ACCA

THE COMPANIES ACT 2006

ITS IMPLICATIONS FOR COMPANY DIRECTORS

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Executive summary

As from October 2007, directors of all limited companies in the UK are affected by important changes in the law. These changes affect all directors of all companies – they affect executive directors and non-executive directors alike, and small and privately-owned companies as well as large and listed ones.

The changes concern the basic structure of the law governing directors' duties. Up until the enactment of the Companies Act 2006, the law in this area had been determined primarily by the courts, acting in line with - and over the years developing – established principles.

The Companies Act 2006 makes a major departure from this traditional approach by taking the most important common law principles and setting them down in legislation – this is the first time that UK law has done this. The intention is to make the law more accessible to non-experts. But it is not only the fact that the common law been translated into statute law – the Act makes some significant changes to the existing position.

The main, common law-derived duties now set out in legislation are as follows:

- directors must respect the terms of their company's constitution and act within their powers
- directors must act in such a way as is most likely to promote the 'success' of their company, and in doing so they must take account of specified consequences of any decision, the interests of the company's employees and the impact of the company's operations on the environment

- directors must exercise independent judgement
- directors must exercise reasonable skill, care and diligence – this means acting not only in accordance with whatever skills and experience they actually have but also in accordance with whatever benchmark of skill and care is considered to be appropriate for the position an individual director is occupying
- directors must avoid conflicts of interest
- directors should not accept benefits from third parties
- directors must declare an interest in any proposed transaction or arrangement

As well as 'codifying' the traditional common law duties of directors, the Act contains new powers for shareholders to enforce these duties. It also brings in some significant new restrictions on who may act as a director.

01 Introduction

The passing of the Companies Act 2006 has resulted in the biggest shake-up of UK company law for over 40 years. This new legislation has important implications for the two million UK businesses which trade as limited companies, as well as for all those who own shares in them, trade with them or provide business or professional services to them.

The Act modernises and simplifies many rules which had remained intact since Victorian times, consolidates the fragmented state of companies legislation by bringing together in one place rules which had been hitherto set out in a burgeoning number of different Acts and statutory instruments, and generally sets out to make our company law more relevant to the business conditions of the 21st century – this is summed up in the phrase 'Think Small First' which the Government adopted to guide its drafting of the new rules.

In particular, the Act sets out to put right what had increasingly become an anomaly in UK company law, namely that the law had, over the years, failed adequately to reflect the reality that the vast majority of companies on the register at Companies House are small and privately owned. One of the main aims of the Act, therefore, is to make the law more flexible and considerate of the circumstances of the smaller, owner-managed company. In this vein, the Act contains the following measures:

- Private companies (whatever their size) will no longer be required by law to appoint a company secretary, hold an Annual General Meeting or lay accounts before their members in general meeting. Whereas at present private companies can choose

to opt out of the latter two requirements, in future the default position will be that they have no obligation to hold an AGM or to lay accounts before their members.

- It has been made easier for private companies to pass resolutions in writing. Under the Act a written resolution need only attain the specific majority (simple or 75%) that is required for the type of resolution being voted on, as opposed to the current requirement for unanimity. The Act also gives new recognition to electronic forms of communication between companies, directors and shareholders.
- New default model articles will include simplified and more flexible rules for decision-making by directors of private companies. Also, the new articles will not expect directors of such companies to re-submit themselves for re-election at regular intervals.
- Private companies will be given greater discretion to allow their directors to pursue other business interests.
- A new 'small companies regime' is created for the legal rules governing accounting and reporting by small private companies: all the rules concerning the form and content of the financial statements of such companies will be set out in place. As is already the case, small private companies need not have their accounts audited and may file with the Registrar 'abbreviated' accounts in place of their 'full' accounts.

The Act will therefore make it easier for small private companies to go about their business without being subjected to excessive formality by the law.

02 The codification of directors' duties

Along with the emphasis on differentiating small private companies from larger companies, one of the Act's other core aims is to address the issue of directors' legal duties. This whole area has long been one which has been understood mainly by specialists alone. This is largely because the rules on directors' duties have never been set down clearly in legislation – the law on directors' duties is formed mainly by the accumulated collection of principles which have derived from cases heard by the courts going back to the 19th century or even earlier. It was felt that, if the Act was to succeed in its aim of making the law more accessible and easier to understand and follow, this situation should change. It was therefore decided to 'codify' the common law principles by spelling them out, in easily understandable form, in the Act.

In codifying the law on directors' duties, the Government hopes the Act will play an educational purpose, in terms of making it easier for directors to understand what is expected of them and, as a result, to improve the level of their compliance with those requirements.

But the codification of directors' duties has not involved solely the re-writing of long-established common law principles into legislation. In the process of consultation over the Act, considerable attention was given to the fundamental issue of what purpose the limited company was expected to serve in the 21st Century. In particular, the question to be resolved was should the law expect from limited companies any wider social responsibilities, or should they simply be left alone to make profits for their shareholders?

The outcome of the lengthy consideration of this issue was that there has indeed been a subtle but important movement in the responsibilities that company directors have, under the law, to take account of interests other than the pursuit of profit. This development has significant implications for how directors of companies are required to go about the process of making decisions. Not only this, but the Act confirms the practice of the courts in recent years to expect higher

standards of skill and care of company directors.

Between them, the changes made in these two respects now form the basis for how directors are expected to act and account for their actions to their companies and the outside world. It should be borne in mind that, even though the Act has sought to make a clearer differentiation between the law as it applies to large companies and the law as it applies to small companies, the new rules on directors' duties apply to all directors without distinction, regardless of the size or type of their company. The same goes for the sanctions available against directors for non-compliance or misconduct – criminal and civil sanctions and disqualification can be brought to bear on any director.

It follows from all this that any person who is considering acting as a company director, or is already acting as a director, should, in his or her own interests, be aware of what the law now expects of them and of the circumstances in which they may need to take special care.

03 The law up until 2006

Traditionally, there have been three main elements to the law on directors' duties – the fiduciary duty, the duty of skill and care and assorted specific statutory duties. These remain crucial to an understanding of the position post-codification.

The fiduciary duty
The courts have always regarded directors as being 'fiduciaries', a fiduciary being 'someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence'. Accordingly, the director is subject to similar obligations derived from the relationship of trust and confidence as are imposed on trustees and professional advisers. Most importantly, they are required to act in good faith, in the best interests of the person that they represent, in this case their company, and must not abuse the trust and confidence placed on them

The duty of skill and care
The duty of skill and care evolved from the basic fiduciary duty and sought to take into account the special circumstances of directors of limited companies, namely the fact that they have been appointed by the shareholders to look after the capital entrusted to them and to use that capital for the purposes of trying to make profits for the company. The law has determined that shareholders are entitled to expect their directors to carry out their functions with a degree of skill, care and diligence. It must be said that the standards expected of directors have, traditionally, been modest and have concentrated mainly on ensuring that a

director with particular skills brings those skills to bear for the benefit of his or her company. This situation has, however, been changing in recent years and the Act gives a further boost to the trend towards the expectation of higher standards of skill and care.

Statutory duties

Companies legislation (as well as other relevant legislation) has for many years imposed a range of specific responsibilities on directors. As well as those duties which are placed on directors by virtue of their status, many others will be imposed on the company itself – in such cases, it will be in practice the responsibility of the directors either to fulfil those obligations themselves or to ensure that they are complied with by some other person.

04 The codified statement of directors' duties in the Companies Act 2006

The Act 'codifies' long-established common law principles by spelling them out in sections 170-177, within what is referred to as a statement of the 'general duties' of directors. Referring to the list in this way helps make the point that the matters covered within it are without prejudice to the large number of specific responsibilities laid down elsewhere in the Act and also in other legislation, for example the duty for directors to prepare annual accounts. Also, it should be noted that the list is not an exhaustive re-statement of long-standing common law principles – it only contains what the Government feels are the most crucial of these. The individual elements of the statement of general duties are summarised below:

Section 170 – scope and nature of the general duties
This section makes the crucial point that the duties set out in the general statement are owed by directors to their company as a body and not to any other party – not to individual shareholders or anybody else. This statement should serve to concentrate directors' minds on whose interests they need to be trying to satisfy in their various actions – it is the company as a whole to which they are accountable.

Section 171 – duty to act within the company's powers
Section 171 makes two points. Firstly, directors must respect and act in accordance with their company's constitution, meaning that they must observe any restrictions on their powers which may be set out in the company's articles of association or which may have been agreed on by the company's shareholders. Secondly, they must only exercise their powers for a proper purpose – this means, broadly, that the powers that they have been delegated by their shareholders must be used only for the purposes of benefiting the company.

Section 172 – duty to promote the success of the company
This is perhaps the key element of the statement of duties. It begins by saying

that a director must act in the way he considers, in good faith, to be most likely to promote the success of the company for the benefit of its members as a whole. Thus, every director has a legal duty to try to act in a way which, in his or her considered judgement, is most likely to bring 'success' to the company. The term 'success' was deliberately not defined by the Government on the basis that the understanding of 'success' may be different for different types of company; for commercial companies, though, success is likely to mean sustainable profitability.

While directors are free to make their own decisions (as long as they are in good faith) and to use their business judgement in the process, in deciding how to act in line with the above, directors are also required by section 172 'to have regard' to a number of specified factors, as follows:

- 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 and
- the need to act fairly as between all members of the company

(NB they must also 'have regard' to any other, unspecified matters which may be relevant at any particular juncture).

Strictly speaking, therefore, what this means is that directors will only be complying with their legal duty to promote the success of their company if they have 'had regard' to the specified matters and to any other matters which may be relevant in the circumstances. The Act does not define what 'have regard' is intended to mean. But the Government has indicated that its intention is not to interfere with how individual companies approach the consideration of the factors in question – it has said that the weight that individual boards of directors choose to attach to the individual factors will be a matter for directors' good faith judgement. On this basis, provided that directors do not ignore the listed factors completely, and take due account of the potential significance of each of them for the company's best interests, they should remain free to make their own balanced, good faith judgements without falling foul of the law.

Section 173 – duty to exercise independent judgement

Section 173 says that the director of any company must exercise 'independent judgement'. Special concessions from this duty are offered in cases where companies have entered into agreements with regard to the future exercise of directors' discretion – this could be relevant, for example, in group situations – and where the company's constitution makes specific provision on this point.

Section 174 – duty of skill, care and diligence

Under section 174, all directors must exercise 'reasonable' care, skill and diligence. The Act brings in a new statutory test for deciding what will be reasonable for this purpose: this test has a subjective and an objective element.

The 'subjective' element is that the director must act in accordance with the general knowledge, skills and experience that he or she actually has. This re-states the traditional test that a director has been subject to and means, for example, that a director who is a qualified accountant will be expected to show a higher level of interest in and responsibility for matters relating to accountancy and finance than a fellow director who is not an accountant.

The 'objective' element is that the director must show the general knowledge and skill that may reasonably be expected of a person carrying out the functions carried out by that director in relation to the company. Thus, the director's conduct should be appropriate for the particular position that he or she occupies. By way of example, an executive director who has specific responsibility for a particular area of board activity, for example Sales or Finance, will be judged in accordance with an objective benchmark for that position. It is likely that section 174 will also lead to the development of an objective benchmark for Non-Executive Directors.

The duty to act with reasonable care, skill and diligence applies to everything that directors do – from making decisions on investments and distributions to complying with their statutory responsibilities to keep accounting records and prepare its annual accounts.

Section 175 – duty to avoid conflicts of interest

Section 175 sets out the long-established position that directors must not allow any personal or outside interest to affect their duty to their company. A director must avoid any situation in which he has, or may have, a direct or indirect interest that conflicts – or possibly may conflict – with the interests of the company. This will mean, at least, that a director should not be involved in another company that competes directly with the company.

This restriction does not extend to immaterial cases and there is in any case provision for the basic rule to be overridden. In the case of private companies, unless there is anything to the contrary in their articles, the directors may decide to authorise one of their number's involvement in a matter which gives rise to a real or potential conflict. In the case of public companies, directors may do this provided there is specific power for them to do so in the company's articles. This particular measure comes into force later than the other elements of the general duties, in October 2008, so as to give companies sufficient time to make any necessary changes to their articles.

The duty to avoid conflicts applies even to former directors. What this means is that a director who resigns his or her appointment in order to take personal advantage of a business opportunity which rightfully belongs to the company will still be liable to the company in respect of it.

Section 176 – duty not to accept benefits from third parties

A director should not accept any benefits from third parties resulting from his status as director or from his doing (or not doing) any specific act. As with section 175, immaterial benefits can be ignored if they cannot reasonably be regarded as giving rise to a conflict of interest.

As with section 175, the duty not to accept benefits from third parties still applies to, and is enforceable against, a director who has left the company.

Section 177 – duty to declare interest in a proposed transaction or arrangement

Where a director is in any way interested in a transaction or arrangement with the company, he or she must declare the nature and extent of that interest to the other directors. This can be given orally at a meeting of the directors when the matter arises for discussion, or it can be given in writing. Written notices can be either specific or general – in the latter case the director can give prior notice to the company of every firm or company in which he or she is involved, at any level.

With the exception of section 175, the above provisions come into effect in October 2007.

05 Enforcement of directors' duties

All directors are required to comply with the above general duties in carrying out their various functions while holding office. They will be judged by reference to them if ever a matter comes to court. Where directors are held to be in breach, they can be required to return any property wrongly taken from the company or to pay damages to the company.

The fact that the duties are owed by directors to the company rather than to individual shareholders or others means that, as long as boards remain united, litigation by companies against individual directors will not be a common event. But where board members fall out with each other, it will of course be open to boards to agree by majority decision to bring proceedings against one of their number in respect of any of these matters. Where a company has become insolvent, it will also be open to the company liquidator to take legal action for alleged breach of these duties in the name of the company.

But directors' duties may also be enforced by actions brought by individual shareholders. In fact, one of the big changes made by the Act is to extend the rights of shareholders to hold their directors to account. Before 2006, shareholders could only cause their company to take legal action against its own directors – via what are known as derivative actions – in very restricted circumstances. Under the reform now made, however, any shareholder has the right to apply to the court for permission to bring proceedings against a director in respect of any alleged negligence, breach of duty or breach of trust: where the court approves any such application, the proceedings will be brought against the director concerned on behalf of the company and not the individual applicant.

This, though, will not be a straightforward procedure – the applicant or applicants will first have to satisfy the court that there is a prima facie case against the director concerned, and then if satisfied on this count, the court will consider a number of other factors, including whether the applicant was acting in good faith, whether the shareholders had authorised or ratified the breach being complained of and whether the conduct of the director concerned was consistent with the requirements of section 172 (as explained above). If the court is not satisfied on all these counts it will have to dismiss the shareholder's application.

The conditions attached to the exercise of the new derivative action are intended to ensure that directors are not unreasonably exposed to the threat of litigation at the hands of disgruntled shareholders, especially 'single-issue' shareholders who might feel that the company should be paying more attention to their favoured cause. It should be remembered that, while directors are now required under section 172 to have regard to a number of 'environmental' factors, none of those factors are stand-alone requirements and the overriding duty in that section is for directors to make decisions which they consider, on balance, are in the best interests of their company.

06 Personal liability of directors

In addition to the new statutory statement of general duties, there are many other provisions of the law which have the effect of stressing the element of accountability of directors to their companies and in some cases others.

The basic rule of company law is that the company enjoys a separate legal existence from the individuals who own and control it. In keeping with this rule, shareholders and directors will not normally be personally liable for the debts and losses of their company. However, there are limits to this rule and in a number of circumstances directors can be made personally liable for debts which they allow their companies to run up.

Wrongful trading

While in general directors owe their duties to their company, the courts have held that where a company is insolvent or approaching insolvency the balance of responsibility swings around and directors' duties are owed to the company's creditors rather then the shareholders. This principle is reflected in the 'Wrongful Trading' provisions of the Insolvency Act 1986.

These provide that, where a company has gone into insolvent liquidation, the liquidator may review the trading history of the business in the two-year period running up to the liquidation and, if he finds that the directors did not do everything they could have done to minimise the eventual losses to creditors, he can apply to the court to make the directors personally liable for those losses. Thus, directors of companies

which are experiencing serious financial problems should think carefully about the implications of continuing to trade and should seek professional advice before they make any decision.

Liquidators also have the power to recover money from directors under the rules on 'Misfeasance', where they consider individual directors to be in breach of their other legal duties to the company. Such powers can, for example, be used to recover illegal dividends paid by directors to themselves.

Involvement with phoenix companies

When a company becomes insolvent, it is perfectly legal for its directors to start up another company immediately after and to start trading through that company. What is not legal (with some exceptions) is for directors of an insolvent company to start up a new company which carries such a similar corporate or trading name to the insolvent company as to suggest to customers or suppliers that the business of the defunct company is continuing. This is considered to be unfair and deceptive business conduct. Directors who infringe this rule not only risk committing a criminal offence but, if the second company itself becomes insolvent, they risk assuming personal liability for the debts of that company. Also liable on the same basis are individual directors who take directions or instructions from persons who they know are barred because of the aforementioned rule.

Acting in breach of disqualification orders

Where a director has been disqualified from acting as a director under the terms of the Company Directors Disqualification Act 1986, acting in breach of the disqualification order may render the director concerned personally liable for the debts that the company runs up during the period in which he is in breach.

In addition to the above, the Companies Act and other statutes provide for a large number of circumstances in which directors can be fined for breaches of specific requirements or else made to compensate their company.

07 Other reforms of the law regarding company directors

As well as the codification exercise already referred to, the Companies Act 2006 brings in the following changes to the law which have a direct affect on company directors.

Minimum age for service as a director
For the first time ever, company law lays down a minimum age for appointment as a director. As from October 2008, a person will need to be at least 16 years old to be appointed. Any director who is below that age when the new rule takes effect automatically ceases to hold office. The rationale behind this change is to ensure that persons who are appointed as directors are equipped to perform their duties properly. At the other end of the age scale, the maximum age of 70 for directors of public companies has been abolished.

Corporate directors
Appointing a limited company as director of another limited company is a well-established practice within groups of companies and with company formation agencies. It will continue to be possible to appoint corporate directors. As from October 2008 though, it will only be possible to appoint a corporate director if there is at least one other director who is a human being.

Registration and publication of directors' residential addresses
Traditionally, companies have been required to keep records of the residential addresses of each of the directors and those same addresses have been required

to be posted on the public record at Companies House. Under the new Act, directors need not have their home addresses posted on the public record. To bring this about, again as from October 2008, companies will have to keep not one but two registers of directors The first, which will contain the information which has to be transmitted to Companies House and will continue to be available for inspection by the company's members, will carry a 'service address' for each director – this service address may be put as the company's registered office. The second register, which will not be available for inspection, will contain the director's residential address. This information must also be communicated to Companies House but will generally remain confidential and accessible only to those with a legitimate interest in it.

08 What does all this mean for directors?

The Companies Act 2006 has reinforced the reputation of the UK as having one of the most flexible and unobtrusive company law regimes in Europe. It is much easier and cheaper to form and run companies in the UK than it is in most other EU countries and, because of this, many businesses from outside the UK have chosen to register as companies in the UK, even if they conduct their business activities elsewhere.

It would, however, be misleading to assume from this comparatively light touch compliance regime that managing a company involves little commitment and responsibility on the part of its directors. There remains a clear distinction in law between the limited company and the unincorporated business and the Act has made some significant changes to the responsibilities and liabilities of those who run companies. Directors of small and private companies in particular should bear in mind that if they take full advantage of the deregulatory exemptions available to them under the Act and dispense with both auditors and company secretaries the onus of complying with the various financial, accounting and administrative provisions of the Act will fall even more squarely on their shoulders. Any person who acts as a director of a company, whether large or small, private or public, needs therefore to familiarise themselves with what the law expects of them and feel confident that they can meet that standard.

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