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Changes to English Company Law: Directors' Duties

by James Barabas and Sarah Trapani

Last Fall saw major change to the English legal regime insofar as it governs the duties and liabilities of directors of English companies and the remedies available to shareholders with a grievance as to how directors have behaved. Ancient common law and equitable duties were for the first time codified and put on a statutory footing. Further reforms touched on the ability of and procedure by which shareholders are able to bring derivative actions. This article looks at some of those changes and notes, if possible, how matters have developed in practice.

The New Duties

There are seven duties in the new statutory statement contained in Part X of the Companies Act 2006. Of these, four came into force on October 1, 2007. These are:

1. Duty to act within powers (Section 171). A director must act in accordance with the company's constitution (by laws) and must only exercise his powers for their proper purpose. This replaces existing, similar duties.
2. Duty to promote the success of the company (Section 172). A director must act in the way he considers would be most likely to promote the success of the company for the benefit of its members as a whole. In complying with this duty, a director must have regard (amongst other matters) to:
   (a) the likely consequences of any 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; and
   (f) the need to act fairly as between the members of the company.

The above make up the so-called principle of "enlightened shareholder value" that lay behind the UK Government's approach to law reform in this area. However, recognizing the varied nature of companies (both profit making and not-for-profit) that will be impacted by the new law, the list of factors that directors are required to have regard to is specifically expressed not to be exhaustive. The impact of these new duties is considered further below.

3. Duty to exercise independent judgment (Section 173). A director must exercise independent judgment. There was no exact equivalent of this duty at English common law; however, directors

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were under a requirement not improperly to fetter their discretion. The new legislation provides that this duty will not be infringed by a director acting in accordance with an agreement entered into by the company that restricts the exercise of a director's discretion.

4. Duty to exercise reasonable care, skill, and diligence (Section 174). A director must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both (a) the general knowledge, skill and experience that may be reasonably 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. In other words, directors bringing particular knowledge, skill or experience to the table, for example in relation to finance or actuarial matters, will be held to a higher standard in that regard.

There are three further duties that are due to come into force at a later date:

5. Duty to avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or may possibly conflict, with the interests of the company (Section 175). There are two statutory safe harbors: (a) where the situation cannot be reasonably regarded as likely to give rise to a conflict and (b) where the matter has been authorized by the (non-conflicted) directors.
6. Duty not to accept a benefit from a third party conferred by reason of being a director (Section 176). The section provides that the duty is not infringed if the acceptance of the benefit cannot be reasonably regarded as likely to give rise to a conflict of interest. In addition, benefits conferred by the company or by the director's service contract are excluded.
7. Duty to declare, if a director is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, the nature and extent of that interest, to the other directors (Section 177). The director does not need to be a party to the transaction for the duty to apply.

Impact of the 2006 Act

Prior to the enactment of the Companies Act there was criticism of the codification of directors' duties from several bodies, including the General Counsel 100 Group (mainly comprising the general counsel to the companies in the UK's FTSE100 index). The GC100 issued a paper voicing the fear that the provisions in the Act risked having the effect of increasing bureaucracy in companies, making the decisionmaking process more cumbersome, and increasing the potential liability to which directors are exposed.[1]

In particular, concern was expressed in relation to Section 172 and the principle of enlightened shareholder value. It was suggested that company board minutes will have to be more detailed to show that the directors have contemplated the non-exhaustive list of factors set out in that section. In an attempt to steer the debate, the GC100 paper set out the view, having consulted leading practitioners and commentators that the changes did not mean that directors would have to evidence in board minutes their thought processes, with regard to the stated factors or any other matter influencing their thinking. That view is consistent with the view of Government Ministers expressed during Parliamentary debate on the draft bill.[2]

The GC100's paper suggested that it was best practice for directors to be made aware of the requirement to consider the factors (to the extent relevant) and for those members of the management team responsible for preparing board papers to ensure that each of the factors that may be relevant is properly considered while board papers are being prepared and that appropriate discussion of the same is included in board papers and/or board presentations.

As to the meaning of the overriding duty—"to promote the success of the company"—guidance came from Government Ministers during the Parliamentary debate on the Bill, with the Attorney General expressing the view that for commercial companies, "success" will usually mean "long term increase in value" and that what will promote success, and what constitutes such success, is one for the directors' good faith judgment.[3]

This reassurance should have the effect of reducing the risk that directors are subject to liability simply because a shareholder takes a different view as to what will promote the success of the company.

Practice in England and Wales since the relevant provisions came into force has been consistent with the GC100's advice. It is the view of some in the English legal community, including these authors, that the low key impact of the changes has in part been due to the drafting of Section 172, which was amended during its parliamentary passage so as to make it clear that the "have regard to" factors are subordinate to the overriding duty to promote the success of the company. This change (and the Ministerial confirmation that the UK Government did not expect the new duty to increase recordkeeping requirements) drew some of the sting from the section. Concern had been expressed for example that activists—environmental campaigners for example—might purchase shares in a company and then bring a derivative action against directors for failure sufficiently to "have regard to" the environmental factor noted above. The subordinate nature of the have regard to factors seems, so far, to have kept this threat more theoretical than real.

Derivative Actions

How might a claim against directors for a breach of duty be brought? In England, the answer traditionally has been clear—generally by the company itself. Actions by shareholders (derivative actions) have been hard to bring before the English Courts. Prior to October 1, 2007, the relevant common law rules on shareholder actions had been established in the case of *Foss v. Harbottle.*[4] In that case it was held that the proper claimant, where wrong was alleged to have been done to a company, was the company itself. In addition, the will of the majority of a company's shareholders was identified as being the will of the company itself. Derivative actions could only be brought where (1) the alleged wrong could not be ratified by a simple majority of the members of the company and (2) the alleged wrongdoers were in control of the company, preventing the company, as the proper claimant, from bringing a claim.

From October 1, 2007, the new derivative procedure contained in Part XI of the Companies Act 2006, extended the situations in which a shareholder may bring a derivative action. They may now be brought in respect of an actual or proposed act or omission involving negligence, default, breach of duty, or breach of trust by a director of the company. The extension of the remedy to encompass negligence (as distinct from the breach of duty of skill and care) is a potentially important relaxation as to the scope of claims that may be brought. Set against this liberalization is a new procedural requirement whereby a shareholder wishing to bring a claim must obtain permission from the court at a preliminary hearing at which they must show that they have a *prima facie* case.

On both duties and remedies a new bargain and a new balance have been struck. Only time will tell if it is the correct one.

NOTES

1. Companies Act (2006)—Director's Duties, publ. by the Association of General Counsel and Company Secretaries of the FTSE on February 7, 2007.
2. *See, e.g.*, statement of Margaret Hodge MP, Minister for Industry and the Regions, House of Commons Standing Committee, Hansard, July 11, 2006 at col 593.
3. The Attorney General, Lords Grand Committee, Hansard, February 6, 2006 at col. 256.
4. *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189.

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