

# Directors' duties



## Overview

**Directors, and in some cases shadow directors, owe numerous duties to a company. Many of those duties have been developed by the courts over hundreds of years from more general common law rules and equitable principles and some have now been set out in statute.**

**The duties of a director are set out in the Companies Act 2006 (CA 2006).**

### Who are directors?

Directors are the agents of a company who manage its day-to-day business. They include any person occupying the position of director, whether or not they have that title.

### What are the general duties?

1. **The duty to act within powers** – this duty requires a director to act in accordance with the company's constitution and only exercise powers for the purposes for which they are conferred;
2. **The duty to promote the success of the company** – this duty is to act in a 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;
3. **The duty to exercise independent judgment** – this duty is not infringed by acting in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by its directors or in a way authorised by the company's constitution;
4. **The duty to exercise reasonable care, skill and diligence** – this duty comprises two tests: it requires a director to exercise 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 of the director in relation to the company (objective test) and to use the general knowledge, skill and experience that the particular director has (subjective test);

5. **The duty to avoid conflicts of interest** – this duty requires a director to avoid a situation in which the director has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company and is subject to various exceptions;
6. **The duty not to accept benefits from third parties** – this duty requires a director not to accept a benefit from a third party conferred by reason of the director being a director; and
7. **The duty to declare interests in proposed transactions or arrangements** – this duty means that a director must declare if they are in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company and the nature and extent of that interest, to the other directors;

In addition to exposure to civil liabilities, directors may be exposed

to criminal liability for offences under CA 2006 (e.g., failing to declare an interest in existing transactions or arrangements) and other under legislation, e.g. for fraudulent trading under the Insolvency Act 1986.

### Who can enforce a breach of the general duties?

A director owes their general duties to the company (except in limited cases). It follows that only the company can enforce them.

If a director breaches one or more of the general duties:

1. the company may have grounds to bring a civil action against the director; or
2. the director may be disqualified if they are shown to be unfit to be concerned in the management of a company as a result of the breach.

Action for breach of duty may be taken by the board of directors on behalf of the company. However, the directors may be unwilling, or unable, to take action against one or more of their fellow directors. For this reason, the courts created derivative claims, a concept that is now contained in the CA 2006. A company can take legal action against a director (or former director) for breach

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of duty through a derivative claim brought by one or more members on behalf of the company (the claim is derived from the rights of the company).

In addition, the court continues to have a wide discretion to give relief if one or more members of a company, in their own name, bring an action for unfair prejudice, on the grounds that:

1. the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of the members generally or some part of the members (including at least the member bringing the action); or
2. an actual or proposed act or omission of the company (including an act or omission on its behalf) would be so prejudicial.

Therefore, a member may seek relief if they have been prejudiced by a director breaching their duty to act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

### What are the consequences of a breach of the general duties?

A director of a company limited by shares is exposed to a wide range of potential liabilities that could arise as a result of their acts (or omissions) carried out during the course of business of the company under statute, contract or tort.

Possible consequences include:

1. damages or compensation;
2. restoration of the company's profits;
3. an account of profits made by the director; or
4. rescission of a contract.

Except for the duty to exercise reasonable care, skill and diligence, the general duties are



enforceable in the same way as any other fiduciary duty owed to a company by its directors. (A fiduciary duty indicates a relationship of trust, assurance or confidence between two or more parties. Most particularly they include fiduciary duties of good faith and loyalty, common law duties of skill and care, and the equitable duty of confidence.)

It is not a criminal offence to breach any of the general duties. However, there are criminal sanctions for other breaches of CA 2006 e.g. it is an offence to fail to comply with the requirement to declare an interest in existing transactions or arrangements.

### Protecting directors from liability for a breach of the general duties

The CA 2006 contains a general prohibition against exempting or indemnifying directors against liabilities that would otherwise attach to them in connection with any negligence, default, breach of duty or breach of trust.

However, there are statutory exceptions to the general rule providing that directors can be protected from liability by the acquisition and maintenance of Directors and Officers insurance by the company for its directors against liabilities and/or the company giving qualifying indemnities to its directors against certain liabilities.

Directors can also be relieved from liability by the shareholders ratifying their acts of misconduct, subject to such conduct being capable of ratification.

In the event of a breach of the general duties, it may therefore be possible for a director in limited circumstances to:

1. have the protection of insurance;
2. have the protection of an indemnity;
3. have the breach ratified by the company; and
4. obtain relief from the court for the breach of duty.

A company may provide funding for the cost of defence proceedings or the cost of an application to the court for relief, provided that such funding is given on the terms required by the relevant statutory provisions and in accordance with any applicable transitional provisions.

Where a company is a charity, the Charity Commission has power to authorise an act that involves the breach of a general duty.

### Provision of Directors and Officers Insurance

The indemnities that a company is permitted to give to directors under the CA 2006 are limited to certain liabilities to third parties or pursuant to a pension scheme liability.

An insurance policy is not limited by statute and can be much wider than an indemnity given by the company to its directors. It can cover both a director's liability to third parties and to the company itself.

The permission in the CA 2006 for a company to acquire insurance for its directors came about due to the recognition of the need for a proportionate balance to be struck between ensuring that directors do not act dishonestly or negligently and sufficiently protecting directors from liabilities, in order that individuals are not dissuaded from taking on the role of company directors.

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A person may be unwilling to take on the role of company director if the company does not maintain an insurance policy to protect its directors because of the disproportionate level of potential exposure to personal liabilities.

It is often a good idea to ensure that your employer retains Directors and Officers Insurance in place in respect of the period of your appointment to those offices, following the termination of your employment and for a relevant time afterwards to cover the limitation period for any claims against you in your former capacity as a company director.

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### Articles of association

The articles of association are a contract between the shareholders and the company and therefore the insurance provisions in the articles will not be enforceable by a director under contract law principles. Consequently, it is common practice for indemnity and insurance provisions to be inserted into the director's service contract or a separate indemnity contract with the company.

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