared.

Two separate provisions require such an interest to be disclosed: the first (one of the general duties) applies where a director is interested in a transaction or arrangement that the company is proposing to enter into; the second (part of the replacement for Part X Companies Act 1985) applies where a director is interested in a transaction or arrangement that has already been entered into.

It is not clear why the two situations have been separated out in this way. There are some differences between the two sections – the most important being that breach of the first has only civil consequences (potential unenforceability of the transaction and a duty on the director to account for any profits), while breach of the second is a criminal offence by the director who fails to make the required disclosure. Although breach of the former renders the transaction voidable at the company's option, breach of the latter (despite being a criminal offence) is unlikely to lead to the unenforceability of the transaction in question (this, at least, is the position in relation to the provision it replaces).

A director is expected to declare interests of which he is aware or 'of which he ought reasonably to be aware'. As with the provisions on conflicts, it is likely that interests of anyone connected with a director will be taken into account. As at present, a director can give a general notice of an interest in another company or firm, or that he is connected with certain people.

Practical advice to companies is to ensure that:

- all interests are notified as soon as the director becomes aware of them, in the manner described in the Act (at a board meeting, by notice in writing to the other directors or by a general notice);
- steps are taken to make sure that anyone connected with a director is aware of the disclosure obligations and is asked to notify the director if a potential conflict arises; and
- directors are reminded regularly of their notification obligations.

Changes to articles of association

Some changes to articles of association will be desirable.

Importantly, public company directors will be able to authorise a conflict only if this is permitted by the company's articles (see above) – this will require express provision in all plc articles of association. At the same time, it would be sensible to amend any existing provisions in the articles that deal with conflicts to ensure they reflect the new statutory regime.

Boards will also be able to give themselves more room for manoeuvre by taking advantage of a provision in the Act that allows companies to deal with conflicts of interest in their articles of association. Anything done in accordance with such a provision will not be a breach of duty. Companies are likely to find it helpful to make provision for particular areas where conflicts are likely to arise – for example, by providing that a director who takes on an additional directorship will not be regarded as being in breach of the no conflict rule and need not disclose confidential information received by virtue of that directorship.

Ratification

Changes have also been made to the rules on shareholder ratification of acts by the directors. Most importantly, any votes in favour of a ratification resolution by a director who holds shares in the company (or by a person connected with him) must be disregarded. In some cases this may give rise to difficulties in practice – for example, where a major shareholder in (or parent of) the company seeking ratification is connected with one of its directors.

Shareholder litigation

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 directors' negligence, default, breach of duty or breach of trust. At present, shareholders have only very limited common law rights, subject to the fulfilment of strict conditions, to bring actions in their company's name. Under the new provisions, shareholders will be able to bring proceedings in the company's name against the directors in a wider range of circumstances than at present. They will also be able to claim against third parties implicated in any breach (again, in the company's name).

The new statutory right – or 'derivative action' – will undoubtedly make it easier for shareholders to take directors to court. Considerable concern has been expressed that this, taken together with the statutory statement of duties – particularly the detailed list of factors to which directors are to have regard – will lead to significant risks for directors.

The government has made some effort to respond to these concerns, by introducing a two stage process for derivative claims. First, a disgruntled shareholder will have to apply to the court for permission to make the claim – if the court considers that the evidence filed by the applicant does not make out a prima facie case, it will be required to dismiss the application ex parte at this stage. If an application survives this process, it will enter the second stage, during which 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. Companies may find it helpful to approach institutional shareholders for support. Only if the claimant is successful will the claim progress to the third stage – a full trial of the issues.

These changes – when looked at against the background of the courts' significantly increased powers of proactive case management, and the obligation on parties in dispute to litigate as a last resort – go some way to improving the likely position of companies and their boards. They should also reduce the risk that the new provisions will lead to a significant increase in time consuming and expensive litigation in relation to claims against directors that are ultimately unsuccessful. Boards that take the steps we have outlined here should be able to minimise these risks still further. However, there is still a risk that activist shareholders and pressure groups will seek to use the new procedures at least to create publicity and put decisions of public company boards under even greater scrutiny. Directors may want to have in place a response plan if action is threatened.

Directors and officers (D&O) insurance

Directors will want to review company indemnification and insurance arrangements and consider whether these need to be revised in light of the potentially increased risk of shareholder litigation referred to above. The costs of dealing with and defending shareholder litigation could be significant for both the company and its directors.

If the court refuses leave to continue an action brought by a shareholder, the shareholder will bear the cost of the application. However, this is unlikely to include all the costs incurred by the company and the directors in dealing with the claim. If the court gives permission for the action to continue, the company may be ordered to reimburse the costs incurred by the shareholder in bringing the action. In these circumstances, the company may have to bear the burden of funding both the shareholder action and the directors' defence. Appropriate D&O insurance can help relieve this burden.

Directors will want to ensure that, in addition to any award of damages against them, the costs and expenses of dealing with and defending shareholder litigation fall within the scope of D&O insurance offered. Companies should review the wording of their policies and check the extent of their cover in relation to shareholder litigation (and any exclusions from cover) with their insurers.

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