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Guide to directors' duties

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Directors have the power to take important business decisions on behalf of the companies they control. Because of this, they have duties imposed on them to protect the interest of these companies.

The Companies Act 2006, which has been phased into force since October 2007 and completed in October 2009, codifies these duties with the aim of making the law governing directors' duties more consistent, certain and accessible. For the first time, it enshrines directors' responsibilities in statute in the form of seven duties.

This overview is designed to highlight the key points of these duties. However, this is a complex area that requires careful compliance, so if you would like more detailed advice, please contact us.

The seven directors' duties

In simple terms, the directors' duties are designed to ensure that the company comes first. Directors must act in the interests of the company and not in the interests of any other party, including shareholders. The seven duties all in force from October 2008 are:

1. To act within the powers of the company's constitution
2. To promote the success of the company
3. To exercise independent judgment
4. To exercise reasonable care, skill and diligence
5. To avoid conflicts of interest
6. To not accept benefits from third parties
7. To declare an interest in a proposed transaction or arrangement

1 The duty to act within their powers

A director must only act in accordance with their powers, which normally originate from the company's constitution, i.e. its memorandum and articles of association. Directors must only exercise their powers for the purposes for which they were granted.

2 The duty to promote the success of the company

This duty replaces the previous directors' duty to act in good faith and in the company's best interest.

A company director is required to act in a way that they consider to be most likely to achieve the 'success' of the company, taking into account factors including:

- the long-term consequence of a decision
- the interests of employees
- the company's relationships with its suppliers and customers
- the impact of the decision on the community and the environment
- maintaining a reputation for high standards of business conduct
- the need to act fairly as between members of the company.

'Success' is not defined in the Act but government guidance suggests that for a commercial company, success would be a long-term increase in value.

There is also no guidance in the Act as to the weight which should be given to each of the factors above. This duty introduces wider corporate social responsibility into a director's duties, which may require directors to balance what may be conflicting factors in making a decision, such as an environmental consideration that is at odds with shareholders' interests.

3 The duty to exercise independent judgment

A director must exercise independent judgment. However, this duty is not infringed if a director acts in accordance with an agreement entered into by the company or in a way that is authorised by the company's constitution.

4 The duty to exercise reasonable care, skill and diligence

This duty enshrines in law the common law duty of care and skill and the "subjective" and "objective" standards that must be met.

Directors must exercise reasonable care, skill and diligence using the general knowledge, skill and experience reasonably expected of a person carrying out a director's functions (the "objective" standard) and their own general knowledge, skill experience (the "subjective" standard).

The effect of the subjective test is that a director who has more experience, knowledge and skill must use a level of diligence in carrying out their duties that reflects their more advanced expertise.



5 The duty to avoid conflicts of interest

This duty makes it easier for a director to enter into a transaction with third parties by allowing directors who are not subject to any conflict to authorise the transaction, provided that certain requirements are met. These requirements govern issues including who can vote on such an authorisation.

6 The duty not to accept benefits from third parties

This reinforces an established principle that a director cannot make a secret profit because they are a director. Which means they cannot accept a benefit from a third party that arises because they are a director or because they take, or do not take, a particular action as a director.

However, a director will not breach this duty if accepting a benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.



7

The duty to declare interest in a proposed transaction or arrangement with the company

When a director has a direct or indirect interest in a proposed transaction, they must disclose this to the board, before the company enters into the transaction.

It is not enough to say only that they have an interest. They must also disclose the nature and the extent of this interest. The director must disclose any matters of which he should reasonably be aware and to also revise or update any declaration that proves to be, or becomes, inaccurate or incomplete over a period of time.

A director does not necessarily need to be party to the transaction for this duty to apply, which means that it also catches the interests of persons “connected” with the director. This covers a director’s family; parents, children or stepchildren over 18, the director’s unmarried partner and infant children of the director’s unmarried partner as well as fellow directors.

The requirement for disclosure is dispensed where the interest cannot reasonably be regarded as likely to give rise to a conflict of interest or if other directors are already aware or “ought reasonably to be aware” of their fellow director’s interest.



Conclusion

The legislation brings greater clarity and certainty to directors' duties but to be fully effective, the seven duties need to be at the forefront of directors' minds.

Directors would be wise to seek professional advice if unsure about issues arising from the changes and to ensure that their decision-making processes and company constitutions recognise the new directors' duties.

To find out more about how we can help you, please contact our company and commercial law specialists:



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