STEVENS&BOLTON

DIRECTORS' DUTIES - A PRACTICAL GUIDE

This guide provides directors of UK incorporated companies with a general overview of the statutory and other duties and obligations which should be complied with in that role. We also offer practical guidance on safeguarding directors from personal liability and on considerations should insolvency of a director’s company become a concern.

Additional duties will be applicable to directors of listed companies and directors of companies operating within regulated industries such as financial services, energy or insurance. While this guide does not address those additional obligations, we would be happy to advise.

If, having considered this guide, you would like to know more or to discuss your own circumstances in greater detail, please speak to your usual contact at Stevens & Bolton or a contact listed at the end of this guide.

THE ROLE AND DUTIES OF DIRECTORS

Each individual director should participate regularly in board meetings to assist the board in taking decisions and meeting the company's obligations.

WHAT IS THE ROLE OF A DIRECTOR?

The board of directors of a UK company is responsible for day to day strategic and operational management of the company's business, including responsibility for ensuring that the company meets its statutory and other legal obligations. The board of directors is entirely separate from the shareholders of the company, even though there may be considerable overlap between the individuals concerned. Unless given additional special rights through the articles of association or contractually, shareholders only take decisions in a limited number of areas where the law (particularly the Companies Act 2006) provides for shareholder approval.

Each individual director should participate regularly in board meetings to assist the board in taking decisions and meeting the company's obligations. Although individual directors may have particular responsibilities or specialist roles (e.g. finance director, sales director), as a general principle all directors are equally responsible for all actions of the board. However, the board is usually permitted to delegate certain of its powers to committees of the board or to individual directors or employees.

STATUTORY GENERAL DUTIES UNDER THE COMPANIES ACT 2006

There are seven statutory duties under the Companies Act 2006:

1. To promote the success of the company

This requires a director to act in the way he or she considers, in good faith, would most likely to promote the success of the company for the benefit of its members as a whole.

While it is for the directors themselves to decide, in good faith, whether a particular course of action is likely to promote the success of the company for the benefit of its members as a whole (although this duty shifts and becomes owed to creditors where the company is insolvent or on the verge of insolvency). A non-exhaustive list of factors which each director should consider has been provided – the Companies Act 2006 states that a director should have regard to:

- the likely consequences of any decision in the long-term;
- the interests of employees of the company;
- the need to foster business relationships with suppliers, customers and others;
- the impact of the company's operations on the community and 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.

In practice, these factors will rarely all be relevant to a particular decision, and as mentioned they are not exhaustive - if directors act in good faith, the courts are unlikely to question their judgment as long as they are seen to be operating in a responsible manner.

2. To act within powers

i.e. in accordance with the company's constitution (including the articles of association) and only exercising powers for the purposes for which they are conferred (e.g. it may be that a director is given specific authority for a specific set of circumstances which doesn't align with the articles of association).

3. To exercise independent judgment

All directors are expected to exercise independent judgment and make their own decisions in the particular circumstances. It should be noted that this requirement does not prevent the directors from complying with the company's constitution (see the duty in the preceding paragraph above) or from acting in accordance with an agreement the company has entered into.

Where directors are directors of several companies in the same group, they must consider their duties in relation to each company separately. Directors of subsidiary companies should remember that the exercise of their duties should have regard to the position of the subsidiary company itself, although the articles of association of the subsidiary may expressly require its directors to take into account the parent company's interests.

4. To exercise reasonable skill, care and diligence

This is a partly objective and partly subjective test. The standard required is the care, skill and diligence that would be exercised by a reasonably diligent person with:

- 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 (i.e. objective test); and
- the general knowledge, skill and experience that the director actually has (i.e. subjective test).

In practice, this means that where a director has a higher level of specialist knowledge and experience, he will be expected to perform to that higher level. However, it will not be

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possible to hide behind a lack of knowledge which the director should reasonably be expected to have, for example in relation to financial issues.

5. To declare interests in proposed or existing transactions or arrangements with the company

Where a director has any direct or indirect interest in a transaction or arrangement with the company, he or she must declare that interest to the board – subject to anything to the contrary in the company's articles of association, the board is not required to approve the interest, it must simply be declared. An example of such an interest is where a company is proposing to enter into a customer or supply contract with another company and a director is a director of both companies.

However, there is no need to disclose an interest:

- which cannot easily be regarded as likely to give rise to a conflict;
- to the extent that the other directors are aware (or ought reasonably to be aware) of it; or
- to the extent that it concerns his service contract with the company.

These duties are owed to the company and not to other group companies or individual shareholders.

Where any such interest is declared, the ability for the director to vote and count in quorum of any board decision relating to the transaction or arrangement will depend on the articles of association – in many cases the director will be able to vote as long as he or she has complied with his obligation to declare the interest.

6. Not to accept benefits from third parties

This duty prevents a director from accepting a benefit from a third party which is given either because he or she is a director or because he or she does (or does not do) anything as a director. This includes non-financial as well as financial benefits, but only extends to benefits which can reasonably be regarded as likely to give rise to a conflict of interest.

This duty could be infringed by a director receiving lavish corporate hospitality – although it will obviously be a question of fact and degree as to whether the receipt of such benefit could be likely to give rise to a conflict.

7. To avoid conflicts of interest

This is a wider general duty to avoid conflicts – that is, a situation in which the director has or could have an interest that conflicts, or may conflict with the interests of the company.

An example of such "situational conflicts" is a director of company A also sitting on the board of company B, which is a potential competitor of company A.

Under the Companies Act 2006, a company is able to empower its directors to authorise such situational conflicts (before this legislation shareholder approval was required). Many companies have already taken the opportunity to empower their directors to authorise conflicts, through appropriate provisions being inserted into the company's articles of association. In relation to approval of any conflict by the directors, the conflicted director and any other interested director is not entitled to vote or count in the quorum and it is not possible to override this provision by amending the articles of association.

CONSEQUENCES OF BREACH OF GENERAL STATUTORY DUTIES

These duties are owed to the company and not to other group companies or individual shareholders, so in most cases it's the company that would take any action against an individual director. However, (i) in an insolvency situation a liquidator may take action and (ii) in certain limited circumstances it may be possible for a shareholder or group of shareholders to bring a "derivative action" against a director on behalf of the company.

Depending on the nature of the breach, a number of potential remedies could be available to claimants, including:

- the transaction being voidable (resulting in rescission of a contract or restoration of property);
- the payment of compensation or damages;
- a requirement to account for profits made;
- injunction; and
- possible fines (e.g. failure to disclose an interest in an existing transaction or arrangement gives rise to criminal fines).

OTHER DUTIES AND RESPONSIBILITIES OF DIRECTORS

Directors have a range of other specific duties imposed by the companies' legislation and other statutory or common law. Examples include:

- a range of administrative requirements relating to preparation and filing of annual reports and accounts and other publicity requirements;
- duties of confidentiality to the company, including only using or disclosing the company's confidential information for the benefit of the company and its business;
- other statutory duties, for example relating to health and safety, anti-bribery/corruption and environmental legislation.

> As soon as directors consider that their company may be getting into financial difficulties, they should seek independent advice.

WHAT CAN DIRECTORS DO TO PROTECT THEMSELVES FROM PERSONAL LIABILITY?

See the section "Safeguarding the director's position" below for practical guidance on protecting directors from personal liability.

WHAT IF THE COMPANY MIGHT BE GETTING INTO FINANCIAL DIFFICULTIES?

As soon as directors consider that their company may be getting into financial difficulties, they should seek independent advice. This is a point at which potential personal liability for the directors becomes a real risk, along with the prospect of being disqualified from acting as a director or being involved in the promotion or management of a company for many years. The best way to minimise these risks is to seek early professional advice.

Further guidance on the special legal considerations which apply in relation to insolvent companies and their directors is given below.

SAFEGUARDING THE DIRECTOR'S POSITION

PRACTICAL STEPS WHICH DIRECTORS CAN TAKE TO SAFEGUARD THEIR POSITION

As previously mentioned, individual directors may have particular responsibilities or specialist roles (e.g. finance director, sales director), but as a general principle all directors are equally responsible for all actions of the board.

However, a director who has performed his duties responsibly will generally not be liable for the defaults of his fellow directors solely by virtue of his position, but if he participates in the unlawful action, he will be liable. In practice "participation" is construed widely and a director cannot escape liability by claiming ignorance as to the transaction in question if he or she has otherwise neglected their duties as a director.

There are a number of practical steps that directors can take to minimise the risk of liability for breach of duty, for example:

- Make sure they know what their duties are – many companies arrange training for their boards and provide directors with guidance notes.
- Ensure regular board meetings happen, attend all board meetings wherever reasonably possible and make themselves aware of the day to day business of the board of directors - including functions which have not been specifically delegated to those directors.
- Make reasonable enquiries into the nature of any documents they are asked to sign and any business to be transacted at a board meeting so as to ensure that they can make an informed decision in deciding how to vote.
- Where a director has the ability to delegate, ensure that any delegate (e.g. a committee, a specific director or any other employee) is competent and trustworthy and ensure the director remains informed as to the activities which the delegate is carrying out.
- Ensure that all formalities are observed, in particular that all meetings are properly minuted and all transactions properly documented.
- Where a director objects to a course of action which is nevertheless approved by the majority of directors, he or she should note their objection in writing to the board of directors and try to ensure that such objection is noted in the minutes of the relevant board meeting.
- In relation to group companies:
    - Adopt a group structure with clarity as to its overall purpose, supported by board minutes. Work out the appropriate role of parents in the affairs of group companies across the full range of the group's business activities, create and adopt (at individual corporate level) appropriate procedures and police/stick to those procedures.
    - Maintain separate governance and operation of each group company, including regular board meetings and minutes, operation of separate bank accounts.
    - Consider the most appropriate composition of the board of directors of each company and if there is overlap ensure that directors treat each company they are directors of as a separate legal person.
    - Ensure that the way each group company contracts with third parties and its stationery, web sites, email footers and other correspondence does not cause confusion as to the entity third parties are dealing with.
    - Ensure that employees and other representatives of the company similarly are clear as to the relevant corporate entity they are representing.
- Should seek relevant legal and other professional advice. The closer the company gets to financial difficulties the more important it is for the board to be seen to have taken suitable independent advice. Further guidance on insolvency appears below.

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COURT'S POWER TO RELIEVE A DIRECTOR FROM LIABILITY

The Court can relieve a director from liability in any proceedings against that director for negligence, default, breach of duty or breach of trust, if it appears to the court that the director has acted honestly and reasonably and that having regard to all the circumstances of the case he or she ought fairly to be excused.

ABILITY OF A COMPANY TO RATIFY AN UNLAWFUL ACTION BY A DIRECTOR

In most cases, a company can ratify a breach by directors by passing a members' resolution to that effect. However, the CA 2006 requires that any such resolution must be passed by the members without counting any shareholder votes of the director in breach and any other member connected with that director.

D & O INSURANCE AND INDEMNITIES BY THE COMPANY

Careful drafting is required because an indemnity that does not satisfy the statutory requirements will be wholly void

The Companies Act 2006 expressly prohibits a company (or any other member of its group) from entering into arrangements with a director or any other person exempting the director from or otherwise indemnifying him against any liability he may have for negligence, default, breach of duty or breach of trust in relation to the company. However, the company may grant an indemnity in respect of certain types of liability that a director may incur to third parties, so long as the indemnity satisfies the criteria for a "qualifying third party indemnity provision". Careful drafting is required because an indemnity that does not wholly satisfy the statutory requirements will be wholly void.

A company may also fund directors' legal costs (for example, by way of loan) incurred in breach of trust in relation to the company. Any loan made by the company to fund costs of legal proceedings must be subject to a right of repayment exercisable by the company if the director's defence proves unsuccessful.

Further a company is able to purchase insurance to cover the director's liability for negligence, default or breach of duty.

The articles of association of many companies provide for these rights of indemnity and enable the company to take out relevant directors' and officers' liability insurance.

INSOLVENCY

GUIDANCE FOR DIRECTORS OF POTENTIALLY INSOLVENT COMPANIES

The Insolvency Act 1986 allows a liquidator or administrator of a company to challenge transactions…where the company received significantly less value than it gave (for example, it sold an asset at a knock down price)

This section of the note sets out a checklist of areas that a liquidator or other relevant insolvency officer is to consider (a) whether he might be able to make recoveries from any party, including the directors, to increase the assets of the company and (b) the conduct of directors for the compulsory report to the Secretary of State which, if a sufficiently damaging report is made, can lead to disqualification proceedings.

Sections 1 to 4 below deal with actions to "undo" various transactions with third parties (which may include directors).

Sections 5 to 9 below deal with a director's potential personal liability.

1. Transactions at an undervalue

The Insolvency Act 1986 (IA 1986) allows a liquidator or administrator of a company to challenge transactions entered into by that company where the company received significantly less value than it gave (for example it sold an asset at a knock down price).

A liquidator or administrator can only challenge transactions entered into up to 2 years before the onset of liquidation or administration.

The court can make a wide range of orders if there has been a transaction at an undervalue. The intention of any order is to restore the position to what it would have been if the company had not entered into the transaction. In practice, this usually means either an order to re-vest property in the company or to pay compensation to the liquidator or administrator for the benefit of the company's estate.

However, the court will not make an order unless it can be shown that the company was unable to pay its debts as at the date of the transaction or became unable to pay its debts as a result of the transaction. An inability to pay debts is defined in this context to include being insolvent on a balance sheet basis (i.e. where the company's liabilities, taking into account its contingent and prospective liabilities, exceed its assets) or a cash flow basis (i.e. where the company is unable to pay debts as they fall due).

Inability to pay is presumed where the transaction is entered into with a connected party. "Connected party" is widely defined but includes, for example, directors and shadow directors of the company, relatives of those directors or shadow directors, shareholders holding more than 33% of the shares in the company, and other companies which have one or more directors in common with the company.

Moreover, no order will be made to set aside the transaction at an undervalue if the court is satisfied that the transaction was entered into in good faith, for the purpose of carrying on the company's business and that at the time the transaction was entered into there were reasonable grounds for believing that the transaction would benefit the company. This might be the case if the company sold assets at an undervalue in order to effect a quick sale and raise cash, or if the company considered a transaction necessary to avoid litigation or to prevent the termination of a valuable trade relationship.

Contemporaneous board minutes may also be useful in demonstrating the good faith purpose of the directors

If directors are concerned that a transaction might be challenged as a transaction at an undervalue, they could consider obtaining an independent valuation of the assets that are to be sold to ensure that the price to be paid is equivalent to market value. Contemporaneous board minutes may also be useful in demonstrating the good faith purpose of the directors.

2. Preferences

A liquidator or administrator can challenge a transaction as a preference if (a) a creditor is put in a better position than they would be in on an insolvent liquidation and (b) the company was influenced by a desire to put the creditor in that better position.

In the case of transactions with connected parties, a liquidator or administrator can only challenge transactions entered into up to 2 years before the onset of liquidation or administration. In the case of unconnected parties, a liquidator or administrator can only challenge transactions entered into up to 6 months before the onset of liquidation or administration.

Putting a creditor into a better position that they would be in on an insolvent liquidation can include situations where the company pays the whole or part of a debt in priority to other debts, grants security for an existing debt, or repays a director's loan account.

The meaning of "influenced by a desire" has been closely examined by the Courts. The test is a subjective test and there must be a positive wish on the part of the company, or, in practical terms, the directors of the company, to put the creditor in a better position. However, it does not matter if this desire is not the primary desire; there only has to be an element of desire to be caught by this section.

If a connected party is put in a better position, then it is presumed that the company had the relevant desire. However, it is open to the company to prove the contrary.

As with transactions at an undervalue, the Court can make a wide range of orders if there has been a preference. The intention of any order is to restore the position to what it would have been if the company had not given the preference. However, the Court will not make an order unless it can be shown that the company was unable to pay its debts as at the date it gave the preference or became unable to pay its debts as a result of giving the preference.

Payment by the company of any debts where a company is in financial difficulty can give rise to a real risk of transactions being attacked as preferences. Directors should seek professional advice at the earliest possible opportunity if they are in any doubt as to their position.

3. Invalid floating charges

A floating charge over a company's assets which is created in respect of existing debt only is invalid if, in the case of a connected party, it was created up to 2 years before the onset of the liquidation or administration, or, in the case of an unconnected party, it was created up to 12 months before the onset of the liquidation or administration. So, a floating charge will only be valid to the extent of new monies advanced at the same time as, or after, the creation of the floating charge.

However, a floating charge granted to an unconnected party will only be invalid if it can be shown that the company was unable to pay its debts as at the date it granted the floating charge or became unable to pay its debts as a result of granting the floating charge. In such a case, there is no need for the liquidator or administrator to apply to court for an order to set it aside.

4. Provisions against debt avoidance

There are special provisions in the IA 1986 which enable any "victim" of a transaction or the administrator or liquidator of a company to apply to set aside transactions which were intended either to put assets beyond the reach of any creditor...or to prejudice the interests of any creditor

There are special provisions in the IA 1986 which enable any "victim" of a transaction or the administrator or liquidator of a company to apply to set aside transactions which were intended either to put assets beyond the reach of any creditor (including future and contingent creditors) or to prejudice the interests of any creditor. These provisions apply without limit as to time but the applicant must prove that the transaction was at an undervalue (as discussed in section 1 above) and that the transaction was entered into with an intent to put the assets beyond the reach of creditors or to prejudice creditors' interests. Again, the order a court would make would be designed to restore the position to what it would have been if such a transaction had not been entered into.

There is no need for there to be any insolvency proceedings in place for a victim to make an application. There is no defence to this action on the ground the company was solvent at the time the transaction was entered into.

However, there is protection for anyone who has entered into a transaction with the company in good faith and for value. Such a person must not have any knowledge of the "relevant circumstances" which include the fact that the transaction is at an undervalue and the fact of the company's intention.

5. Breach of the statutory duties

An action for breach of the duty may result in the defaulting director having to pay compensation to the liquidator or administrator for the benefit of the company's estate. A breach of any of the provisions mentioned in sections 1 - 4 above might also be a breach of duty. The general limitation period of 6 years applies to ordinary actions for breach of duty. So, even if there is a transaction which could not be attacked because of the time limits in sections 1 - 3 above, the directors might be exposed to a personal action for breach of duty if proceedings are commenced for recovery of a monetary sum within 6 years from the date of breach.

In addition, if there is fraud or if money or property has come into the director's hands which he or she has disposed of improperly, there is no time limit to an action by or on behalf of the company to recover from the director.

6. Directors' disqualification

If a director is found to have been "unfit" in the conduct of a company then that director can be disqualified from acting as a director of another company for a period of between 2 and 15 years.

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Administrators, liquidators and receivers are obliged to make a report to the Secretary of State upon the conduct of all the directors of any company over which they are appointed. This report is confidential but may lead to disqualification proceedings being commenced by the Secretary of State. This may lead to a court making a disqualification order against a director. However, it is possible for a director to provide the Secretary of State with a disqualification undertaking as an alternative to going to court for a full trial. A disqualification undertaking has the same effect as if it were a court order but is a quicker and more cost effective process.

If a director is responsible in relation to any of the matters at sections 1 - 5 above or 7 - 9 below, that would be likely to amount to unfitness. This may be included in the relevant officer's report even if the transaction cannot be attacked because of applicable time limits.

7. Wrongful trading

Directors can be ordered to contribute personally to the assets of a company if they allowed the company to continue trading when they knew, or ought to have concluded, that there was no reasonable prospect of the company avoiding an insolvent liquidation and they failed to take every step a reasonably diligent person could be expected to take to minimise loss to creditors.

In determining whether or not a director knew or ought to have known that insolvent liquidation was inevitable, both the actual knowledge, skill and experience of the individual concerned and that which may reasonably be expected of somebody carrying out the functions carried out by that person will be taken into account (i.e. the court will apply both a subjective and objective test). In this way, a person with financial responsibility in relation to the affairs of a company (who is ignorant of the extent of its difficulties but who would have been aware of those difficulties if he had ensured that adequate systems were in place) will be liable.

It is not sufficient for the directors simply to consider the net asset position; the directors must also consider management information and consider whether the company can continue to meet its debts as they fall due. If the directors foresee, or even if they ought to have foreseen, that the company could not continue to meet its debts as they fell due then they may be exposed to a wrongful trading action. This provision applies without limit as to time and is judged with hindsight.

A liquidator will seek to determine a moment in time when the directors ought to have concluded that insolvency was inevitable. He will then consider the directors' actions after that "trigger date" to see if they took "every step they ought to have taken" to minimise the loss to creditors. Case law demonstrates that "taking every step" means doing all that is within the power of the individual concerned to cause that company to stop all operations which would have the effect of worsening the overall position of creditors.

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Ordinarily, once directors form the view that the company is inevitably insolvent they will take immediate steps to place a company into a formal insolvency process. In deciding what is the appropriate form of insolvency process, directors should consider whether there are any positive steps that can be taken to rescue all or any part of the business. Also, it is permissible for directors to consider whether any form of informal rescue package, further investment or sale of the business may be possible in the foreseeable future.

8. Fraudulent trading

The provisions relating to fraudulent trading allow a liquidator to seek an order against directors who were knowingly parties to the carrying on of a business within intent to defraud creditors, or for any fraudulent purpose.

It can be sufficient to show that a company continued to carry on business and to incur debts at a time when there was, to the knowledge of the directors, no reasonable prospect of those debts being paid. It is therefore important for a director to be confident of the ability of the company to meet its liabilities. If the company is relying upon the continued support of one or more of its fund providers and its directors become aware of an intention to withdraw or discontinue that support, there would be a prospect of fraudulent trading if new liabilities are undertaken (in the absence of any alternative available funding).

However, these applications are very rare because, in nearly all cases, such fraudulent trading by a director will also be caught by the wrongful trading provisions, for which the burden of proof is lower.

9. Criminal penalties

There are various provisions in the IA 1986 allowing for directors to be prosecuted, for example, if directors engage in fraudulent transactions (or other fraud) in anticipation of winding-up, or make false representations to creditors. These only apply in the case of a liquidation.

KEY CONTACTS

For further information about any of the issues raised in this guide, please contact:

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