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Companies Act 2006 — Directors' Duties

The latest phase of changes introduced by the Companies Act 2006 (the "**Act**") came into force on 1 October 2008. Several of these changes relate to directors' duties and build upon other duties that the Act introduced in October 2007. This note provides an overview of the new landscape facing directors and how the changes will affect the way that companies are run.

The Act codifies directors' duties that had previously evolved through case law. The new provisions apply to all company directors, including shadow directors, and, in certain circumstances, even to former directors. Although the relevant provisions of the Act largely reflect the previous case law, there are nevertheless some significant changes. It is therefore important that directors within any size of organisation understand precisely what these codified duties are, especially in light of the new ability of shareholders, under the Act, to bring derivative claims against directors on behalf of a company.

The Duties

Although the Act has codified directors' duties in an unprecedented way, regard must still be had to the common law rules and equitable principles that pre-existed it. However, for the most part, the duties listed below will determine how directors should exercise their powers.

Duty to act within powers

This relatively simple restriction outlaws ultra vires acts and means that directors must act within the constraints of the company's constitution, namely its articles of association.

Duty to promote the success of the company

This is a duty to act in good faith to promote the company's business for the benefit of the members as a whole. Most directors will consider that they discharge this duty naturally in their efforts to maximise profits. However, the pursuit of short-term profits may not be sufficient; this duty imposes an obligation on directors to exercise their judgement in a way that will bring about a "long-term increase in value" for the company. In doing so, the directors must have regard to the following non-exhaustive list of factors that are set out in the Act:

- the likely consequences of any decision in the long term;
- the interests of the company's employees;
- the company's relationships with suppliers and customers;
- the company's impact on the environment and community;
- the impact on the company's reputation; and
- the fair interests of the company's shareholders.

This has introduced the concept of the "enlightened shareholder", as a result of which directors are forced to ask themselves, with the over-arching aim of maximising the long-term value of the business, what a socially and fiscally responsible person would do. This is a large extension of the previous concept which required the directors only to have regard to the best interests of the shareholders. The effect is that the notion of corporate responsibility is now enshrined in legislation.

Duty to exercise independent judgement

A director must act solely in accordance with his own good faith judgements and must not be influenced by external factors.

Duty to exercise reasonable skill, care and diligence

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 in such a role as well as the actual knowledge, skill and experience that the particular director has. The first, objective element to the test means that it is important that all directors are properly qualified to carry out the roles that they are assigned.

Duty to avoid conflicts of interest

Directors must not put themselves in a position which may, directly or indirectly, conflict with the interests of the company. This does not apply to transactions with the company which must simply be notified to the other directors. Further, a test of materiality applies, in that there is only a breach of the duty where a conflict of interest could reasonably be expected to arise. This is wider than the previous restriction — it is not enough now for a director to absent himself from a meeting at which a matter is discussed in relation to which he has a conflict. Simply allowing the possibility of such a conflict arising may place the director in breach of his duties.

Unlike the previous regime, conflicts of interest may be authorised by directors in a private company where the constitution does not specifically invalidate the authorisation. The situation is slightly more onerous for public companies where the constitution must specifically allow the authorisation.

The Act does provide for transitional arrangements, so that no authorisation is needed for conflicts existing prior to 1 October 2008. However, if the circumstances of the conflict change after this date, the General Counsel 100 (a group of in-house legal advisers representing FTSE 100 companies) recommend seeking authorisation under the new regime.

Companies should therefore review the existing provisions in their articles of association in relation to conflicts in light of these changes, as well as ensuring that all directors disclose all their existing conflicts and those of their connected persons and that any future changes to such conflicts are reported to the company.

Duty not to accept benefits from third parties

This precludes directors from accepting any benefits which may be granted due to their position as a director. This duty does not apply if it could not reasonably be expected to result in a conflict of interest nor to benefits conferred by companies within the same group.

Unlike the procedure for generic conflicts above, this duty can be waived only with authorisation from the shareholders.

Duty to declare an interest in proposed and existing transactions with the company

All directors must declare to the other directors the nature and extent of their interest in both existing and proposed transactions with the company. This includes both the director's own interests and those of his connected persons. It is an objective test, applying to interests of which the director ought reasonably to have been aware. A materiality test also applies to this duty. There is no need to disclose interests of which the other directors were aware prior to 1 October 2008.

Practical Effects

The codification of directors' duties clarifies the issues that the board must consider when running the company. However, it is still unclear exactly how the courts will interpret some of the new duties in practice and this naturally introduces an element of uncertainty.

The Act does make clear that the duties must be read in context, so that they all apply equally, even in the event of a conflict. In such instances, directors will need to demonstrate that they have properly considered all the factors set out in the Act (and any others that may be relevant) when reaching their decisions.

The description and reality of each director's role should be analysed carefully to ensure that they are not exposed to the objective test of what knowledge they should have for a role for which they are not appropriately qualified.

Directors should be asked to ensure that they have disclosed all their existing conflicts and those of their connected persons, and systems should be in place to ensure that any future changes to such conflicts are reported to the company.

Finally, existing constitutional documents, particularly the articles of association, should be reviewed and updated, if necessary — especially in relation to the new provisions on conflicts of interest.

How We Can Help

Hunton & Williams' London office has over 15 lawyers able to assist with any concerns arising from the implementation of the Companies Act 2006 and any other corporate or commercial legal issues. If you would like to discuss further any of the issues discussed in this note, please contact James Green or Christopher Raggett at this Firm.