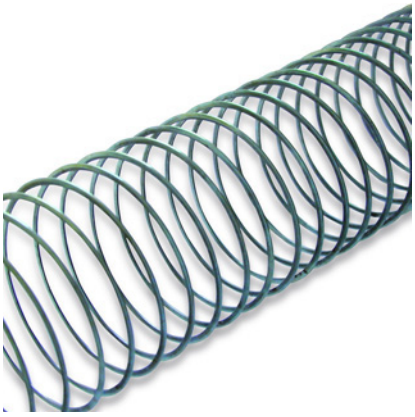

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Companies Act 2006 Update

Codification of directors' duties

On 01 October 2007, directors' general duties will be codified in statute for the first time. Codification follows a DTI survey, which concluded that only 5% of directors actually know what their duties are. Codification is intended to make it clearer to directors and shareholders alike what is expected of directors.

Given that changes in the Act will make it easier for shareholders and liquidators to sue directors for default, directors should ensure that they understand what their duties are and comply with them.

Likewise, companies should:

- Ensure that directors are briefed upon their new duties
- Review/amend director profiles and service contracts to refer to the new duties
- Where appropriate, review their existing HR, ethics, compliance and corporate responsibility policies against the background of the new duties.

Codification is of a director's general duties only. Other statutory duties remain, both in the companies' legislation (for example, the duty to deliver accounts) and in other legislation (for example, in the insolvency, health and safety legislation etc).

The codified duties

Codification is intended to be of the current law regarding directors' general duties in relation to conflicts of interest, where changes are being made. To give directors time to get to grips with these changes, implementation of the new conflict of interest duties is being delayed until 01 October 2008. A briefing note on these new duties will follow.

In the meantime, the following codified duties come into force on 01 October 2007:

- A duty to act in accordance with the company's constitution (broadly, the company's Articles) and only exercise powers for the purposes for which they were conferred.
- A duty to act in the way the director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.
- A duty to exercise independent judgment.
- A duty to exercise reasonable care, skill and diligence.

Duty to promote the success of the company

This duty is intended to codify the existing duty on directors to exercise their powers in what the director considers to be the best interests of the company. The new wording reflects existing case law in making it clear that the interests of the company's shareholders are key.

However, directors still need to tread carefully (and take legal advice, where appropriate) where the company is in financial difficulties. The Act makes it clear that in these circumstances, the interests of the creditors may take precedence.

Codification of this duty has provoked controversy due to the "new" requirement in the Act for directors, in deciding what is most likely to promote the success of the company, to have regard, amongst other matters, to:

- The likely consequences of any decision in the long term
- 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 the company maintaining a reputation for high standards of business conduct
- The need to act fairly as between the company's shareholders.

Many argue that the introduction of this requirement will, given that it will be easier for shareholders and liquidators to sue directors, force directors to adopt practices to establish that they have considered the statutory factors, leading to more protracted decision-making and the creation of paper trails.

The Government argues that directors acting in the best interests of the company have always needed to have regard to factors such as the statutory factors set out above and that it is merely enshrining good business practice in statute. The Government maintains that directors who have been exercising their business judgment in the proper manner have nothing to fear from the new legislation and that there is nothing in the Act that requires the creation of paper trails.

It remains to be seen how the law will develop. In the meantime, directors wanting to limit their exposure should take into account the following:

- The duty of reasonable skill, care and diligence will apply in relation to the requirement to have regard to the statutory factors, meaning that directors will need to pay more than lip service to them.
- Provided that directors have actively considered the statutory factors, it is unlikely that they will be criticised, even if, with the benefit of hindsight, it is clear that the wrong decision was taken. Traditionally, the courts have been reluctant to interfere with business decisions taken in good faith and this is likely to continue.
- The duty operates not only in respect of formal decisions of the board, but all day-to-day decisions taken by directors, whether as a board, or individually. It is simply impractical for directors to paper trail every single decision they make, although there may be some sense in doing so for key decisions.
- In the event of challenge, it is questionable whether recitals in board minutes recording that the statutory factors were/were not considered is really going to help a director in the witness box. It may, however, be sensible for board minutes to cover any of the statutory factors that are particularly relevant to the matter in question.

- Even if individual shareholders are able to sue a director on behalf of the company, any damages that are awarded will go to the company and not to the shareholder personally. This will continue to deter many, but not all, shareholders.

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