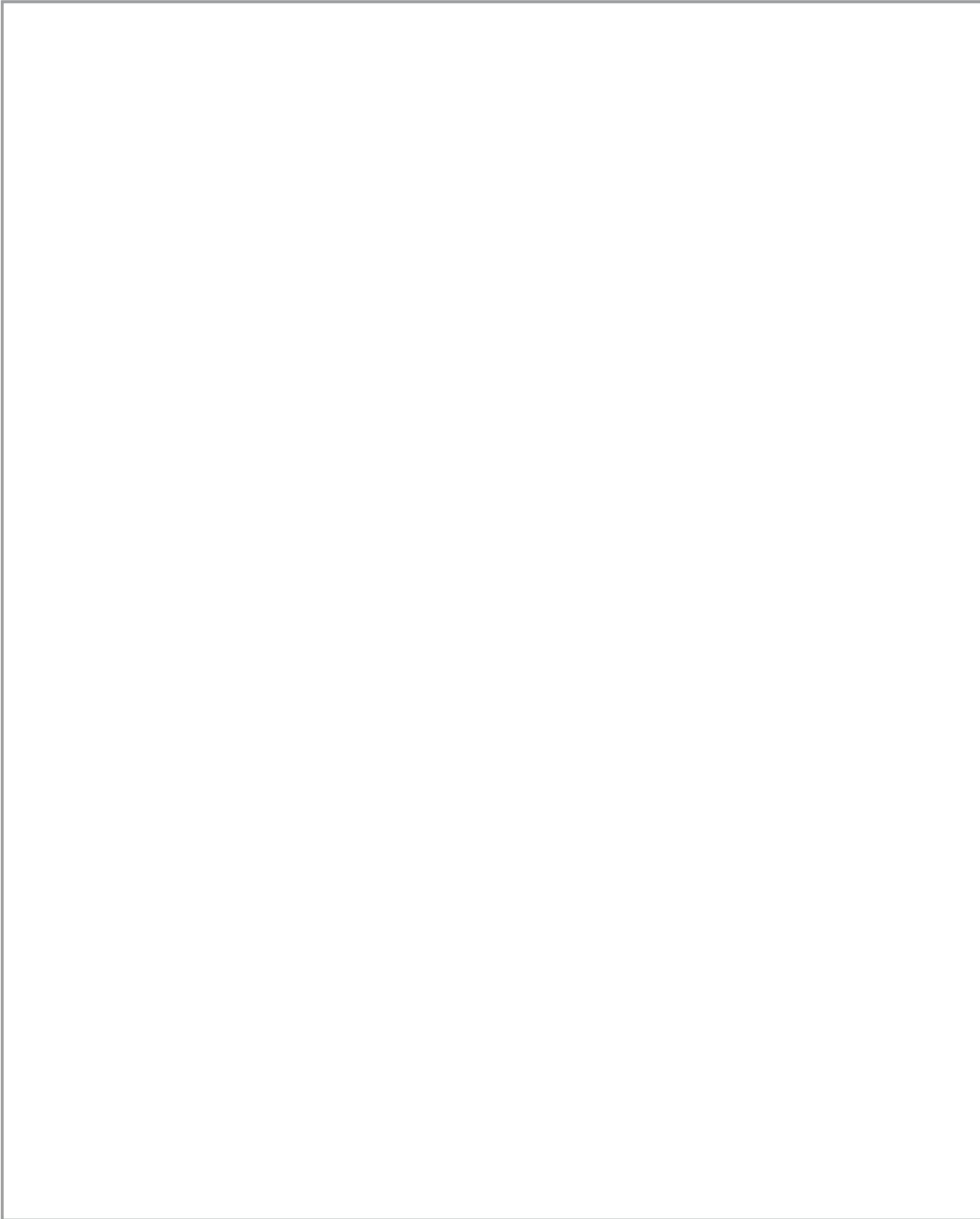


A guide to directors' responsibilities  
under the Companies Act 2006



# A guide to directors' responsibilities under the Companies Act 2006

**John Davies**

Head of Business Law, ACCA

Certified Accountants Educational Trust, July 2007

## ABOUT ACCA

---

ACCA (the Association of Chartered Certified Accountants) is the largest and fastest-growing global professional accountancy body with 296,000 students and 115,000 members in 170 countries. We aim to offer first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

We deliver our qualifications in partnership with many organisations. We operate 18 joint examination schemes with national bodies around the world and work closely with 470 registered tuition providers and nearly 8,500 employers of accountants and finance professionals. We aim to support our students and members throughout their careers, delivering services through a network of nearly 80 offices and centres.

We use our expertise and experience to work with governments, donor agencies and professional bodies to develop the accounting profession. We aim to achieve and promote the highest professional, ethical and governance standards and advance the public interest.

ACCA's reputation is grounded in over 100 years of providing accounting and financial qualifications. Our long traditions are complemented by modern thinking, backed by a young, dynamic membership.

No responsibility for loss occasioned to any person acting or refraining from acting as a result of any material in this publication can be accepted by ACCA.

© The Association of Chartered Certified Accountants, 2007

# Contents

|   |            |
|---|------------|
| <b>Abbreviations used in the text</b>                                     | <b>6</b>   |
| <b>1. Introduction</b>  | <b>7</b>   |
| <b>2. What is a 'director'?</b>   | <b>10</b>  |
| <b>3. Eligibility to act as a director</b>                                | <b>16</b>  |
| <b>4. Appointment and vacation of office</b>                              | <b>18</b>  |
| <b>5. Powers of directors</b>   | <b>25</b>  |
| <b>6. Directors' 'general duties' under the Companies Act 2006</b>        | <b>28</b>  |
| <b>7. Directors' responsibilities concerning accounting and reporting</b> | <b>47</b>  |
| <b>8. Directors' other statutory responsibilities</b>                     | <b>61</b>  |
| <b>9. Directors' transactions with their company</b>                      | <b>71</b>  |
| <b>10. Consequences of breaches of directors' responsibilities</b>        | <b>82</b>  |
| <b>11. Ratification of breaches and relief from liability</b>             | <b>100</b> |
| <b>12. Special cases</b>  | <b>102</b> |
| <b>Appendix 1</b>   | <b>107</b> |
| <b>Appendix 2</b>   | <b>130</b> |

## Abbreviations used in the text

|                        |   |
|------------------------|---|
| 'CA 2006' or 'the Act' | Companies Act 2006                          |
| 'CDDA 86'              | Company Directors Disqualification Act 1986 |
| CLR                    | Company Law Review Steering Group           |
| 'IA 86'                | Insolvency Act 1986                         |
| 'the Code'             | the Combined Code on Corporate Governance   |

# 1. Introduction

1.1 The enactment of the Companies Act 2006 in November of that year was the culmination of a nine-year project which amounted to the biggest official review of UK company law for over 40 years. The project comprised a three-year in-depth investigation by a Government-appointed expert group – the Company Law Review Steering Group (CLR) – detailed research on specific issues by the Law Commissions of England and Wales and Scotland, and extensive public consultations on a wide range of technical matters by the Government itself. The new Act which has emerged from this exercise consolidates the great bulk of the pre-existing companies legislation, in the process creating the biggest single statute in UK legal history: the Act contains 1,300 sections and 16 schedules, with much more material to be issued separately in the form of regulations to be made under the Act.

1.2 The aim behind the reform process was not, however, just to consolidate the fragmented state of UK companies legislation but to modernise it where appropriate and thus make it more relevant to the business conditions of the 21st century. In keeping with this aim, the Act makes changes in the following areas (among others):

- It streamlines the legal rules for the administration of private companies so as to recognise the fact that, in most such companies, ownership and management is in the hands of the same individuals. Private companies, which form the vast majority of the companies on the register at Companies House, will no longer need to appoint a company secretary, hold an Annual General Meeting or lay accounts before their members in general meeting. The Act also makes it easier for such companies to pass resolutions in writing.
- It brings company law up to date by giving new recognition to electronic forms of communication for the purposes of conveying statutory information. Public companies are required to have web sites and to post specified corporate information on them.
- New measures are introduced to try to improve the accuracy and integrity of company information on the public record at Companies House. The Act also gives the Registrar of Companies the power to insist that any statutory document, including companies' annual accounts, be filed electronically.
- Company auditors will be able to negotiate liability limitation agreements with their clients.
- Shareholders have new powers to intervene in the governance of their companies.

A significant constitutional reform made by the Act is that the separate company law status of Northern Ireland is ended, meaning that the new Act and all the regulations to be made under it will apply for the first time to the whole of the UK.

- 1.3 Two fundamental issues were considered during the review process in the context of the need to modernise UK company law. First, should the law expect from limited companies any wider social responsibilities or should they simply be left alone to make profits? Secondly, should any new legislation be more specific about what the responsibilities of company directors should be? The outcome of the lengthy consideration of these two related issues is that not only have the legal responsibilities of directors been for the first time ‘codified’ – in other words set out in statute, rather than left to be addressed by common law principles – but they have been in some respects expanded with the aim of ensuring that, in running their companies, directors take into account a range of wider ‘environmental’ factors that are considered to characterise responsible corporate behaviour in the 21st century. As well as this important reform to the structure of the decision-making process, the Act recognises the trend of the courts in recent years by expecting higher standards of skill and care from company directors. Between them the changes made in these two areas now form the basis for how directors are expected to operate and account for their actions to their companies and the outside world.
- 1.4 The greatest potential impact of these new statutory responsibilities for directors will be felt in large and listed companies which have complex business activities and large numbers of shareholders and other stakeholders. In fact, however, the changes apply to all companies, large and small, so it is essential that all directors familiarise themselves with what is expected of them under the Act.
- 1.5 The new Act is carefully worded to make clear that, as has always been the case, directors owe their legal responsibilities to the company alone, and not to outside parties (except in certain exceptional cases). Thus, there is no question that in carrying out their functions directors will be accountable routinely to individual shareholders or to third parties. But the rules on directors’ accountability to their own members are reinforced – shareholders are given new legal rights to initiate company proceedings against directors for breach of their responsibilities. Thus, the revised rules on directors’ duties are backed up by strengthened provisions for the enforcement of those duties.
- 1.6 The Act makes a number of other, technical reforms to the rules on eligibility to act as a company director and to the information that individual directors must provide to their company and place on the public record. In addition, directors need to be aware of the changes which are made to the legal rules on the administration of company affairs, since they will be responsible for ensuring compliance with these rules.
- 1.7 This guide looks at what the Companies Act 2006 means for company directors, with special emphasis on the reforms to the rules on directors’ duties. It is not a comprehensive guide to the Act but to those aspects of the Act which impact squarely on directors. Much of the content may be familiar in that it refers to legal requirements which have been carried over from the Companies Act 1985 and other legislation (though the statutory references have changed), but the new measures introduced by the Act are looked at separately. Where appropriate, relevant company law principles laid down by the courts are referred to in the text. The guide also contains a comprehensive table, at Appendix 1, of the statutory duties for breach of which directors may be criminally liable under the Act, together with a summary of relevant offences under other legislation.



- 1.8 Two additional points need to be made at the outset. First, although the Act became law in November 2006, it was decided to bring it into effect in stages between then and October 2008, with existing provisions of the Companies Act 1985 remaining in force until such time as they are formally repealed or replaced by provisions of the new Act. This guide only refers to provisions of the new Act but makes clear, where appropriate, when the 'new' provisions take effect. Most of the 'codified' rules on the duties of company directors – addressed in Chapter 6 of this guide – were scheduled to come into force in October 2007. Where an implementation date other than October 2007 applies with respect to a particular provision, a reference to the date concerned is given in the text. The second point to bear in mind is that, even though the Companies Act 2006 is so large, many matters of detail – including rules on the form and content of company accounts – are left to be dealt with in regulations to be made under the Act. In due course, therefore, compliance with the Act will require companies and their directors to comply with the provisions of those regulations as well.

## 2. What is a 'director'?

- 2.1 All companies are required to have at least one director (a public company must have two) (section 154 CA 2006). This is because companies, as 'artificial' legal entities, cannot act themselves – they need to act through other persons. A company's directors are the persons to whom the law looks to manage the affairs of a company on behalf of its owners. This is so even in the case of small private companies which may have only one or two shareholders: such a company must still have at least one director even where the director and the shareholder are one and the same person. In such a situation the law will still see a technical distinction between the interests of the shareholder as owner of the company and the responsibilities of the director as the person who makes decisions on its behalf.
- 2.2 Although the CA 2006 requires all limited companies to have directors, and while a company's directors are the people who invariably take most of the decisions relating to its affairs, the term 'director' is not actually defined in the Act. The nearest that the Act comes to a definition of the term is the provision in section 250 CA 2006 which says that the term 'director' includes *any person occupying the position of director by whatever name called*. This is a long-standing feature of UK company law and has remained intact following the law reform process. It means that, in determining whether any person is or has been a director of a company, account must be taken not only of whether a person has been duly appointed and registered as a director in accordance with the prescribed procedures, but also of whether that person is or has been exercising the actual legal functions of a director and taking part as a full member in the process of making the sort of decisions that directors routinely make.
- 2.3 The absence of an exact definition of the term may be considered by many to be unhelpful in the context of making the law accessible to non-specialists. On the other hand, the absence of an exhaustive definition serves the interests of flexibility: while most companies are commercial enterprises, they can also be charities or quasi-partnerships, in which case the companies concerned may feel it more in keeping with the nature of their operations for the persons who control them to be referred to principally as 'trustees' or 'partners'. The broad definition of the term 'director' ensures that persons who are commonly referred to in such terms will be directors for company law purposes and will be treated as directors by the law. Further, the deliberately wide definition also allows the law on directors' duties to be applied to persons who, for one reason or another, do not formally register themselves as directors of their companies (yet still act as though they are directors).
- 2.4 Accordingly, whether or not a person is a director of a company as far as the law is concerned depends not so much on his or her title but on the role that he or she plays in relation to the company and, in particular, to its decision-making processes. If a person has a job title which includes the title 'director' then this would suggest that the person concerned is in fact a director of the company. This need not, however, always be the case – the title 'director' is sometimes bestowed on an employee as a designation of purely internal significance (NB where an employee with a job title which includes the word 'director' presents him or herself as such to a third party, that other party may be entitled to infer that the person is in fact a director for legal purposes). Conversely, if a person whose title does not include the word 'director' nevertheless actually participates in the central decision-making processes of a company, that person will be 'occupying the position of director' under section 250 and will therefore be a director under the law.

2.5 For the purposes of attributing compliance responsibilities under the Companies Act, all directors are deemed to be 'officers' of their company (section 1121 CA 2006). The company secretary and, in some cases the company's auditor, are also officers.

2.6 While the Act does not generally differentiate between different types of director, the following categories are in widespread use.

### **EXECUTIVE AND NON-EXECUTIVE DIRECTORS**

---

2.7 An *executive director* is a director who works on a full-time basis for his or her company, whether or not this is under a contract of employment. A sole director of a small company will invariably fit this description, even if he or she decides not to adopt it formally. The term 'executive director' is most commonly used, though, in the context of large and listed companies in order to differentiate between those directors who have full-time commitments to their company, usually under contracts of employment, and those directors who do not, viz '*Non-executive directors*'.

2.8 Directors who have been given specific responsibility by the board for dealing with particular aspects of the company's affairs and who carry status titles that bear this out, eg 'Finance Director' or 'Sales Director' will invariably be executive directors and employees of the company. Non-executive directors (commonly referred to as NEDs) will not usually be given specific responsibility for the management of any specific aspect of the company's affairs.

2.9 The special status of non-executive directors has been the subject of considerable attention in recent years in the context of developing guidance on corporate governance in – primarily – the listed company environment. NEDs are now looked to to provide special input to the process of governance. The fact that NEDs are not involved with their company on an executive, day-to-day basis means that they can offer, and are today expected to offer, a more detached, objective and comprehensive view of how the company's affairs ought to be directed than might be possible if the company's board consisted solely of executive directors. Another virtue of NEDs, which is by no means limited to the listed company environment, is that they can provide a board with skills, perspectives and experience to complement the talents of the executive directors. In the light of the increasingly specialised role of the NED, the courts have started to address the question of how the role of the NED differs in law from that of executive directors and how the two groups should be expected to interact (see paragraphs 6.58-6.59 below).

2.10 The UK's authoritative guidance on corporate governance for listed companies, the Combined Code, has developed and helped to standardise the role of the NED. The Code suggests that NEDs:

- should constructively challenge and help develop proposals on strategy
- should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance

- should satisfy themselves as to the integrity of financial information and that financial controls on risk management are robust and defensible
- are responsible for determining appropriate levels of remuneration for executive directors and have prime roles in appointing – and where necessary removing – executive directors and in succession planning.

To reinforce the distinctive contribution that NEDs are called upon to provide, the Code states that every board should include a balance of executive directors and NEDs with the aim of ensuring that no individual or group of individuals can dominate the decision-making process. Further, it suggests that, except for 'smaller companies' – which in this context means those outside the FTSE 350 – at least half the board, apart from the chair, should comprise NEDs who are considered to be 'independent' in terms of their character, judgement and circumstances.

- 2.11 The European Commission has added to the official recognition of the contribution that NEDs can make to the governance of listed companies by issuing a formal Recommendation to EU member state governments to take positive action to encourage the participation of NEDs. The Recommendation, which is not legally binding, contains minimum standards for the qualifications, commitment and independence of NEDs. It can be accessed via the EU's website at [http://ec.europa.eu/internal\\_market/company/independence/index\\_en.htm](http://ec.europa.eu/internal_market/company/independence/index_en.htm)

#### **De jure directors**

- 2.12 A de jure director is one who has been validly appointed as a director via standard procedure, eg by being elected by the company's membership at a general meeting or by being appointed by the board acting under constitutional authority, and whose appointment has been duly registered with Companies House. This is the orthodox route to service as a director.

#### **De facto directors**

- 2.13 A de facto director differs from a de jure director in that he or she will not have been validly appointed as director via any accepted standard procedure. Notwithstanding any defects in his or her appointment, however, a de facto director will take part in the board's decision-making machinery on the same basis as other directors and, in its dealings with the outside world, the board may hold him or her out to be a director of the company. Where a person acts as a de facto director, he or she will be subject to the law on directors' duties in exactly the same way as will de jure directors.

### Shadow directors

2.14 Unlike the foregoing terms, the term shadow director is regulated by the Act. The statutory definition of the term is contained in section 251 of CA 2006. It says that a shadow director is 'a person in accordance with whose directions or instructions the directors of a company are accustomed to act.' While the term 'accustomed to act' leaves open the question of whether the directors have to obey the directions/instructions given to them all of the time or only most of the time, the definition will clearly apply in any case where a board of directors recognise communications given to them by a particular person as being effectively directions or instructions and where they obey these directions or instructions on any routine basis. The definition of shadow director can apply to individuals or to corporate bodies.

2.15 There are two exceptions to the statutory definition of shadow director.

First, a person will not be deemed to be a shadow director of a company if he or she is a professional adviser to a company and its directors act on the basis of advice given to them solely in that capacity. So an accountant who advises a company's directors on issues relating to compliance with their various responsibilities will not be thereby risk becoming a shadow director. (This could conceivably change if the adviser sought to give instructions or directions to the directors which went beyond the status of purely professional advice and the directors came to view the adviser's guidance as directions and instructions and acted upon them accordingly: any professional adviser should be careful to ensure that this situation does not arise).

The second exception applies to parent companies. Where a company is a parent company, the possibility of it being deemed to act as a shadow director of its subsidiary companies is real – the greater the level of control exercised by the parent the higher the chances are that it will fall within the definition. The Act does not discount the possibility of this happening but says that, for the purposes of three specified sets of Companies Act rules, a parent is not to be regarded as a shadow director in respect of its subsidiaries 'by reason only' that the directors of the subsidiary companies are accustomed to act in accordance with the parent's directions or instructions. The relevant provisions are:

- The general duties of directors (Chapter 2 Part 10 CA 2006) (see Chapter 6 below)
- Transactions requiring members' approval (Chapter 4 Part 10 CA 2006) (See Chapter 9 below)
- Contracts with sole member who is a director (Chapter 6 Part 10 CA 2006) (See Chapter 9 below)

2.16 The question of whether there is any real distinction between the de facto director and the shadow director has been the subject of legal and academic debate over the years. Some have argued that there is no real difference between the two categories and that they should not be treated separately. Certainly, the two categories have one thing in common, ie the fact that although persons acting in both capacities will not have been validly appointed as de jure directors of a company, they both act as if they have the right to make decisions on its behalf or at least to contribute to the decision-making process.

2.17 It is, however, possible to identify three significant differences between the two categories:

- the term 'shadow director' is a term which is recognised and defined in the Act: the term de facto director is not.
- the nature of the two categories is different – while a de facto director will openly act as a director and will be held out to be a director both by virtue of his own actions and possibly by the actions of the company, the shadow director will not normally claim to be a director, preferring to exert influence from behind the scenes.
- the legal definition of the term 'shadow director' provides that a person will be held to occupy this position if the directors of a company routinely act upon his or her directions or instructions. In other words, a shadow director, unlike a de facto or de jure director, will not be one among equals – he or she (or it, in the case of a company acting as a shadow director) will be the person who is recognised by the directors as being the company's ultimate source of decision-making power and they will be prepared to carry out the instructions given by that person.

2.18 The courts have laid down the following further guidelines on the identification of shadow directors:

- to be a shadow director a person need not give directions or instructions on every matter but should be shown to have a real influence on the company's affairs
- the courts will assess on a case by case basis whether particular communications amount to directions or instructions
- 'advice' given to directors may amount to a direction or instruction
- a shadow director does not in all cases have to operate 'in the shadows': depending on the facts of the case it is possible for a shadow director to operate openly as such

*(Secretary of State for Trade and Industry v Devrell [2000] 2 WLR 907).*

2.19 Further, a holding company will not be considered to be a shadow director of one of its subsidiaries unless the subsidiary's directors as a whole are accustomed to act on the parent's directions or instructions (*Kuwait Asia Bank EC v National Mutual Life Nominees Ltd [1990] BCC 567*). But even if a parent company is held to be a shadow director of one of its subsidiaries, it does not necessarily follow that the directors of the parent must also be shadow directors of the subsidiary (*Re Hydrodan (Corby) Ltd [1994] BCC 161*).

2.20 Some (but not all) of the provisions of the Act which impose duties on directors are specifically extended to shadow directors.

### **Managing directors**

- 2.21 Companies' articles of association will often give their directors the right to appoint a managing director (or similar term, such as chief executive) to assume senior powers of responsibility within the executive director team. The exact powers of any person appointed under such a provision will depend on the terms of the articles and of the person's employment contract with the company.

### **Alternate directors**

- 2.22 A company's articles may also entitle individual directors of the company to appoint an 'alternate' to represent them when they are unable to attend meetings or otherwise to perform their duties as directors. The Companies Act itself does not make any provision for alternates, so where the articles are silent on this matter, directors may not appoint alternates.

### 3. Eligibility to act as a director

- 3.1 There has never been any prior test of competence that must be passed by a person wishing to act as a director of a limited company. Neither is there any expectation that any formal qualification be held by such a person (unlike the eligibility rules that apply to company secretaries). The UK Institute of Directors issues the qualification 'chartered director' which aims to equip individuals with the skills needed by directors, especially in the listed company environment, but this has no legal recognition or significance. UK law has always made the limited company format very widely available to businesses of all kinds and sizes and, in keeping with this liberal approach, the law allows persons from all backgrounds to act as directors.
- 3.2 The principal statutory restrictions on acting as director derive from the Company Directors Disqualification Act 1986 (CDDA). Section 11 of that Act provides that persons who are undischarged bankrupts or subject to a bankruptcy restrictions order may not act as directors of limited companies. It is an offence for persons to act in contravention of these provisions. The CDDA lays down a number of other grounds on which directors may be disqualified by law from acting as directors: these are addressed in Chapter 10.
- 3.3 The above notwithstanding, however, the CA 2006 introduces two new restrictions on eligibility to act as a company director. The first is that a person must be at least 16 years of age on appointment (section 157 CA 2006). Where a person is under the age of 16 when section 157 comes into force – in October 2008 – he or she will be deemed to cease to be a director as of that date and the company will have to make the necessary amendment to its register of directors. This is the first time that an age restriction has been imposed on directors by UK company law – in a famous case of the early 20<sup>th</sup> century (the Marquis of Bute case) it was held that it was possible for a six-month old baby to be appointed as director of a limited company. Such absurdities are no longer to be tolerated. That being said, the Act authorises the government to issue regulations under the Act for the purpose of specifying circumstances in which a person under the age of 16 could still validly be appointed as a director: it will be for future governments to consider whether to exercise this power.
- 3.4 The second restriction introduced by the CA 2006 is that, while a company may still act as a director of another company, this will only be possible under the Act if there is at least one other serving director who is a 'natural person', ie an individual human being (section 155 CA 2006). This change will have important implications for, eg, company formation agencies and parent companies that have adopted the practice of using nominee companies to act as directors of their newly-formed companies and subsidiaries respectively. With the coming into force of the Act, it will no longer be possible to set up a company with a single director that is another corporate body – where a corporate director is appointed, there must be at least one other director who is a natural person. As is the case with section 157, the Government decided to bring this particular provision into effect later than most of the other provisions of the Act – in October 2008 – so as to give companies more time to make any necessary adjustments.
- 3.5 Individual companies may, in their own articles of association, place additional restrictions on who may and may not act as directors. For example, articles may insist that the company's directors own shares in their company and may specify what the minimum shareholding is to be.



- 3.6 While the law still places few restrictions on eligibility, it should be borne in mind that the Act makes some significant changes to the law on directors' duties. In the light of these, and regardless of statutory or constitutional eligibility tests, any person should consider carefully, before accepting appointment as a director, whether they are aware of the standard of conduct that the law expects from them and whether they are confident that they will be able to meet that standard.

## 4. Appointment and vacation of office

### **MEANS OF APPOINTMENT TO OFFICE**

---

- 4.1 Since every company has to have directors, it follows that there have to be means by which they are validly appointed. For the most part, it is left to individual companies to determine the means of appointment, via their articles of association. Articles may also impose requirements as to the number of directors that there should be on the board and as to whether directors should be subject to some sort of specific eligibility condition, such as a requirement to hold shares in the company. (It should be borne in mind that, while new model articles of association – separate model documents for private, ‘guarantee’ and public companies – are being issued that are consistent with the changes made to company law by the 2006 Act, these new model articles will not apply automatically to pre-existing companies: those companies will continue to be subject to their existing articles, which will in most cases be based on the model articles issued under the Companies Act 1985, until such time as they are changed. Therefore, any pre-existing company which wishes to take full advantage of the changes made to company law by the CA 2006 should consider revising its articles).
- 4.2 In only one situation, namely the appointment of a new company’s first directors, is the means of appointment dealt with by the Act. In the case of a company formed after October 2008, its first directors will be those who are listed as such in the statement of proposed officers (section 12 CA 2006). This mirrors the approach taken in section 10 of the Companies Act 1985.
- 4.3 Thereafter, new directors can be appointed by the company in one of the following ways:

#### **(i) By resolution of the company’s members**

The conventional way for a director to be appointed is via a resolution passed by the company’s members. Company articles will invariably provide for this to happen. Article 78 of the model articles issued under the Companies Act 1985 (known as Table A) says that the company’s members may appoint a person to act as director by ordinary resolution, either to fill a vacancy or to act as an additional director. The draft model articles for private and public companies issued by the DTI in March 2007 both make similar provisions for the appointment of new directors by ordinary resolution of the company’s members.

With regard to public companies only, section 160 CA 2006 places a condition on how the motion to appoint new directors is presented to the members. It says that the proposed appointment of two or more new directors must be presented to the members and voted on individually, unless the company’s members have previously agreed unanimously to the consideration of multiple appointments by means of a single resolution. Any resolution in breach of this rule is void.

#### **(ii) By resolution of the directors**

Again, a company’s articles of association will usually empower the directors to appoint a new director, either to fill a vacancy or to act as an additional director. Table A contains such a power at article 79; the draft 2007 model articles for private and public companies both contain provision for new directors to be

appointed 'by decision of the [existing] directors.' A power of this kind is especially useful when a director leaves office unexpectedly and the remaining director or directors feel that the company needs to recruit a new person in the short term, ie before the next scheduled general meeting, either to fill a skills gap or to ensure that the company has any required minimum number of members set down by the articles. Article 79 of Table A (and article 20 of the draft 2007 model articles for public companies) provide, however, that a person appointed by the directors holds office only until the next annual general meeting, at which he or she must stand for re-election. No such provision is made in the draft articles for private companies.

A statutory power for directors to make an appointment to fill a 'casual vacancy' is contained in section 168 CA 2006. This section provides that, where a director is removed by ordinary resolution of the members under that same section, the 'vacancy', if not filled by the members at the same meeting, may be filled as a casual vacancy by the directors.

#### **(iii) By resolution following direction from the Secretary of State**

The Secretary of State has the power to intervene if it appears that any company is in default regarding section 154 CA 2006 (the requirement for private companies to have at least one director and public companies to have at least two directors) or section 155 CA 2006 (the requirement for a company to have at least one director who is a natural person). The power takes the form of a direction given to the company to make good the default concerned, which must be complied with within a specified period. Notice of the appointment should be given, in due course, to Companies House in the standard manner. Failure to comply with the terms of the direction is an offence.

#### **NOTIFICATION OF APPOINTMENT**

---

- 4.4 All new appointments as directors must be notified to Companies House within 14 days (section 167 CA 2006). This is the responsibility of the company. The notice, given on the prescribed statutory form, must include the details that are required to be held on each individual director in the company's own register of directors, ie name, service address, country of residence, nationality, business occupation and date of birth.

#### **RE-APPOINTMENT TO OFFICE**

---

- 4.5 Companies' articles will also invariably provide for the frequency with which directors, once appointed, are required to present themselves for re-election. It is common for private companies not to require their directors to subject themselves for regular re-election – the 2007 draft model articles for private companies contain no such standard requirement. This will not be appropriate for public and listed companies – a requirement for regular re-appointment is thus present in the 2007 draft model articles for public companies. The Combined Code on corporate governance (see Chapter 12) says that i) all directors should be submitted for re-election at regular intervals; and ii) the board should ensure a planned and progressive refreshing of the board's membership.

## **MEANS OF VACATION OF OFFICE**

---

4.6 A director may leave office in one of the following ways.

### **(i) Removal by the members of the company**

4.7 The members of a company have a statutory power to remove a director from office at any time by passing an ordinary resolution for that purpose (section 168(1) CA 2006). That section also provides that the members' right of removal applies notwithstanding the terms of any contractual or other agreement between the director and the company, meaning that the power is exercisable with respect to executive directors with contracts of employment with the company as it is to any other type of director.

4.8 The law affords certain rights to a director whom the members, or some of them, wish to remove. Firstly, the resolution needs to be considered at a general meeting of the company, meaning that removal cannot be effected by means of a process of correspondence. Secondly, 'special notice' must be given of the intention to table the resolution: this means that 28 days notice of the meeting must be given to the company. Thirdly, the director has the right under section 169 CA 2006 to protest against the proposal to remove him or her. The director has the right to speak to the resolution when it is tabled at the meeting and is entitled to require the company to circulate to the company's members, in advance of the meeting, any written representations (provided they are of a 'reasonable length') that he or she prepares concerning the resolution. If the representations are not sent out as required, the director can insist that they are read out at the meeting.

4.9 A company which is presented with a request that it circulate representations in these circumstances may, however, apply to the court for a determination that the director's rights under section 169 are being 'abused'. If the court is satisfied that this is the case, the company will not be bound to circulate the representations and the court may even make the director liable to pay part or all of the company's legal costs. Even where the company succeeds in such an application, though, this will not affect the director's right to be heard on the resolution at the meeting.

4.10 While section 168 appears to be quite a straightforward route for removing a director, in practice it may not always be an easy thing for ordinary members to achieve. For one thing, a company which is presented with the special notice required by the Act is not actually obliged to convene the necessary meeting to consider the resolution (*Pedley v Inland Waterways Association Ltd* [1977] 1 All ER 209). This means that the members who wish to remove a director may be required, additionally, to muster sufficient support – that is, members representing 10% of the company's paid-up share capital or (in the case of a company without share capital) 10% of its membership – to require the company's directors to convene a general meeting under section 303 CA 2006. Alternatively, in the case of a public company (which is required by law to hold an AGM), the members may opt to oblige the company to table the resolution at a forthcoming AGM, in which case the threshold of support they will need to muster in order to require the inclusion of the resolution on the agenda will be 5% of the total voting rights in the company or at least 100 members with voting rights who have paid up an average of at least £100 each on their holdings (section 338 CA 2006).

4.11 While the members may have power under section 168 to remove a director from office, this could prove an expensive matter for the company where the director has a contract with the company entitling him or her to compensation or damages for dismissal during the period of the contract.

#### **(ii) Resignation**

4.12 Individual directors may wish to voluntarily terminate their own appointments for any number of reasons, both personal and business. They will normally do this via a formal resignation from office. It is important that the director's intention to resign is communicated to the company unambiguously and in accordance with any procedural rules that the company has identified as being necessary for this purpose. If it is not done properly then the company may be able to refuse to recognise the notice of resignation and, in the meantime, the director might have to continue to assume partial responsibility for the actions of the board.

4.13 Traditionally, companies' articles of association have set out in detail the mechanics of how resignation should be effected. Table A provides, in article 81, that a director may resign by giving notice to the company. Table A provides a further three things:

- any notice required to be given by or to the company should be in writing – this is to ensure that a director's intentions are clear and to allow for things that may be said at the heat of the moment at a fractious board meeting to be re-considered;
- proof of an envelope being properly addressed, pre-paid and posted will be conclusive evidence that the notice was given; and
- notice will be deemed to have been given 48 hours after it was posted.

Accordingly, where a company has adopted articles of association that mirror the above provisions of Table A, a director wishing to resign should ensure that these core criteria are complied with.

4.14 A notice of resignation will be treated as effective if it is given to the company secretary. (Note that under section 270 CA 2006 – which takes effect in April 2008 – private companies are not obliged to have a company secretary: in this situation, it will be convenient to send the notice of resignation either to the chair or to each of the directors.) Even where the articles require notice to be given in writing, however, if a notice of resignation is made orally and is accepted there and then by the other directors present, the notice will be effective and the resignation may be definitively recorded by the company (*Latchford Premier Cinema Ltd v Ennion [1931] 2 Ch 409*).

4.15 The provisions in Table A as to proof of posting provide comfort for a director where he or she decides to send the notice of resignation through the post as opposed to presenting it in person to the company secretary or chairman. Where a director decides to use this method, it is a sensible precaution to make a copy of the notice and to secure and retain proof of posting: article 115 of Table A will thereafter ensure that the notice is deemed to be validly given even if the notice never actually arrives or the company claims that it has not received it.

- 4.16 Individual companies may have articles which diverge from the standard requirements of Table A or go further than them. For example, it may be the case that a set of articles will provide that a resignation is not effective until it has been approved or recorded by the board. Thus, directors should ensure that they are familiar with any special provisions of their companies' articles with regard to resignation procedures.
- 4.17 The draft 2007 model articles, for both private and public companies, contain fewer formal requirements for the process of resignation. They say only that the director will cease to hold office 'as soon as a notification to the company that [he or she] is resigning or retiring from office takes effect in accordance with its terms.' This suggests that the resigning director can specify the date on which his or her resignation will take effect and that this will be conclusive in determining the effective date. The draft articles go on to provide that, in respect of all notices and communications between directors and their company, they may be sent by any means authorised under Schedule 4 of the Companies Act 2006 itself – this will expressly legitimise electronic as well as hard copy means of communication for this purpose. (Note that, to be valid, electronic communications to the company must be sent to the address specified by the company for the purpose of the communication). The draft 2007 articles also provide that individual directors may agree with their company that notices may be deemed to have arrived within a specified time of their being sent.
- 4.18 In *CMS Dolphin Ltd v Simonet* [2002] BCC 600, it was held that a director's decision as to whether or not to resign was not subject to any fiduciary duty – he was entitled to resign even if his resignation might have a disastrous effect on the business or reputation of the company. But, as is discussed later in paragraph 10.44 et seq, a director should consider carefully any decision as to whether to resign if the company is in financial difficulties and there is a strong possibility that insolvent liquidation will result. The wrongful trading provisions of section 214 IA 86 mean that, where a company's directors know or ought to conclude that their company cannot avoid insolvent liquidation, they will be at risk of being made personally liable for the debts that their company continues to run up unless they can show that they took 'every step' to minimise losses to creditors. Exposure to liability under these rules is not avoided by the simple expedient of resignation – a court can impose liability on any person who has been a director of the company in the two-year period leading up to liquidation. Accordingly, resignation in such circumstances could mean that a director who leaves, as opposed to staying on to try to arrange a proper resolution of the company's affairs, may be more – rather than less – likely to fall foul of the provisions of section 214.
- 4.19 When a director resigns from a company it is the responsibility of the company, under section 167 CA 2006, to file a notice of that fact with Companies House. The notice is given on a prescribed statutory form, and is – on receipt – added to the company's file on the Companies House database and made available for public inspection. The purpose of the filing of this form is solely to enable the details of the company's officers on the public record to be kept up-to-date and is unconnected with any question of the validity of the director's resignation. Where a company fails to give proper notice of a director's resignation, this may give rise to legitimate concern on the part of the resigned director as to his or her continuing responsibility for the company's affairs. The Act contains power for new measures to be introduced, via regulations, which will improve the rights of persons to insist that inaccurate information on a company's

public file is rectified: this power may conceivably be used to ensure that resignations are properly recorded. While this would provide some additional comfort, the non-deposit of a notice of resignation does not mean that a director who has validly resigned in accordance with the constitutional provisions of his or her company is still a director for legal purposes.

**(iii) Cessation of office under terms of the company's constitution**

- 4.20 A company's constitution may provide that a director will cease to hold that office in any of a number of specified circumstances. Article 81 of Table A lists the following circumstances as leading to automatic vacation of office:
- if the director becomes bankrupt or makes any arrangement or composition with his creditors generally
  - if the director is disqualified from holding office as director (see Chapter 10)
  - if he or she is, or may be, suffering from mental disorder and either –
    - is admitted to hospital in pursuance of an application for admission to treatment under the Mental Health Act 1983 or, in Scotland, an application for admission under the Mental Health (Scotland) Act 1984, or
    - an order is made by a court having jurisdiction (whether in the UK or elsewhere) in matters concerning mental disorder for his detention or for the appointment of a receiver, curator bonis or other person to exercise powers with respect to his property or affairs;
  - if he or she has for more than six consecutive months been absent without the permission of the directors from meetings of the directors held during that period and the directors resolve that the director vacates office
- 4.21 The draft 2007 model articles for both private and public companies update these criteria in some respects but add a new, more wide-ranging power for directors to dismiss one of their number. Under this new provision, a director will cease to hold office once he or she receives a notice signed by all the other directors stating that he or she should cease to be a director.
- 4.22 Companies are also free to specify in their articles additional grounds for vacation of office by directors. For example, they may provide that a director will be deemed to vacate office if convicted of a criminal offence or if they have failed to obtain a specified number or proportion of the company's shares by a set deadline.

**(iv) Cessation of office on grounds of age**

- 4.23 As described in Chapter 3, under section 157 CA 2006, a director must be at least 16 years of age. Where a director is appointed in breach of that provision, the appointment is void. Any person who was already serving as a director before section 157 came into effect – October 2008 – ceases to hold office as of that date. Note, however, that regulations may be made under section 158 to specify circumstances in which persons under the minimum age may be validly appointed. There is no upper age limit for service as a director.

**VALIDITY OF DIRECTORS' ACTS**

---

- 4.24 The acts of individual directors will be valid and binding on the company even if it subsequently transpires that there is a defect in their appointment, that they were disqualified from acting as a director (see Chapter 10 below), that they had ceased to hold office or were not entitled to vote on a particular matter (section 161 CA 2006). While this ensures that company transactions are not invalidated, it will not absolve the director concerned from any personal repercussions that may ensue.



## 5. Powers of directors

- 5.1 The legal powers available to any board of directors are powers to act on behalf of their company. Their powers are not independent of the company and as a rule they may not carry out, in the name of the company, any activity that the company itself is not entitled to perform. Consideration of the issue of directors' powers needs therefore to take place in the light of the powers of the company itself.
- 5.2 The restrictions on what companies themselves may and may not do have today been substantially removed. In the past, company activities were subject to the rule of *ultra vires*, meaning that individual companies were entitled to carry out only those activities that were – expressly or implicitly – provided for in the objects clauses of their constitutions. That rule led to the drafting of very lengthy objects clauses as companies sought to give themselves so wide a range of powers as to ensure that the validity of their activities would not be called into question. The Companies Act 2006 now provides that, unless a company's articles specifically restrict the objects of the company, the company's objects are unrestricted (section 31 CA 2006). Accordingly, whereas in the past a company's constitution would have had to specify what activities it was to be entitled to perform, under the new Act the role of the constitution as regards the company's powers is to specify what restrictions are to be imposed on what the company may do. A company with no constitutional restrictions on its range of activities may in theory conduct an unlimited range of lawful activities.
- 5.3 The company's constitution will not only establish the range of activity that the company may engage in but will also, invariably, define the powers that are to be delegated from the company to the directors. The articles will usually delegate formally to the directors wide powers to manage the business and affairs of the company as they think fit. As well as a general delegation of power, the articles may also set out a series of specific powers, such as to the power to borrow up to a certain amount, the power to refuse to register share transfers and to forfeit shares in certain circumstances. The relevant article in Table A is article 70, which says that the directors of the company shall manage the business of the company and exercise all of its powers subject to the provisions of the Companies Act, the memorandum and articles, and any direction that may be given by the company by special resolution. The draft 2007 model articles provide that, subject to the articles, the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company.
- 5.4 Where the company's constitution places any restrictions on the powers of the company or on the powers of the directors, those restrictions must be observed by the directors as part of their duties to the company (section 171 CA 2006). In most cases, however, the presence or absence of any such constitutional restrictions will have no bearing on third parties who deal with the company. Section 39 CA 2006 says that the validity of any act undertaken by a company is not to be called into question on the ground of any lack of capacity provided for in the company's constitution. Thus, where a company engages in transactions that are prohibited under its constitution, those transactions will still be valid and enforceable. Section 40 CA 2006 adds that, where a third party deals with a company in good faith, the power of the directors to bind the company, or to authorise others to do so, is deemed to be free of any restriction in the company's constitution. Specifically, any third party is not bound to enquire as to whether there is any constitutional limitation on the directors' powers to authorise the transaction in question, meaning that he or she is not expected to inspect the company's constitutional documents or even to raise the issue with

the directors during the course of negotiations. Further, section 40 provides that the third party will not be regarded as acting in bad faith by reason only that he or she actually knew that the transaction was beyond the powers of the directors. (NB while sections 39 and 40 CA 2006 do not take effect until October 2008, corresponding provisions of the Companies Act remain in force).

5.5 These provisions concerning constitutional capacity now reinforce the long-standing common law position that a third party is not expected to be aware, when dealing with a company, of whether relevant internal management requirements have in fact been complied with (*Royal British Bank v Turquand* [1856] 6 E&B 327). Thus, as far as third parties are concerned, they are in most cases entitled to expect that when they are dealing with directors of a company, those directors are authorised to commit their company to the transaction concerned.

5.6 If the company's members become aware of a proposed transaction that would exceed the directors' powers, they may be able to bring proceedings to restrain the transaction in question, but even if they are unsuccessful and the transaction goes ahead, the directors would still be in breach of their statutory duty to the company under section 171 CA 2006 and liable to the company accordingly (see Chapter 6 below).

5.7 Once powers have been laid down by the articles, the company cannot ordinarily intervene subsequently. If particular powers have been constitutionally delegated to the board, then it is entitled to exercise those powers and the company's members cannot override board decisions nor direct the board on how to act. For example, when the board is delegated the power to sue in the company's name, the company in general meeting cannot later restrain it from doing so in any particular case (*Breckland Group v London & Suffolk Properties* [1988] 4 BCC 542).

5.8 The powers of individual directors to bind their company are also strongly affected by the rules of the law of agency. These rules apply to the determination of whether a principal (in this case the company) is bound by the acts undertaken by persons acting on its authority (its agents) in their dealings with third parties. The Act now makes clear that a contract may be made by a company by any person acting on its authority, either express or implied (section 43 CA 2006 – but note that this does not apply in Scotland).

5.9 As a rule, powers delegated via a company's constitution are to the directors acting collectively. Where this is the case, individual directors have no 'actual' authority – express and explicit authority – to commit their company as its agents. The articles may, however, expressly provide for the delegation of powers to a managing director (or to other executive director(s), or to a committee of the board): where this is the case, the managing director will be considered to have an additional, special authority to negotiate on behalf of the company and to bind it. If no such further delegation of power is provided for, no single person or body apart from the board itself has explicit authority to act on behalf of the company (although the company may subsequently ratify any such act in general meeting).

5.10 While express authority to act for the company does not normally rest with individual directors, in some cases a director may be deemed to have 'ostensible' or 'apparent' authority to act as his or her company's agent – this authority will be created if a third party is led to believe that the person is acting with the authority of the principal, whether or not that person has 'actual' authority.

- 5.11 The conditions which must be present if apparent authority is to apply were set down in the case of *Freeman & Lockyear v Buckhurst Park Properties (Mangal) [1964] 2 WLR 618*.
- (i) There must be some representation ('holding out') that the agent had the requisite authority to act. This need not involve an explicit statement of authorisation to the third party but instead can take the form of conduct by the principal that gives the necessary impression to the third party.
  - (ii) The representation must come from persons who do have actual authority to manage the business generally (ie the board) or the specific business to which the contract relates (eg an executive director).
  - (iii) The other party must have relied on the representation in entering into the contract.

#### **SPECIFIC POWERS**

---

- 5.12 Over and above the general powers delegated to directors via the articles, directors also have the following specific powers:

##### **(i) Right to inspect company books**

- 5.13 All serving directors have the right to inspect the company's records, minutes and accounts (*Conway v Petronius Clothing Co Ltd [1978] 1 WLR 72*). In exercising this right they may also be accompanied by an expert.

##### **(ii) Power to make provision for employees on cessation of company's business**

- 5.14 Directors have the independent power under section 247 CA 2006 to make provision for the benefit of the company's current or former employees when the company's business ceases or is transferred wholly or in part. This power, which is exercisable notwithstanding the provisions of 172 (duty to promote the success of the company) may only be exercised with the approval of the members in general meeting or (if authorised by the company's articles) by resolution of the board.

##### **(iii) Power to call general meetings of the company**

- 5.15 Directors have the power to call general meetings of the company (section 302 CA 2006).

## 6. Directors' 'general duties' under the Companies Act 2006

### **BACKGROUND TO THE REFORM OF DIRECTORS' DUTIES**

---

- 6.1 As explained in Chapter 1, one of the outcomes of the company law reform process was the 'codification' of the principles of directors' duties under the common law. This particular reform had been strongly supported by the CLR and by the Law Commissions of England and Wales and Scotland. They all considered that it would improve the general understanding of the law in this area: setting out the established law concerning directors' duties in statute would make the law easier to follow by non-specialists and thereby help reduce unnecessary legal costs, particularly for smaller companies.
- 6.2 The Government endorsed this approach and Parliament subsequently gave effect to it via the statement of the 'General duties of directors' which is set out in Chapter 2 of Part 1 of the Act. By virtue of these provisions, what were previously looked upon as common law principles are now presented as provisions of primary legislation and will be viewed as such by the courts.
- 6.3 The provisions on directors' general duties do not, however, limit themselves to a simple re-statement of existing common law principles. Not all the existing rules have been codified, and in some significant respects the statement adds wholly new elements to the law on directors' duties. It would be fair to say, therefore, that the provisions of the Act in this area not only codify the more fundamental aspects of the established law on directors' duties but develop them further.
- 6.4 This evolution of the law on directors' duties has happened because of the conscious attempt made, via the Company Law Review process, to re-think the legal position of the limited company within the wider business and social environment. Traditionally in the UK, it has been accepted that the mission of any commercial company is to maximise economic value for its shareholders – other objectives are ancillary to this core purpose. Many have argued, though, that companies' activities have, potentially, such a wide impact on other elements in society that it should not be seen as sufficient for companies to operate single-mindedly in the economic interests of their shareholders and to be accountable only to them.
- 6.5 These arguments are not new: the fundamental question – 'in whose interests are companies supposed to be run?' – was debated at length in the mid-20th century by the US commentators AA Berle and EM Dodd. Berle's basic argument, that 'all powers granted to a corporation or to the management of a corporation are necessarily and at all times exercisable only for the benefit of all the shareholders' became known as the shareholder primacy theory, which has tended to hold sway in the company law regimes of the Anglo-Saxon world. Dodd's counter-argument was that companies are social institutions and should have responsibilities not just to their shareholders but also to their employees, customers and the general public. This conflicting philosophy came to be associated with the 'social model' regimes of continental Europe, with their insistence on incorporating the concerns of non-shareholder interest groups into the corporate decision-making process. While it used different terminology, the CLR addressed the same basic issue in the course of its consideration of what should be the future scope of UK company law. In seeking a suitable model for the future, it considered two options – an 'enlightened shareholder value' (ESV) approach and a 'pluralist' approach.

- 6.6 The concept of ESV as considered by the CLR accepted that maximising shareholder value was and should be the ultimate aim of limited companies. Nonetheless, developing thinking about corporate social responsibility and the role of company directors with regard to it should be accommodated within that concept. Accordingly, the legitimate aim of maximising shareholder wealth should be tempered by an express acknowledgement that any company's prospects of success are dependent on its effective management of the various risks that confront it. The concept implied that a blinkered approach to the pursuit of shareholder wealth, whereby short-term profit was sought at the expense of long-term value, and the interests of suppliers, customers and other 'stakeholders' were taken for granted, was not conducive to 'sustainable' wealth creation. Shareholders should be entitled to expect that the companies in which they invest, acting through their directors, pay heed to and address all issues that are likely to be relevant to the good management of the company – and hence the interests of its shareholders – over the long term. The ESV concept therefore holds that shareholder interests will be best served if companies are responsive to a wider group of dynamics than the single-minded pursuit of profit.
- 6.7 The 'pluralist' approach, on the other hand, went much further in terms of expanding the responsibilities of companies and their directors in relation to external matters. It argued that companies and their directors should be accountable not only to their shareholder bodies but to other, external 'stakeholder' interests, which might include bodies such as environmental pressure groups and trade unions. Under this approach, directors would be required to act in the interests of a range of different interest groups; in some cases the interests of one or more of those external groups could, conceivably, be given priority over the interests of the company's own shareholders. Companies and/or their directors could be liable to those stakeholder groups if they failed to protect the groups' interests. This approach, if it had been adopted, would have altered substantially the character of the limited company because it would have obliged companies to play an active role in the pursuit of wider social policy goals, over and above their own business objectives.
- 6.8 The CLR concluded that the pluralist approach was unreasonable and impractical as a basis for the scope of future UK company law. It was unreasonable in that it subjected the interests of shareholders to external groups even where those groups had no ownership stake in the company. It was seen as impractical in that it would expose company directors to the substantial uncertainty of deciding how to balance what were often likely to be competing and conflicting interests.
- 6.9 The CLR therefore decided to develop its proposals for the reform of company law on the basis of the concept of ESV: this approach was subsequently endorsed by the Government. This decision has had direct implications for the formulation of the new statutory provisions regarding the duty of directors to act in the best interests of their company. In summary these provisions say that directors are (still) expected to manage their companies' affairs in the interests, ultimately, of their members collectively and not of any external parties. Nonetheless, in keeping with the 'enlightened' element of the ESV concept, the law now provides expressly that directors' understanding of what are the best interests of their company is expected to be influenced by their systematic consideration by them of a range of specified 'environmental' factors, which are outlined below.

- 6.10 While directors retain the discretion to make the ultimate decision as to what courses of action are right for their company in a business sense, the law is now involved in the structure of the corporate decision-making process in a way that it has not been before. The overriding aim of the new legislation in this area is to ensure that, in making decisions, directors are mindful and reflective of all matters which could conceivably have a bearing on the long-term success of their company.
- 6.11 Whether this 'inclusive' approach to decision-making needs to be incorporated into law is another question. It was argued by many, both before and during the process of Parliamentary scrutiny of the Act, that well-run companies, whose directors were complying with their long-standing legal duty to act in the best interests of their companies, always have sought to pay due attention, in their decision-making processes, to all matters which could affect their company's long-term health. The enlightened shareholder value approach was already, therefore, effectively practised by responsible companies and there was no need to spell out specific responsibilities in this area in law. Opponents also argued that imposing rigid rules on the decision-making process would introduce unwanted bureaucracy and increase the risk that directors might be sued for non-compliance with procedural obligations.
- 6.12 Nevertheless, the view of the CLR, a view which was supported by many interest groups and individuals as well as the Government itself, was that society's expectations of responsible corporate behaviour had changed and that it was right that the law should reflect that development. Even if responsible companies were already acting in ways which were consistent with the requirements being proposed, such practices were by no means universal and any project to modernise UK company law would be incomplete if it did not provide for some accommodation of the principles of corporate social responsibility. The CLR believed that it was possible to codify existing principles so as to clarify company law in the interests of the great majority of directors who are not specialists in this area, as well as reflecting expressly society's changing expectations of responsible corporate behaviour. This approach has now been adopted in the statement of general duties.
- 6.13 For those companies which already adopt this 'inclusive' decision-making approach, the reform may mean little more than a need to ensure the proper documentation of the fact that the board has paid due regard to the matters in question. For other boards, however, the change may mean that they need to broaden their approach to the decision-making process and perhaps be prepared to consider the implications for their company of matters that they have not thought to be relevant in the past. In all cases, however, directors should be aware that their decisions as to what course of action is in the best interests of their company are now to be made in the light of a standard set of 'environmental' factors.

## **THE LAW ON DIRECTORS' DUTIES UP UNTIL 2006**

---

- 6.14 The specific provisions of the Act on the 'general' duties of company directors are discussed later on. To place those provisions in context, however, it is worth reviewing how the law has dealt with these issues up until now.
- 6.15 Under the law as it existed until the enactment of the CA 2006, the duties imposed on company directors have fallen under three principal headings:
- the fiduciary duty
  - the duty of skill and care
  - the statutory duties.

### **(i) The fiduciary duty**

- 6.16 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' (*Bristol and West Building Society v Mothew [1998] Ch1*). Accordingly, the director is subject to similar obligations derived from the relationship of trust and confidence as those that 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. While the role of director is often compared to that of a trustee proper, they are not quite the same – the trustee is expected to observe a higher standard of prudence in protecting the interests of his or her beneficiary than would be reasonable to impose on a person in charge of a commercial company. Subject to this allowance for a higher threshold of risk on the part of directors, however, the positions of the two are comparable.

### **(ii) The duty of skill and care**

- 6.17 The duty of skill and care evolved from the basic fiduciary duty and sought to address the particular implications of the director's position within the limited company environment. In this environment, shareholders entrust to directors responsibility for running a business which is funded by the capital they have invested. Those shareholders, therefore, have a direct interest in the degree of skill with which the directors manage the business. A further feature of the limited company environment which had a bearing on the development of the duty of skill and care was and still is that the concept of limited liability ensures that the members of a company are able to limit their personal liability to the company's creditors for the company's debts. Thus, both shareholders and creditors have always had to accept significant financial risks in their dealings with company directors. The duty of skill and care evolved as a means of restricting those risks to an acceptable level. Traditionally, though, the standards of skill and care that have been expected of company directors in the UK have not been high. This is in large part because Parliament and the courts have not wanted to discourage entrepreneurial activity by restricting access to the company format. The courts have also accepted that, given the wide range of backgrounds from which directors can

legitimately come, it is unrealistic to expect the conduct of all directors to be judged by a single benchmark. Accordingly, the standards expected of directors have, over the years, been modest and have concentrated mainly on considerations of whether the director concerned has lived up to the standards that may be expected by reference to his or her own background and experience. 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.

### **(iii) Statutory duties**

- 6.18 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 that 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.

## **THE STATEMENT OF GENERAL DUTIES IN THE COMPANIES ACT 2006**

---

- 6.19 The provisions that codify the long-standing common law duties of company directors are presented in sections 170–177 CA 2006. In these eight sections, which are referred to here collectively as the statement of general duties, established common law rules and principles are condensed into a series of concise statements. Most of these follow familiar lines but, as has already been discussed, there are some important innovations. The effect of the statement of general duties is discussed in the remainder of this Chapter. Note that most of these provisions come into effect in October 2007 – the exception is section 175, which takes effect in April 2008.

### **(i) The status of the general duties**

- 6.20 The statement begins by stating unambiguously that the various duties set out in the statement are owed by directors to their company (section 170(1) CA 2006). Each aspect of the statement, therefore, needs to be viewed as representing the director's duty to his or her company as a collective body: no duty is owed under the statement to individual shareholders or to persons outside the company. This point is of particular significance for the duty to promote the success of the company under section 172 (see paragraph 6.29 et seq below).
- 6.21 Section 170(3) and (4) explain how the new statutory statement of duties is intended to relate to the established legal framework. Sub-section (3) says that the new statement has effect in place of 'certain' common law rules and equitable principles as they apply to directors. By virtue of this, rules and principles which for many years have defined directors' legal duties are superseded by the corresponding provisions of the new statutory statement. This notwithstanding, sub-section (4) says that the duties which are set out in the statement are to be 'interpreted and applied in the same way as common law rules or equitable principles and regard shall be had to the corresponding common law principles and equitable principles in interpreting and applying the general duties.'



- 6.22 Accordingly, while the established rules and principles that are superseded by the statement of general duties no longer have direct effect, the accumulated experience of the courts in defining directors' duties over many years is likely to remain highly influential for the way that the courts decide to interpret the new statutory provisions. Where the statement uses familiar wording and terminology, case precedents can be expected to be followed faithfully. Consistency with established practice may be less so where the new statement adopts new wording and terminology – the courts have held that cases decided under superseded legislation cannot be of any assistance when the language of the statute has been completely and deliberately changed (*Re MC Bacon Ltd (No 1)* [1990] BCLC 324).
- 6.23 The statement also makes clear that, while in general a person who ceases to be a director no longer has obligations under it, this will not be the case in two circumstances (section 170(2)). The first of these relates to section 175 (duty to avoid conflicts of interest) and the second to section 176 (duty not to accept benefits from third parties). Both those exceptions are discussed in the appropriate paragraphs below.
- (ii) Duty for directors to act within their powers (section 171 CA 2006)**
- 6.24 Section 171 says that a director must a) act in accordance with the company's constitution and b) only exercise powers for the purposes for which they are conferred.
- 6.25 Section 171(a) requires a company's directors to follow all the directions as to how the company's affairs should be organised and administered that are set down in the company's constitution and – just as importantly – to comply with any limitations laid down in the constitution on what activities a company may validly engage in. The passage implies that it is essential that all directors familiarise themselves with the detailed contents of their own company's constitution.
- 6.26 The definition of the company's constitution in section 17 of the Act includes not only the company's articles of association but the resolutions and agreements specified in section 29 – these include special resolutions passed by the company and any resolutions or agreements that have been agreed to or which otherwise bind classes of shareholders.
- 6.27 Section 171(b) sets out the long-standing common law rule that directors' powers should be used only for the purposes for which they were conferred – this has long been known as the 'proper purposes doctrine'. The doctrine was developed by the courts in order to ensure that directors, as agents of their companies with extensive powers to manage their affairs, apply those powers in ways that the company as principal would wish, and for no other, improper purposes which are inconsistent with the interests of the company.
- 6.28 The proper purpose doctrine causes particular problems in its transposition to a statutory basis. This is because the courts have been unable over the years to establish fixed principles as to what is a proper purpose and what is not: the matter has tended to be dealt with very much on a case-by-case basis. In the case of *Howard Smith Ltd v Ampol Ltd* [1974] AC 821 it was said:

'To define in advance exact limits beyond which directors must not pass is, in their Lordships' view, impossible. This clearly cannot be done by enumeration, since the variety of situations facing directors of different types of company in different situations cannot be anticipated.' 'It is ... necessary for the court, if a particular exercise of [a power] is challenged, to examine the substantial purpose for which it was exercised and to reach a conclusion as to whether that purpose was proper or not.'

**(iii) Duty to promote the success of the company (section 172 CA 2006)**

6.29 This is the single most fundamental requirement of the statement of general duties and is crucial to the performance of directors' duties under the new legislation. The precise wording of section 172 caused more discussion than virtually any other clause in the Bill during its passage through Parliament and its full effect will, inevitably, only become known after it has been tested in the courts. The following paragraphs review its essential content.

6.30 Although section 172 is presented in the legislation as a single, integrated measure there are effectively two, but interlinking, parts to it. These two parts are discussed separately below.

**Part 1 – statement of objective**

6.31 This first part states that a director must act in the way that he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

6.32 This passage codifies, but with some potentially significant changes of terminology, the long-standing common law position that directors must act in the way that they themselves, acting in good faith, consider to be conducive to the interests of their company (*Re Smith and Fawcett Ltd [1942] Ch 304*). Provided they meet this standard, honest business misjudgements or failures will not give grounds for claims of negligence against them, and the courts for their part have always been reluctant to intervene in questions of business judgement. The intention of the Government in formulating the new statutory statement was to re-iterate this basic position.

6.33 There are three key elements to the first part of the statement. The first is the phrase 'considers, in good faith'. This suggests that, as long as they act honestly and in way which is mindful of their responsibilities, directors have the right to use discretion and judgement in the exercise of their decision-making powers. The second key element is the reference to directors' obligation to make decisions which are most likely to promote the 'success' of their company. This term, which is not defined in the Act, was chosen to appear in the statement rather than the long-standing common law concept of acting in the company's 'interests'. Some have voiced doubts as to whether the two concepts are really the same, and whether the new term will be interpreted as such by the courts in due course. But success would appear to imply, at least, the achievement of whatever objectives the company concerned has set for itself, whether they be financial, strategic or otherwise. Explanatory notes prepared by the Department of Trade and Industry (DTI) and published along with the Act convey the Government's intention that 'the decision as to what will promote the success of the company, and what constitutes such success, is one for the director's good faith judgement'. The third key element of Part 1 of the statement is that directors must seek the success of

their company 'for the benefit of its members as a whole'. This suggests that the aim should be to achieve 'success' for the company – however this is determined – which can be viewed as such and shared in by the generality of the company's membership, and not just by some of them.

**Part 2 – the enlightened shareholder value provisions**

6.34 The second part of section 172 incorporates the gist of the ESV concept which was recommended by the CLR and which was discussed in paragraph 6.7 above. As already stated, the first and second parts of section 172 need to be looked at as an integrated whole.

6.35 In the course of making their decisions under Part 1 of the section, then, directors are now required to 'have regard' to each of the following list of matters:

- 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 members of the company.

(Note that this list is presented in the Act as a non-exhaustive list: directors must also, in the same way, 'have regard' to 'other matters', which are – unhelpfully – not specified in the Act).

6.36 This part of the statement gives rise to two practical questions. Firstly, what is meant by the requirement for directors to 'have regard' to the various factors? And secondly, how are directors supposed to resolve any conflict which might arise between the specified factors?

6.37 The term 'have regard' is, again, not defined in the Act. The DTI's explanatory notes only make the point that 'it will not be sufficient to pay lip service' to the specified factors. (They add, however, that in 'having regard to' the specified factors their conduct must meet the test of reasonable care, skill and diligence which is set out at section 174 – see below). There is, therefore, no instruction as to exactly what treatment is expected to be given to these factors in the decision-making process. What seems clear, however, is that directors can not be expected to make decisions which favour all of the specified interests at all times. This is because in some cases the various interests specified may conflict with each other. For example, a decision to close down an uneconomic factory in an area of high unemployment might have an adverse impact on the local community where the factory was situated; it could damage the economic interests of businesses that supplied materials to that factory; and it would certainly be against the interests of the company's employees (or at least those employees who were made redundant). On the other hand,

the directors' decision to cut the company's losses might be in the long-term economic interests of the company and safeguard the position of the remainder of the company's workforce. Secondly, companies which are involved in lines of business which are ethically contentious will have particular cause to 'have regard' to the desirability of maintaining high standards of business conduct. But those companies will at the same time have employees and suppliers – and of course shareholders – and their interests are to be taken into account too. In the great majority of circumstances, therefore, the reaching of some sort of considered, balanced view is likely to be the only practical course of action.

6.38 Pending any elaboration by the courts in due course, it would be reasonable to suggest that the term 'have regard' in this context is meant to require directors to be aware systematically of the listed factors – and any other factors which may affect the company's interests in respect of a particular matter – and to take them into account in the decision-making process. But this should not be done in isolation and should always be done in the broader context of deciding whether a particular course of action would be likely to promote the success of the company. Directors are likely to be at most risk of breaching their duty under section 172 if, as a result of failing to pay adequate heed to any of the factors addressed in Part 2, they make decisions or pursue courses of action which prove conspicuously unsuccessful in business terms. Such an outcome could conceivably occur, for example, where a company fails to put in place adequate environmental protection controls – a reference to point d) above – which results in pollution, death or injury to employees or third parties and, consequently, loss of revenue and consumer confidence in the company. Directors might also be at risk of breaching their responsibilities under section 172 where they allow their company to engage in illicit business practices – a reference to point (e) above – and where the exposure of those activities leads to bad publicity for the company, regulatory or criminal action against it and, in the long run, adverse consequences for the company's commercial and business interests.

6.39 It should be borne in mind that, by virtue of section 170(1) CA 2006, directors' duties are owed only to their company and there is no suggestion that directors will owe duties directly to any bodies that might claim to speak for the interests covered in the second part of section 172(1). Accordingly, it is clear that the various 'stakeholder' factors set out therein need to be taken into account to the extent that the implications of any decision for them would have a bearing on the success of the company as a whole.

6.40 As with the term 'have regard', there is no indication in the Act of what weight should be given to individual factors. The Government's intention was to leave decisions on this matter to the directors. As long as they 'have regard' to the factors listed – and any other relevant factors – they will have fulfilled their responsibilities under the second part of section 172(1). During the passage of the Bill through Parliament, the Government Minister responsible, Margaret Hodge MP, said:

'We believe it is essential for the weight given to any factor to be a matter for the director's good faith judgement. Importantly, the decision is not subject to the reasonableness test.'

6.41 Complying with the new decision-making procedure is the most obviously important aspect of section 172 as far as individual directors are concerned. There is also, however, the issue of how, if it all, directors should record the fact of their compliance for future reference. The Act is not explicit about how boards of directors should reflect their compliance (or otherwise) with section 172 in board minutes. One prominent school of thought on this is that, since minutes of board meetings will usually only record decisions, and will not necessarily record every single factor that was considered in the course of arriving at those decisions, section 172 will have no effect on the amount of detail recorded in minutes. Supporters of this point of view also point to section 309 of the Companies Act 1985, which has for many years required directors to have regard to the interests of their company's employees, and claim that this requirement has not led company boards to feel obliged to cross-refer to this provision when recording all decisions that affect their workforces. Against this, the purpose of the Act in this area is clearly to introduce a greater measure of structure and formality into the decision-making process. It seems clear also that, when faced with an allegation of being in breach of section 172, either from shareholders or a liquidator, directors will find it far easier to defend their actions if they can produce evidence that they were striving to comply with the statutory procedure. Companies may thus find it safer to include in their minutes at least a standard reference to the fact that they have followed the decision-making provisions in section 172 in respect of their deliberations (assuming of course that they have done so). Where matters arise that call on directors to make a conscious decision as to which of a number of competing and apparently mutually-exclusive factors to favour – for example the interests of the company's employees against the impact of the company's operations on the environment – directors may feel it useful to record the reasons why that particular option was considered to be the more likely to promote the success of the company.

6.42 Section 172(3) makes clear that the requirements discussed above are subject to the common law and statutory rules which provide that where a company is insolvent or approaching insolvency, directors owe their duties not to shareholders but to their company's creditors (see Chapter 10 below).

**(iv) Duty to exercise independent judgement (section 173 CA 2006)**

6.43 This section says that a director must exercise independent judgement. There are two caveats to this basic position. Firstly, the duty to exercise independent judgement is not infringed if the director acts in accordance with an agreement duly entered into by the company which restricts the future exercise of discretion by the directors. And secondly, the duty is not infringed if the directors act in a way that is authorised by the company's constitution. These two caveats enable a company's shareholders, if they see fit, to exert some measure of control over the directors' powers of discretion.

**(v) Duty to exercise reasonable care, skill and diligence (section 174 CA 2006)**

6.44 This is the section of the general duties which identifies the standard of competence which directors are expected to meet in the course of carrying out their functions. While, as with other areas of the statement of general duties, the Act codifies existing principles of the common law, this section is noteworthy because it incorporates into the Act a developing theme of the common law in recent years, namely that the law should impose on directors a higher standard of skill and care than has traditionally been expected of them by the UK courts.

6.45 The following extracts from court judgements illustrate the level of demands traditionally made of company directors in the area of skill and care:

'A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.' (Re *City Equitable Fire Insurance Co Ltd* [1925] Ch 407).

'[A director] may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without accruing responsibility for the mistakes which may result from such ignorance. Such reasonable care [as a director owes to his company] must, I think, be measured by the care an ordinary man might be expected to take in the same circumstances on his own behalf.' (Re *Brazilian Rubber Plantation and Estates* [1911] 1 Ch 425).

But while the general standard of skill and care has been low, those individual directors who have particular skills relevant to the business of their company will have been expected to use those skills for its benefit (Re *Cladrose Ltd* [1990] BCC 11).

6.46 The approach of the courts has, however, been evolving, particularly since the introduction in 1986 of a new, stricter test of competence for directors who have taken companies into insolvent liquidation. The following statement, approved by the Court of Appeal, is a reflection of the gradual raising of the bar in terms of what the law expects of directors generally:

'Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.' Re *Barings plc (No 5)* [2000] 1 BCLC 523.

6.47 As regards the duty to exercise diligence, a term which equates to conscientiousness and attentiveness, the term is used in this context to refer to the responsibility of directors to take an active interest in ensuring that the affairs of their company are properly looked after. Again, the courts have traditionally adopted a relaxed approach in this area.

In *City Equitable* it was held, with regard to the directors' responsibility to act diligently, that:

'A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend wherever, in the circumstances he is reasonably able to do.'

6.48 This rather lenient approach was taken to its extremes in the famous 'Marquis of Bute' case, where a director who had attended one board meeting in 38 years after being appointed to the board at the age of 6 months was held not to be negligent (Re *Cardiff Savings Bank* [1892] 2 Ch 100).

- 6.49 As with the duty of skill and care, the courts' approach to the issue of diligence has been evolving and growing stricter, and the old standards should no longer be relied upon. In the case of *Dorchester Finance Co Ltd v Stebbings* [1989] BCLC 498, two of the company's three directors took no active part in the management of the company, leaving everything in the hands of the third. No board meetings were ever held. They had even, at the request of the third director, signed blank cheque forms which he used to make illegal loans to other companies which he controlled. All three directors were held to be negligent. In *Re D'Jan of London Ltd* ([1993] BCC 646), a director filled out an insurance claim form wrongly, with the result that the insurers repudiated liability for a fire at the company's premises which caused the loss of £174,000 worth of the company's stock. The director was held to be liable to compensate the company for its loss.
- 6.50 The wrongful trading provisions referred to in Chapter 10 have had obvious ramifications for the standard of diligence expected of directors. Those provisions reflect the rule that directors owe a personal responsibility to their company's creditors where they allow their company to continue trading beyond the point where they know or ought to know that their company will not be able to avoid insolvent liquidation. It follows from this that directors are expected, in their own interests as well as in the interests of their company's creditors, to monitor the financial situation of their company sufficiently carefully to enable them to make reasonable judgements about its health and prospects or at least to seek advice on those matters from outside experts at an appropriate stage. Directors who take such little interest in the on-going financial state of their company as to render them incapable of making informed decisions about its affairs will accordingly put themselves at risk of assuming personal liability.
- 6.51 Another development which has had implications for the standards which the law expects as regards diligence, as well as skill and care, was the introduction of the Company Directors Disqualification Act 1986. This allows the courts to make an order to disqualify a person from acting as a director if that person's conduct as a director shows him or her to be 'unfit' to be concerned in the management of a company. Orders can be made wherever the court is satisfied from the facts of a case that unfitness has been proved – the courts have been prepared to disqualify directors on this ground where directors have failed to show sufficient interest in exercising their functions. In *Baker v Secretary of State for Trade and Industry* [2001] BCC 273, a case following the collapse of Barings Bank, senior executive directors of the bank were disqualified from acting as directors for not having ensured that the company had adequate systems in place to control and monitor the activities of junior staff, and in particular of the individual trader whose unauthorised dealings had led to the bank's total collapse.
- 6.52 Very relevant to the issue of diligence over the years has been the extent to which the law expects directors to attend to matters themselves, as opposed to delegating responsibilities to others. This is clearly a crucial matter for all directors, whatever the size of their company. In large, multinational companies, the scale and complexity of the business, the need for quick decision-making and the high level of regulatory supervision to which the company is subject will make it impractical for them to function effectively without there being substantial delegation of authority downwards from the board. The directors of small companies will invariably know a great deal about their particular line of business but may not know much about other areas of business management so will of necessity be dependent on the services of others.

- 6.53 The City Equitable case laid down an important rule on delegation:
- ‘in respect of all duties that, having regard to the exigences of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.’
- 6.54 Accordingly, the law has long accepted that it is impractical to expect directors to do everything themselves and that it is permissible for directors to delegate responsibility for at least some of their functions, whether that delegation is to fellow directors or to employees of the company.
- 6.55 In any situation whereby directors place reliance on the input of a particular individual, or delegate tasks to an individual, the proviso is that they should take adequate steps to ensure that any such person is a suitable person: delegation of their functions without taking due steps to satisfy themselves that they are suitable persons to rely on may well result in the directors failing in their duty. So where a board of directors seeks to appoint, for example, a Director of Finance, who is to have specific authority for the company's control systems, for managing the company's finances and for preparing the company's accounts, it is their primary responsibility to ensure that the person to whom they propose to delegate these important functions is assessed not only for competence to perform those tasks but for trustworthiness. Where directors are satisfied that particular responsibilities may be safely delegated to individual directors or officials, they will be normally entitled to place reliance on the work of those persons.
- 6.56 The essence of the City Equitable principle on delegation holds good today. But, in keeping with the gradual tightening up process that has already been described, the courts have held that it may not today be sufficient. In particular, directors who have delegated aspects of their responsibilities should not think that the decision, once made, need no longer be kept under review. Rather, they should continue to monitor the delegation and be prepared to intervene if the circumstances require it.
- 6.57 In the case of *Re Barings plc (No 5 [2000] 1 BCLC 523*, the Court of Appeal approved this statement from a judge in a lower court:
- ‘Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated function. No rule of universal application can be formulated as to the [foregoing]. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director's role in the management of the company.’
- 6.58 The above case dealt specifically with the issue of diligence as regards powers delegated by directors to persons below board level. Another aspect of delegation which has more recently come to the fore, however, and this concerns the extent to which NEDs are entitled to delegate responsibility to the executive directors. This matter was addressed in *Equitable Life v Bowry [2003] EWHC 2263*. In that case, Equitable Life brought proceedings for negligence and breach of duty against its former NEDs – part of the



company's case was that the NEDs had failed to exercise adequate supervisory control over the actions of the company's executive directors (which had caused loss to the company). The court held thus:

'The extent to which a NED may reasonably rely on the executive directors and other professionals to perform their duties is one which the law can be fairly said to be developing and is plainly 'fact sensitive'. It is plainly arguable, I think, that a company may reasonably at least look to NEDs for independence of judgement and supervision of the executive management.'

6.59 The issue was not in the event resolved since the legal action against the directors was ultimately withdrawn. Nonetheless, by allowing the company's case against the directors to be heard in a full trial, clearly the court thought that there was merit in the argument that there is or should be a legal benchmark for the conduct of NEDs and at the same time some clearer protocol for the interaction of NEDs and executives.

6.60 Section 174(1) CA 2006 now states that a director must exercise reasonable care, skill and diligence. Section 174(2) adds that the requirement in section 174(1) means 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 carried out by the director in relation to the company and
- the general knowledge, skill and experience that the director has.

Accordingly, there is a basic obligation under the Act for a director to carry out his or her duties in accordance with the broadly-framed benchmark set out in section 174(1) – he or she must exercise a 'reasonable' level of care, skill and diligence.

6.61 The use of the term 'reasonable' ensures that the benchmark of conduct is not set at such an unrealistically high level that it would deter people from forming companies and becoming directors. What the term will amount to in any particular case will depend, via the provisions of sub-section (2), on both objective and subjective factors, and on how the courts apply them in specific cases. Taking the objective factors covered by (a) above first, the director will be expected to act in accordance with a conception of the knowledge, skill and experience that 'may reasonably be expected' of a person carrying out the duties that he or she is carrying out. Thus, the law will expect all directors who are performing either specific or general functions to perform to a standard appropriate to those functions.

6.62 As regards the subjective factors covered by (b), a director will be expected to act in accordance with the knowledge, skills and experience that he or she actually has – this allows the same basic test to be applied to all individual directors, who will of course come from many different backgrounds. A director will therefore be judged – in part – by reference to his or her own background, qualifications and experience. Under this test, where a director has particular professional or business skills, for example as a qualified accountant, that will have a bearing on whether the standard of skill and diligence he or she displays in

practice, both generally and in respect of specific matters, is 'reasonable' and thereby meets the statutory test. A director who has such special skills will be expected by virtue of section 174(2)(b) to pay particular attention to, demonstrate an appropriate level of competence in and be prepared to assume a higher degree of responsibility in relation to issues which relate to the area in which he or she specialises: in the case of a director who is an accountant, this will clearly mean issues relating to accounting and finance.

- 6.63 By virtue of section 174(2)(a), a director will be expected to act in a way which is appropriate for the position he or she occupies. If the director has a specific role, for example as a Director of Marketing, then the law will expect that director to demonstrate the knowledge, skill and experience that is considered to be reasonable to expect from a person in that particular position. It will thus be important that any person who takes on a directorship with a specific, specialised remit is confident that they are competent to carry out that remit. If the director carries out general functions of control over the company, either in a sole director capacity or in conjunction with one or more others, then the standard of knowledge, skill and experience expected will be that of a director with those general functions. Similarly, and in the light of *Equitable Life v Bowry* referred to above, the performance of a NED is likely to be assessed in due course by reference to a specific benchmark for NEDs.
- 6.64 The standards expected of a director under both the objective and subjective criteria will be subject to the 'reasonably diligent person' test. Directors who have no specialist knowledge, skills or experience will not be entitled to use that fact as a justification for not showing a measure of diligence in the way that they approach the conduct of their functions.
- 6.65 Company directors as such are not covered by the provision in the Supply of Goods and Services Act 1982 which states that, in a contract for the supply of a service where the supplier is acting in the course of a business, there is an implied term that the supplier will carry out the service with reasonable care and skill. The *Supply of Services (Exclusion of Implied Terms) Order 1982 (SI 1982/1771)* says that section 13 of that Act is not to apply to 'the services rendered to a company by a director in his capacity as such'. Where, however, a director has a service contract with his or her company the implied term in the Order relating to reasonable care and skill will apply.
- 6.66 In summary then, the duty in section 174 is sufficiently flexible for a modest test of skill and care to be applied to all directors, albeit one which incorporates at the same time scope for individual directors to be judged by reference to their own backgrounds, circumstances and specific functions. The way that the section is framed means that the way that the law develops will to some extent depend on the way that the courts interpret the various provisions and determine the benchmarks implicit in them, for example, what is a 'reasonably diligent person' and what are the things that may 'reasonably be expected' of persons carrying out the functions of a director.
- 6.67 It should be noted that, while much of the Companies Act 2006 is concerned with creating differential rules as between public companies and private companies, section 174 – as with the other elements of the statement of general duties – applies equally to directors of all companies, regardless of the size or type of their company or the nature of the business that a company carries on. The terms of the section

are designed so as to be sufficiently broad as to be capable of application to directors of vastly different backgrounds and functions and in relation to the full range of limited companies. As already stated, there is no basis by which persons are tested on their knowledge or competence before they are allowed to be appointed as directors: subject to the restrictions on eligibility discussed in Chapter 3, any person may be a director of a company. (Note that listed companies are required by the Listing Rules of the London Stock Exchange to ensure that the directors collectively have appropriate expertise and experience for the management of the business). Once a person becomes a director, however, the law will expect him or her to act in accordance with the legal standard. Thus, all prospective directors should ensure that they are aware of what the law requires them to do and the standard of conduct which is expected of them, in line with the following statement:

'Anyone accepting the office of director was required to understand the nature of the duty which he/she was called upon to perform. The nature of that duty would depend on the size and business of that company and the experience the director held himself out as having.' (Re *Barings* (No 5) [2000] BCLC 523).

**(vi) Duty to avoid conflicts of interest (section 175 CA 2006)**

- 6.68 Under this section, a director must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company.
- 6.69 This provision faithfully incorporates the long-standing common law rule that directors, like any other person who has fiduciary responsibilities, must respect the trust and confidence placed in them and should do nothing to undermine or abuse that trust and confidence. The practical effect of the rule is that where directors find themselves in any situation where their own personal interests clash or may clash with the interests of their company, the interests of the company must be put first: indeed, directors should strive to ensure that situations where they could be called upon to make such a decision do not arise in the first place.
- 6.70 The following extracts from leading judgements show how seriously the courts have treated this matter in the past.
- 'It is a rule of universal application that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect.' (*Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461).
- 'It is an inflexible rule of a court of equity that a person in a fiduciary position ... is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict.' (*Bray v Ford* [1896] AC 44).

- 6.71 Section 175 requires a director to avoid not only situations where there is plainly a conflict but also those that 'possibly may conflict' with the director's duty to the company. Thus the director is obliged to consider whether his outside interests are likely to give others the impression that there may be a conflict. In *Boardman v Phipps* [1967] 2 AC 46 it was held that the term 'possibly may conflict' means 'that the reasonable man looking at the relevant facts and circumstances of the particular case would think that there was a real sensible possibility of conflict.' While a very old precedent holds that the rule against conflict of interest did not in itself prevent a director from acting simultaneously as a director of another, competing company (*London and Mashonaland Exploration Co v New Mashonaland Exploration Co* [1891] WN 165), the more recent case of *Shepherds Investment v Andrew Walters* [2006] EWHC 836 has confirmed that the law no longer regards such conduct as consistent with the director's fiduciary duty. It has been held separately that executive directors, who have service contracts with their company, may not become directors of a competing company (*Hivac Ltd v Park Royal Scientific Instruments Ltd* [1946] Ch 169).
- 6.72 The common law rule on avoiding conflicts of interest has been applied many times over the years in cases involving directors who profit from business opportunities that might have been taken by their company. In *Cook v Deeks* [1916] 1 AC 554, a group of directors who conspired to divert new business from an existing client of their company to a new company they formed for that specific purpose were held to be liable to their (original) company as constructive trustees. A director will also be liable to account to the company where he or she resigns from the board expressly to transact, on a personal basis, a business deal which had come to the director's notice in his or her capacity as director (*IDC v Cooley* [1972] 1 WLR 443). In the latter case, the company had sought, unsuccessfully, to win the business but the other company did not wish to deal with it.
- 6.73 A director may not resolve a conflict of interest simply by resigning – this principle is now expressly incorporated into the statement of general duties. Under section 170(2)(a), the duty to avoid conflicts continues to apply to a director after retirement from office 'as regards the exploitation of any property, information or opportunity of which he became aware at a time when he was a director.' Accordingly, after leaving a company, directors still owe that company a duty not to profit from property, information or opportunity that came their way during their time in office, and the company may still take legal action against any director it believes to be in breach.
- 6.74 There are two exceptions to the basic duty in section 175(1) to avoid conflicts. First, it does not apply to conflicts of interest arising in relation to a director's transactions or arrangements with his or her own company: these specific situations are addressed separately in sections 177 and 182 CA 2006 (see paragraphs 9.29-9.41 below). Second, the duty will not be breached by the director if the situation 'cannot reasonably be regarded as being likely to give rise to a conflict of interest' or if the matter has been authorised by the directors in accordance with the provisions of section 175(5). (Either of these avenues might be used to validate a director's dealings post-retirement so as to enable him or her to avoid infringing the basic duty).

6.75 The procedure for authorisation of potential breaches of section 175 is different for private and public companies. In the case of a private company, the directors may authorise the director's involvement in the situation that risks breaching section 175 as long as there is nothing in the company's constitution that invalidates their giving such authorisation. In a public company, the directors may give authorisation only if the company's constitution expressly gives power to them to do so. So in the case of a private company, if the articles are silent on this matter the directors may grant authorisation, while in a public company silence means that they may not. In both cases, a director who is the subject of a proposed authorisation resolution must not be taken into account for quorum purposes and neither may his or her vote be taken into account. (Note that the Government decided to commence section 175 in April 2008, six months later than the other general duty provisions, in order to allow more time for companies to change their articles).

**(vii) Duty not to accept benefits from third parties (section 176 CA 2006)**

6.76 Under section 176, a director must not accept a benefit from a third party which is conferred by reason of a) his being a director or b) his doing (or not doing) anything as director.

6.77 This rule is intended to ensure that a director is not distracted from performing his or her duty to the company by rewards offered for doing unspecified things (or not doing any such things). By virtue of section 176(4), however, there will be no breach of duty if the acceptance of the benefit by the director cannot reasonably be regarded as likely to give rise to a conflict of interest: so immaterial benefits and those which are entirely unrelated to the affairs of the company may be accepted.

6.78 For the purposes of section 176 CA 2006 a third party is any person other than the company, an associated company or a person acting on behalf of the company or the associated company.

**(viii) Duty to declare interest in proposed transactions or arrangements (section 177 CA 2006)**

6.79 A director must declare to the other directors any situation in which he is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company.

6.80 This rule is intended to reinforce the rule against conflict of interests by ensuring that directors are transparent about personal interests which might affect their judgement or which might be seen to affect it.

6.81 Any declaration required under section 177 must be made in advance of the company entering into the transaction or arrangement. The director may make it at a formal meeting of the directors or by notice given to fellow directors under section 184 CA 2006 (written notice of an interest in a transaction or arrangement) or under section 185 CA 2006 (general notice of a director's external interests). These sections are discussed further in Chapter 9.

6.82 A director is not required to declare an interest under section 177 if the other directors are aware of it (or ought reasonably to be aware of it) and if the interest concerns the terms of his or her service contract which have been or are to be considered by the directors or a committee of the board set up for the purpose (such as a Remuneration Committee).

A declaration is also not required in the following circumstances:

- where the interest is one that he or she is not aware of having
- where the director is not aware of the company entering into the transaction or arrangement in question
- if the interest cannot reasonably be regarded as likely to give rise to a conflict of interest

6.83 Disclosure, where required, must be made to all the other directors. It was held in *Guinness plc v Saunders (1988) 4 BCC 377* that the requirements of what was then section 317 of the Companies Act 1985 (the forerunner of section 177 CA 2006) were not satisfied by making disclosure merely to a committee of the directors, and also that the statutory duty of disclosure could not be relaxed by any provision in the company's articles.

#### **CONCLUSION ON THE STATEMENT OF GENERAL DUTIES**

---

6.84 The introduction of the statement of general duties, as discussed in this Chapter, is highly significant for the way that directors are expected to act and for how they account for their actions to their company. This is for two reasons. Firstly, the Act introduces new rights for shareholders to take legal action against the directors of their company for alleged breach of their duties to the company. The courts will approach any such actions, in part, by weighing up whether the directors concerned have lived up to their duty to promote the success of their company under 172. Secondly, companies (other than small companies) are required under the Act to prepare and publish a 'business review' as part of their annual accounts and report. The overriding purpose of this review is to help the company's members to assess how the directors have performed their duty under section 172. Accordingly, the combination of section 172 and the duty to report via the business review becomes the essential yardstick of corporate accountability.

6.85 The exercise of codifying the common law duties may or may not make it easier for companies and their directors to operate as the law expects them to. On the one hand, the general rules on directors' duties have been set out succinctly and in one place. This is consistent with the Law Commissions' original aim for the codification process to serve an educational purpose. On the other hand, the way that the Government has gone about the process of codification has led to the adoption, in some cases, of different terminology to that used in the established common law rules, and there is also some unhelpfully loose wording – for example, in section 172 directors are legally obliged to have regard to 'other matters'. In due course, it can only be for the courts to determine the real extent to which the new provisions in the statement have resulted in substantial changes to what the law requires from directors.

6.86 With the exception of section 175, the provisions discussed in this Chapter all take effect in October 2007.

## 7. Directors' responsibilities concerning accounting and reporting

- 7.1 The main way in which limited companies account for the conduct of their affairs to their shareholders and to wider society is via the legal requirements to prepare and publish annual accounts and reports. A company's directors are responsible for ensuring that it complies with its responsibilities in this regard.
- 7.2 The Companies Act 2006 requires all private and public limited companies to prepare annual accounts (which should comprise a profit and loss account and balance sheet together with notes to those statements) together with a directors' report. Public companies that have a full listing in the UK or elsewhere in the EEA must, additionally, prepare a remuneration report – containing specified information on the company's policies and practices on the remuneration of their directors and senior staff. Any company may also, if it wishes, prepare additionally a summary financial statement based on the main accounts.
- 7.3 In keeping with the aim behind the company law reform process of achieving a clearer distinction between the law as it applies to small private companies and the law that applies to other companies, the Act creates a separate reporting regime for 'small companies', as well as reserving the most extensive reporting and disclosure requirements for 'quoted companies'.

### **THE SMALL COMPANIES REGIME**

---

- 7.4 The reporting rules of the new 'small companies regime' incorporate the various derogations from the standard reporting rules that were previously contained in the Companies Act 1985. A company that is eligible for the small companies regime is required to comply only with the rules which specifically apply to that regime. The detailed rules on disclosure in accounts and reports, to be set out in regulations made under the Act, will contain stand-alone requirements for small companies.

To qualify, a company must satisfy at least two of the following size criteria in the reporting year and in the previous financial year:

- its turnover must not exceed £5.6 million\*
- its balance sheet total must not exceed £2.8 million\*
- it must have no more than 50 employees.\*

\* NB these thresholds shadow the corresponding thresholds set out in the EU's Fourth Company Law Directive and may be revised upwards by the UK Government as and when the thresholds in the Directive are themselves revised.

7.5 If a company is a parent company, ie it has subsidiary companies, it will only qualify as a small company if the group that it heads would qualify as a small group. To qualify as a small group, the group must meet at least two of the following size criteria:

- its aggregate turnover must not exceed £5.6 million net (or £6.72 million gross)
- its aggregate balance sheet total must not exceed £2.8 million net (or £3.36 million gross)
- its aggregate number of employees must not exceed 50.

(The figures in respect of each company in the group must be taken from its individual company accounts.)

7.6 Public companies are not eligible for the small companies regime. Also excluded from the regime are companies that carry out regulated investment activities under Part 4 of the Financial Services and Markets Act 2000 or carry on insurance market activity. Groups are ineligible if any member of the group is a public company or carries on the activities just mentioned, or is any sort of body corporate whose shares are admitted to trading on any regulated market in the EEA.

#### **QUOTED COMPANIES**

---

7.7 The most extensive accounting disclosure obligations under the Act are imposed on the small minority of companies that are listed on regulated stock markets. A company will come within the quoted company regime if it has equity share capital which

- has been included in the 'official list' under part 6 of the Financial Services and Markets Act 2000
- is officially listed in any EEA state
- is admitted to dealing on the New York Stock Exchange or on NASDAQ.

7.8 The particular responsibilities that fall on directors to fulfil are set out in the following paragraphs.



## **PREPARATION OF ACCOUNTS AND REPORTS**

---

### **(i) Accounting records**

- 7.9 Under section 386 of CA 2006, every company must keep 'adequate' accounting records – the term adequate means that the records must be sufficient to:
- show and explain the company's transactions
  - disclose with reasonable accuracy the financial position of the company at that time and
  - enable the directors to ensure that the accounts they are required to prepare comply with the relevant requirements of the law.
- 7.10 The records must contain, in particular, i) entries from day to day of all sums of money received and spent by the company and the matters to which they relate and ii) a record of the company's assets and liabilities. Where a company's business involves trading in goods, the records must contain statements of stock held by the company at the end of each financial year (and all statements of stock-takings from which those statements are prepared) and – except where goods are sold in the course of ordinary retail trade – statements of all goods sold and purchased, showing the goods and the buyers and sellers in sufficient detail to enable all these to be identified.
- 7.11 These records must be kept at the company's registered office (or such other place as the directors think fit to keep them) for at least three years from the date on which they are made (in the case of a private company) and six years (in the case of a public company).
- 7.12 Accounting records, like any other records of the company, may be kept in hard copy or electronic form (section 1135 CA 2006).

### **(ii) Accounting reference periods and financial years**

- 7.13 Every set of annual accounts that a company produces must be prepared in relation to its 'financial year' (section 394 CA 2006). The financial year is in turn determined in relation to the company's 'accounting reference period'.
- 7.14 An accounting reference period is determined according to its 'accounting reference date'. For a company incorporated in Great Britain on or after 1 April 1996 or in Northern Ireland on or after 22 August 1997, and for companies incorporated after the coming into force of the Act, its accounting reference date will be the last day of the month on which the anniversary of its incorporation falls. So under this formula, a company which is incorporated on 15 January 2007 will have an accounting reference date of 31 January, so its first accounting reference period would cover the period of just over one year ending at the end of January 2008 (although the first period can be any duration between 6 and 18 months). Subsequent accounting periods will be successive periods of twelve months beginning immediately after the end of the previous accounting reference period and ending on its accounting reference date.

7.15 A company's directors may change their company's accounting reference date under section 392 CA 2006. This can be done so as to shorten or extend the current reference period; it is also possible to change a reference date so as to change the duration of a reference period which has already expired (as long as the period allowed for filing the company's annual accounts for that period has not itself already expired). A reference period may not be extended so as to exceed 18 months and extension will not be permitted if less than five years has passed since the end of a previously-extended reference period.

7.16 Where a company is a parent company, its directors must ensure that the financial year of each of their subsidiaries coincides with that of the parent, unless in their opinion there are good reasons why this should not be the case (section 390(5) CA 2006).

### **(iii) Preparation of the company's annual accounts**

7.17 Directors are responsible for preparing annual accounts for each of the financial years of their company (section 394 CA 2006). They must not approve any set of annual accounts unless they are satisfied that they give a 'true and fair view' of the assets, liabilities, financial position and profit or loss of their company (and in the case where the company has subsidiaries and prepares group accounts, of the group as a whole) (section 393 CA 2006).

7.18 Where a company does not have subsidiaries and is not therefore required to prepare group accounts, its accounts will relate only to the activities of the company itself – these accounts are referred to by the Act as 'individual accounts'. In preparing their individual accounts, directors have a choice under the Act between one of two accounting regimes. They may either prepare them as 'Companies Act individual accounts', which term involves following the rules on form and content set out in the Act and supporting regulations and observing the technical requirements of UK accounting standards as issued by the Accounting Standards Board, or they can prepare their accounts in accordance with the requirements of International Accounting Standards (IAS – alternatively known as International Financial Reporting Standards (IFRS)). Where a company chooses the latter option they are required to disclose in the notes to the accounts that they have been prepared in accordance with International Accounting Standards. In practice the option to prepare accounts in accordance with IFRS/IAS is likely to be taken advantage of only by listed companies, which are actually required to prepare their group accounts in accordance with IFRS by the EU's IAS Regulation of 2002 and may for that reason find it appropriate to prepare the accounts of the parent and subsidiary companies on the same basis. Note that companies which are charities do not have any choice as to which regime to follow – their accounts must be prepared on the former basis. ie Companies Act individual accounts.

7.19 Companies Act individual accounts comprise a balance sheet, made up to the last day of the financial year, and a profit and loss account covering the financial year. The accounts must comply with the rules on form and content set out in regulations made under the Act and must also disclose, in notes to the accounts, the information that the regulations require to be disclosed therein (section 396(3) CA 2006).

- 7.20 The overriding requirement regarding the accounts is that the balance sheet must give a true and fair view of the state of affairs of the company as at the end of the financial year and the profit and loss account must give a true and fair view of the profit or loss of the company for the financial year (section 396(2) CA 2006). Where a company has its accounts audited by an independent auditor, that auditor will give an opinion as to whether the tests has been met. Even where the company's accounts are not audited, however, it remains the legal responsibility of the directors to ensure that the true and fair test is met.
- 7.21 The true and fair requirement incorporates a degree of flexibility. If compliance with the disclosure requirements of the Act and supporting regulations would not be sufficient for the accounts to give a true and fair view, the directors must provide the necessary additional information. On the other hand, if in special circumstances compliance with the requirements of the Act and supporting regulations is inconsistent with the obligation to give a true and fair view, the directors must depart from the requirement concerned to the extent necessary to ensure that the accounts give a true and fair view (though if such a departure is made, the directors must ensure that they set out in a note to the accounts particulars of the departure, the reasons for it and its effect). This provision for accounts to depart from standard accounting requirements is commonly referred to as the 'true and fair override'.
- 7.22 Where a company has not had its accounts audited on the ground that it is a small or dormant company, its balance sheet must carry a statement to that effect (section 475(2) CA 2006).

**(iv) Preparation of group accounts**

- 7.23 Where a company is a parent company, ie it has subsidiary companies, it must prepare group accounts unless it is exempt under sections 400 or 401 (where the parent is itself a subsidiary and its affairs are included in a wider set of group accounts) or 402 (where each of its subsidiary companies is eligible to be excluded from consolidation under section 405) of the Act. Further, the requirement to prepare group accounts does not apply to companies that are subject to the 'small companies regime', though they may choose to prepare them if they wish.
- 7.24 As with individual company accounts, group accounts may be prepared in accordance with one of two permissible regimes – either the rules of 'Companies Act group accounts' or the requirements of IAS. Companies which have a full stock market listing must prepare their group accounts in accordance with the IAS regime under the requirements of the EU's IAS Regulation. Where IAS group accounts are prepared, the notes to those accounts must state that the accounts have been prepared in accordance with International Accounting Standards.
- 7.25 Where companies prepare Companies Act group accounts, those accounts must comprise a consolidated balance sheet, dealing with the state of affairs of the parent company and its subsidiary undertakings, and a consolidated profit and loss account, dealing with the profit and loss of the parent company and its subsidiaries. As with individual accounts, the group accounts must give a true and fair view of the state of affairs as at the end of the financial year and of the profit and loss for the financial year of the undertakings

included in the consolidation, and must comply with the rules on form, content and disclosure set out in regulations made under the Act. The provisions described earlier relating to the provision of additional information and the true and fair override apply to group accounts in exactly the same way as they do to individual accounts.

- 7.26 Regardless of whether the parent prepares the group accounts in accordance with the Companies Act regime or the IAS regime, it is the responsibility of the directors (other than those of charitable companies who do not have this choice) to ensure that the individual accounts of the parent and all those of its subsidiaries that stand to be included in group accounts are prepared using the same financial reporting framework, except where, in their opinion, there are good reasons for not doing so (section 407 CA 2006).

**(v) The directors' report**

- 7.27 In addition to preparing the financial statements, directors of every company must prepare a directors' report (section 415 CA 2006). Wherever the directors prepare group accounts, the directors' report must be a consolidated report and the information in it must cover the affairs of all the companies included in the consolidation.

- 7.28 The directors' report must contain the following information:

- the names of the persons who were directors of the company at any time during the financial year under review
- a statement of the principal activities of the company during the year
- the amount (if any) that the directors recommend should be paid as a dividend to shareholders (NB this statement need not be made by companies subject to the small companies regime)
- information required to be disclosed by regulations made under the Act – this information is likely to contain, at least, the information contained in Schedule 7 to the Companies Act 1985: NB section 992 CA 2006 adds to the information that quoted companies are required to disclose under that schedule
- (unless a company is exempt from the requirement to have its accounts audited) a statement from the directors that, so far as each of them is aware, there is no information relevant to the audit of which the company's auditor is unaware and that they have taken all steps that they ought to have taken as directors to make themselves aware of any relevant audit information and to establish that the auditor is aware of that information (section 418 CA 2006): a director will be regarded as having taken all steps that ought to be taken in this context if he or she makes such enquiries of the other directors and the auditor and takes such other steps (if appropriate) as a director would be required to carry out by the duty under section 174 CA 2006 to exercise reasonable care, skill and diligence – see paragraph 6.44 et seq above).

- a business review (NB this need not be produced by a company which is subject to the small companies regime).

7.29 The business review is an element of the directors' report which was required to be introduced by the EU's Accounts Modernisation Directive of 2003 (2003/51/EC). The Directive set out the matters that the review should cover and these have been faithfully incorporated into UK law via the Act. With respect to listed companies, though, those basic requirements have in some respects been added to by the UK Government. This development followed the reversal, in 2005, of the Government's previously agreed policy, which was to require listed companies to prepare not a business review as such but a statutory version of the Operating and Financial Review (OFR), the narrative statement that many listed companies had been preparing and publishing since the 1990s and on which guidance from the Accounting Standards Board had been developed.

7.30 The Government's decision to withdraw the regulations providing for the new statutory OFR was based on the argument that some of its requirements were too onerous a burden for the listed companies that would have to comply with them. Subsequent to the decision to abolish the OFR regulations, the Government consulted with interested parties on whether some elements of the statutory OFR should in the event be retained as supplementary requirements in the replacement regulations on the business review. That process of consultation led the Government to conclude that some elements of the statutory OFR should indeed be retained in the interests of 'transparency' and 'forward-looking reporting' and have therefore been added to the basic format of the review as presaged by the Directive.

7.31 For all companies that prepare it, the express purpose of the business review is to inform members of the company about how the directors have performed their duty under section 172 CA 2006 (duty to promote the success of the company) and to help members assess the extent to which the directors have done this. In preparing any business review, therefore, directors are expected to present the information contained in it in such a way as to explain to the members of the company how they have fulfilled their statutory duty.

7.32 The review should constitute a 'balanced and comprehensive analysis of the development and performance of the company's business during the course of the financial year and of the position of the company's business at the end of that year, consistent with the size and complexity of the business.'

It must contain, in particular:

- a fair review of the company's business
- a description of the principal risks and uncertainties facing the company and
- where appropriate, references and additional explanations of amounts included in the annual accounts.

7.33 To the extent necessary for an understanding of the development, performance or position of the company's business, the review must include analysis using financial key performance indicators (KPIs) and, where appropriate, other KPIs including information relating to environmental and employee matters. (NB in this matter medium-sized companies are only required to provide analysis using financial KPIs).

7.34 Quoted companies must provide additional information. Again to the extent necessary for an understanding of the development, performance or position of the company's business, the business review must include

- the main trends and factors likely to affect the future development, performance and position of the company's business and
- information about
  - environmental matters (including the impact of the company's business on the environment)
  - the company's employees and
  - social and community issuesin all cases including information on any policies the company has on such matters and the effectiveness of those policies. Where a review does not contain any information on these matters it must state which of the three kinds of information the review does not contain.
- information about persons with whom the company has contractual or other arrangements which are essential to the business of the company. No information need be disclosed under this requirement, however, if the disclosure would, in the directors' opinion, be seriously prejudicial to any of the persons concerned and would be contrary to the public interest.

7.35 While companies are required to disclose information on risks, uncertainties and (in the case of quoted companies) factors likely to affect the future of the business, companies are not required to disclose any information on impending developments or pending negotiations if the disclosure of that information would, in the opinion of the directors, be seriously prejudicial to the interests of the company (section 417(10) CA 2006).

**(v) Directors' remuneration report**

7.36 The directors of a quoted company must prepare a directors' remuneration report for each financial year (section 420 CA 2006). This report must comply with regulations to be made under the Act (prior to the coming into force of this section in April 2008) covering the form and content of the report. This report must be presented to the company's AGM/accounts meeting and the shareholders invited to vote on it (section 439 CA 2006).

#### **(vi) The Summary Financial Statement (SFS)**

7.37 Section 426 of the Act gives any company the power to prepare a summary financial statement (SFS), which will be derived from its 'full' annual accounts. Where an SFS is prepared, the company may send it to its members (and other persons entitled to receive its accounts) rather than the full accounts. Any member will, however, be entitled to insist on receipt of the full accounts. In practice the SFS is not likely to be a worthwhile option for companies other than listed companies and those unquoted companies that have large numbers of shareholders. Sections 427 and 428 set out the basic contents of the SFS for unquoted and quoted companies respectively, though these will be added to by regulations made under the Act.

#### **(vii) Approval and signing of the accounts and reports**

7.38 Once the directors have prepared the individual and group accounts that they are required to prepare, and they are satisfied that they comply with the requirements of the Act and supporting regulations, including the overriding requirement that they give a true and fair view, they must formally approve those accounts (section 414 CA 2006). One director must indicate the board's approval of the accounts by signing them on the balance sheet. Where the accounts are prepared under the small companies regime, the balance sheet must contain a statement to that effect in a prominent position above the signature.

7.39 Similarly, once the directors are satisfied that they have prepared their directors' report so that it complies with the requirements of the Act and supporting regulations, they must approve the report. Once approved, the report must be signed on behalf of the directors by one of their number or by the company secretary (section 419 CA 2006). Again, if the report is prepared in accordance with the small companies regime, the report must carry a statement to that effect. The directors' remuneration report must also be approved by the board and signed on its behalf by a director or the company secretary (section 422 CA 2006).

### **PUBLICATION OF ACCOUNTS AND REPORTS**

---

#### **(i) Distribution of accounts to members et al**

7.40 Once approved and signed, companies' annual accounts and directors' reports (and any additional report a company may be required to produce) must be sent to:

- every member of the company
- every holder of the company's debentures
- every person who is entitled to receive notice of the company's general meetings (this will include a company's auditor – the company's articles of association may add others).

7.41 The accounts and report(s) must be sent out by set deadlines. In the case of a private company – whether or not it is subject to the small companies regime – they must be sent by the end of the period allowed for the filing of accounts (ie 9 months from the end of the financial year) or, if earlier, the date on which they are actually delivered to the Registrar of Companies. In the case of a public company, the accounts and reports must be sent no later than 21 days before the accounts meeting at which the accounts are to be laid before the company's members. (A private company has no obligation to lay its annual accounts before its members in general meeting.) A quoted company must also give notice to its members, before the accounts meeting, that a resolution will be tabled on the directors' remuneration report (section 439 CA 2006).

7.42 A company has no obligation to send copies of its accounts and reports to any person for whom the company does not have a current address (section 423(2) CA 2006).

#### **(ii) Filing of accounts with Companies House**

7.43 Separately from the above procedure, it is the responsibility of a company's directors to ensure that its accounts and reports are filed with the Registrar of Companies within set deadlines. Different deadlines apply to private and public companies for this purpose – private companies are required to file their accounts and reports no more than nine months after the end of their last accounting reference period; for public companies the time allowed is six months from the end of the reference period (section 442 CA 2006).

#### **Filing – small companies**

7.44 Companies within the small companies regime need not file their 'full' accounts with the Registrar (section 444 CA 2006). They are only obliged to file their balance sheet and – if the accounts have been audited – a copy of the auditor's report on the accounts and directors' report. They may, if they wish, also file their profit and loss account and directors' report, though they are not obliged to do so. If a company takes advantage of the option not to file its directors' report and balance sheet, the balance sheet must contain, in a prominent position, a statement to the effect that the company's annual accounts and directors' report have been prepared in accordance with the provisions applicable to companies subject to the small companies regime.

7.45 Companies that are within the small companies regime (and which prepare Companies Act accounts as opposed to IAS accounts) may make an additional choice, which is to file 'abbreviated accounts' with the Registrar (section 444(3) CA 2006). 'Abbreviated accounts' comprise a balance sheet and profit and loss account drawn up under special rules on form and content to be laid down in regulations made under the Act. Where abbreviated accounts are prepared, and where the company's full accounts have been audited, there must be a special report from the company's auditor filed along with the abbreviated accounts stating the auditor's opinion that the company is entitled to file abbreviated accounts (section 449 CA 2006).



7.46 All balance sheets and directors' reports filed with the Registrar under the small company rules must state the name of the person who signed the documents concerned on behalf of the board.

[Filing – medium-sized companies](#)

7.47 Companies which qualify as 'medium sized' may also choose to file 'abbreviated accounts' with the Registrar rather than their 'full' accounts. A company will qualify as medium sized if it meets two out three of the following conditions in the reporting year and the previous financial year:

- turnover – not more than £22.8 million
- balance sheet total – not more than £11.4 million
- number of employees – not more than 250.

The disclosure requirements for medium-sized abbreviated accounts are also to be governed by regulations made under the Act. NB as with the size criteria for the small companies regime set out in paragraph 7.4 above, these limits are subject to periodical review.

[Filing – Quoted companies](#)

7.48 Directors of quoted companies are required to file their annual accounts, their directors' report and a remuneration report, together with the auditor's report on those statements.

[Filing – Unquoted companies](#)

7.49 Directors of unquoted companies which are not subject to the small companies regime and which are not medium-sized are required to file the company's annual accounts and their directors' report, together with a copy of the auditor's report on those statements.

[Filing – Unlimited companies](#)

7.50 Unlimited companies are not subject to any filing requirements, though they must still prepare and approve annual accounts and, unless exempt, obtain an auditor's report on the accounts.

## APPOINTMENT OF AUDITORS

---

- 7.51 Unless the company is exempt from the requirement to appoint auditors as a 'small company' or a 'dormant company' (and its members have not required an audit to be carried out) the company must appoint an auditor for each financial year (section 485 CA 2006 for private companies and section 489 CA 2006 for public companies).
- 7.52 In the case of a public company, the appointment must normally be made at the company's 'accounts meeting', ie the meeting at which the company's annual accounts and reports are laid before the members (this will invariably be the company's AGM). In the case of a private company (which is not required to hold an AGM), the appointment must normally be made during 'the period for appointing auditors'. This is a period of 28 days starting with the end of the period allowed for sending out accounts to members: this is based on the period allowed for filing accounts, ie 9 months from the year end or, if earlier, the date on which the accounts have actually been sent out to members by the company. So, for example, if the company sends out its accounts for a year end of 31 December on the following 1 July, the company will have a further 28 days after that date to appoint its auditors for the current year.
- 7.53 Companies that fail to appoint auditors on either of these bases must inform the Secretary of State within one week. The Secretary of State has the default power under section 486 (private company) and section 490 (public company) to fill the vacancy.
- 7.54 In both cases the directors have the statutory power to fill a casual vacancy in the office of auditor. No time limit applies for this.
- 7.55 The auditor ceases to hold office at the next accounts meeting or at the end of the next 'period for appointing auditors' as the case may be. In the case of a private company, the serving auditor will be deemed to have been re-appointed unless
- some other auditor is appointed
  - the serving auditor had been appointed by the directors under section 485(3) CA 2006, in which case the members' approval is required
  - the company's articles require actual re-appointment
  - the members have resolved to oppose the re-appointment under section 488 CA 2006
  - the directors have resolved not to appoint an auditor for the current year.
- 7.56 The Act provides for regulations be made to require disclosure, in the notes to the company's accounts or in the directors' report, or in the auditor's own report, of (i) the terms on which the auditor is appointed, remunerated or performs his duties and (ii) non-audit services provided by the company's auditor and the amount of remuneration paid for those services.

## LIABILITY LIMITATION AGREEMENTS

---

7.57 Wherever a company appoints an auditor, it will be entitled to take advantage of one of the most significant reforms introduced by the Act, namely the provision for companies and their auditors to enter into liability limitation agreements. These will have the effect of limiting the ability owed by the auditor to the company for negligence, default, breach of duty or trust relating to the auditor's audit of the company's accounts (section 534 CA 2006). The directors of a company may negotiate with its auditor the terms of any such agreement but they are not authorised to approve an agreement without reference to the members. Authorisation is possible in any of the following ways:

- (a) the members of the company pass a resolution, before the agreement is entered into, waiving the need for approval
- (b) the members of the company pass a resolution, again before the agreement is entered into, approving the agreement's principal terms
- (c) the members of the company pass a resolution, after the agreement is entered into, retrospectively approving the agreement.

NB option (a) above is only available to private companies.

Where a liability limitation agreement is in force the company will be required, under regulations to be made under section 538 CA 2006, to disclose prescribed particulars of the agreement in its balance sheet or directors' report.

## LIABILITY OF DIRECTORS FOR COMPANY ACCOUNTS

---

7.58 Section 463 CA 2006 introduces a new provision which makes directors liable to compensate their company, in some circumstances, if it suffers loss as a result of untrue or misleading statements in (or omissions from) the directors' report, directors' remuneration report or summary financial statement. The relevant circumstances are discussed further in paragraph 10.30 below. Other than this, the Act does nothing to change the position as regards directors' civil liability for the information contained in the accounts that they approve and publish. In *Caparo v Dickman* [1990] 2 AC 605, a case involving a negligence claim brought against a company's auditor, the House of Lords held that:

'the purpose of annual accounts, so far as members are concerned, is to enable them to question the past management of the company, to exercise their voting rights, if so advised, and to influence future policy and management.'

7.59 Thus the law regards the essential purpose of annual statutory accounts as being to enable the shareholders to assess how the directors are exercising their responsibilities of stewardship over the company and its assets and in the light of this information to enable them – the shareholders – to decide how to exercise their own powers. Accounts prepared for company law purposes are not regarded by the law as providing a basis for individuals to make decisions as regards the buying or selling shares in the company or for third parties to make any other decisions regarding the company. The necessary conditions for the creation of a relationship of 'proximity' – a necessary pre-condition for the assumption of a duty of care by any party to another – will not be present as long as the only purpose of the accounts is to fulfil the statutory purpose as summarised in the above quote from the *Caparo* decision.

#### **IMPLEMENTATION**

---

7.60 The provisions of the Companies Act 2006 discussed in this Chapter take effect, for the most part, in April 2008. Exceptions to this are as set out below:

- section 417 – the business review, discussed in paragraph 7.27 et seq – October 2007
- section 463 – liability for false or misleading statements in reports, discussed in paragraph 7.58 – January 2007
- sections 485-488 – appointment of auditors by private companies, discussed in paragraph 7.52 – October 2007.

## 8. Directors' other statutory responsibilities

- 8.1 This section summarises the principal administrative responsibilities imposed on companies by the Act (other than those connected with the company's accounts and reports dealt with in Chapter 7). In respect of most of the individual matters reviewed here, responsibility for complying with them is not imposed on directors expressly but on the company. Although ultimate responsibility for ensuring that the company complies with its obligations will rest with the directors themselves, functional day-to-day responsibility for dealing with many of these matters will normally be delegated by the directors to, for example, the company secretary or the managing director. Where this is the case, they will normally be entitled to look to that person to ensure that the matters concerned are properly dealt with, and where the company fails to comply with statutory requirements and proceedings are brought, liability for the breach may be imposed on that person and not the (other) directors. Where a private company takes advantage of its entitlement under the Act not to appoint a company secretary, the various administrative responsibilities will in all cases become the legal responsibility of the directors themselves. This will also be the case where a company does not appoint a company secretary as such but engages a professional adviser, such as an accountant or solicitor, to advise it on these matters or to undertake them on its behalf.

### **COMPANY'S REGISTERED OFFICE**

---

- 8.2 Every company must at all times have a registered office to which all official communications and notices may be addressed (section 86 CA 2006). The address of the registered office may be changed at any time. But following any change, notice of the new address must be given to the Registrar. The change only takes effect when the notice is registered by the Registrar, whereupon the new address is treated as the address to which communications and notices are to be sent. However, in order to allow some leeway to third parties, documents may still be validly served on the company at the previous address for a period of 14 days beginning with the date of the registration of the change.

### **STATUTORY REGISTERS**

---

- 8.3 Under the Act, every company must keep a number of separate registers, as follows:

#### **(i) Register of members**

- 8.4 The register of a company's members should contain the name and address of each member, the date on which they were first registered as a member and the date on which a person ceased to be a member (section 113 CA 2006). Where the company has a share capital, the register must also state how many shares each member holds, identifying the share number(s) and class of shares held, in both cases where that would be appropriate.
- 8.5 Under section 114, the register must be kept available for inspection by any person either at its registered office or at some other place (details of which must be given to the Registrar). Under section 115, where the company has more than 50 members, it must keep a separate index of the members to enable details of a particular member to be readily found, and this index must be kept in the same location as the main register.

8.6 Any person may apply to inspect the register or request a copy of it or part of it on submitting the identification details prescribed by section 116. Where a valid request is received, the company has five days to either comply with the request or to apply to the court on the ground that the request is not being made for a proper purpose. When access is provided, the company must make clear to the inspecting person when the register was most recently amended.

8.7 Where a company is formed with only one member, or becomes a one-member company at some point after being formed, it must include a statement in its register of members that it has only one member. Where an existing company becomes a single-member company, the register must give the date on which that event happened. Where a single-member company acquires an additional member or members, the register must state that the company has ceased to have only one member and, again, give the date on which that occurred (section 123 CA 2006).

#### **(ii) Registers of directors**

8.8 Under the 2006 Act, companies must keep two separate registers on its directors. The main register of directors must, like the register of members, be kept either at the company's registered office or at some other place, notice of which is given to the Registrar (section 162 CA 2006). It must be made available for inspection by any member of the company free of charge and by any other person for a fee. The register must include prescribed particulars on each director. Where the director is an individual, these will be:

- his or her name and any former name
- a service address (which may be stated as 'the company's registered office')
- the country, state or part of the UK where he or she is usually resident
- nationality
- business occupation, if any and
- date of birth.

The required details for corporate directors are:

- the corporate or firm name
- the address of its registered or principal office
- (in the case of companies registered in other EU states) details of the national register in which its details can be found and the company's registration number
- in other cases, the legal form of the company or firm, the law by which it is governed and (if applicable) details of its entry in any register.

- 8.9 Details of any changes to the details in the register must be notified to the Registrar within 14 days.
- 8.10 With respect to individual directors, they may still, if they wish, list their home address on the register as their 'service address'. But this is no longer mandatory – the service address can be the company's own registered address or any other address they wish to provide. The wider significance of this is that the given address will be the one which is filed with the Registrar and placed on the public record. Prior to the coming into force of the Companies Act 2006, only directors who claimed to have a valid fear of intimidation could opt to keep their residential address off the public record – this exemption is now, under the 2006 Act, extended to all directors of all companies, whatever their circumstances.
- 8.11 But to ensure that individual directors can be traced where necessary, companies now have a separate duty to retain information on individual directors' home addresses: this information must be kept in a second, separate register of directors' residential addresses required under section 165 CA 2006. This register will be confidential to the company and the details will not be publicly accessible. Unless it is done with the consent of the director concerned, the company may not disclose details of the director's home address except in the following circumstances:
- (a) to communicate with the director concerned
  - (b) to comply with any other requirement of the Companies Acts which might require disclosure of the information
  - (c) to comply with a court order for disclosure of the details issued under section 244 CA 2006.
- 8.12 With regard to (b) above, the information kept on the second register will still need to be made available to Companies House. But in parallel with the situation with companies themselves, the information concerned will be kept on a second, confidential register which will not be publicly accessible. The Registrar will be subject to an obligation not to disclose home addresses but will be entitled, if he or she wishes, to use them for communicating directly with directors. The Registrar also has the power, under section 245 CA 2006, to place the director's residential address on the public record if it appears that communications sent to his or her service address have not been effective in terms of bringing matters to the director's attention or of generating a desired response. Before the Registrar does this, however, notice will be sent both to the director (using his or her home address) and to every company of which the person concerned is registered as a director. Consequently, the companies concerned must make the same change of address in their register of directors and state, in their register of directors' residential addresses, that the director's residential address is the same as his or her service address.
- 8.13 With regard to (c) above, the provision for a court order to be made to enforce disclosure of a director's address by a company or the Registrar is intended for use only in exceptional circumstances – eligibility to apply for a disclosure order is restricted to a liquidator, creditor or member of the company or some other who appears to the court to have 'a sufficient interest' in the disclosure. Even where a person is eligible to apply for an order, the court may only accede where it is necessary or expedient for the disclosure to be made in connection with the enforcement of an order or decree made by it, and if it is otherwise satisfied that it would be appropriate to make the order.

**(iii) Register of secretaries**

- 8.14 A company is required to keep a register of its secretaries (section 275 CA 2006). This must be kept at its registered office or at some other place of which notice has been given to the Registrar. It must also be made available for inspection by its members or by any other person. The register must contain the information required by section 277 in the case of an individual and section 278 in the case of a corporate body. Any new appointment as secretary, or any changes to the details kept in the register, must be notified to Companies House within 14 days.

**(iv) Register of charges**

- 8.15 Every company must keep a register of any fixed or floating charges given over the company's property and record in it a description of any property charged, the amount of the charge and, except in the case of securities to bearer, the names of the person(s) entitled to the charge (section 876 CA 2006). The register must be made available for inspection by any person and its location notified to the Registrar.

**(v) Register of debenture holders**

- 8.16 It is not compulsory for a company to keep a register of debenture holders. Where one is kept, similar rules to those relating to the register of members apply to the inspection of the register of debenture holders and to the notification of its location to the Registrar.

**(vi) Register of information acquired following investigations**

- 8.17 In the case of public companies only, a company must keep a register of information received by it following the issue by it of a notice requiring information about interests in its shares (section 808 CA 2006). Again, this register must be made available for inspection by any person and the Registrar must be notified of its location.

**DIRECTORS' SERVICE CONTRACTS**

---

- 8.18 Every company is required to keep available for inspection, by members of the company, copies of its directors' service contracts, if any, and – where service contracts are not in writing – a written memorandum setting out the terms of the contract (section 228 CA 2006). As with the statutory registers referred to above, this information must be kept either at the company's registered office or else at some other place, details of which have been notified to the Registrar. Any member has the right to inspect the contract or memorandum and to receive a copy of it, which must be sent within 7 days.



## **DIRECTORS' MEETINGS**

---

- 8.19 Companies must keep minutes of all proceedings at meetings of their directors (section 248 CA 2006). This should be interpreted as covering meetings of the full board and any committees of the board. These must be kept for at least ten years from the date of the meeting. The significance of minutes is that, once they are authenticated by the chair of the meeting concerned, or of the next meeting, they constitute evidence of the proceedings at the meeting, and in particular, that the meeting is deemed to have been duly held and convened, that all proceedings at the meeting have duly taken place and that all appointments made at the meeting are valid (section 249 CA 2006).
- 8.20 A company's articles will invariably contain procedural requirements regarding the convening and conduct of directors' meetings. Such provisions are contained in Table A and in the draft 2007 model articles published in March 2007.

## **THE COMPANY SECRETARY**

---

- 8.21 Every public company is required to appoint a company secretary (section 271 CA 2006). The holder of the post will be an officer of the company (section 1121 CA 2006). The directors of a public company have a duty under section 273 to take all reasonable steps to ensure that the person they appoint (a) appears to have the requisite knowledge and experience to discharge the functions of secretary and (b) has one or more of the qualifications set out in section 272(3). Where a public company appears not to have a secretary, the Secretary of State may issue a direction calling on it to make an appointment (section 272 CA 2006).
- 8.22 A private company, regardless of its size, does not need to appoint a company secretary (section 270 CA 2006) though it may do so if it wishes. Where it appoints a company secretary the person holding that position will be an officer of the company and the company will need to maintain the register of secretaries referred to in paragraph 8.14 above.

## **RULES REGARDING GENERAL MEETINGS**

---

- 8.23 The Act contains a number of procedural rules regarding company meetings.

The directors have a statutory power to call general meetings of the company at any time (section 302 CA 2006). This is in addition to any power they may have under the company's articles.

Directors have a duty to call a meeting where the members present them with a requisition to do so which satisfies the requirements of section 303. Any such requisition must be supported by members representing at least 10% of the paid up capital carrying voting rights or, in the case of a company without a share capital, at least 10% of the voting rights. The meeting must be called within 21 days and must be held not more than 28 days after the date of the meeting notice. If the directors do not comply with their obligation to do this, the members who requisitioned the meeting, or otherwise those representing at

least 50% of the voting rights, may call the meeting themselves. The reasonable expenses that they incur in doing this must be repaid to them by the company; in turn, the amount repaid must be withheld by the company from any fees or remuneration owed to those of the directors who were in default.

Private companies are not required by the Act to hold Annual General Meetings (AGMs), though they may do so if they wish and individual private company articles may still require the directors to hold an AGM. Every public company is required to hold an AGM and may call general meetings where appropriate. The AGM must be held within 6 months of its accounting reference date (viz the end of its last financial year).

Public companies are required to lay their annual accounts and reports before their members each year at an 'accounts meeting'. This meeting will invariably double as the company's AGM.

At least 21 days notice is required for an AGM of a public company and 14 days for other general meetings. Again, the articles may require longer periods. Shorter notice may be permitted in respect of a public company's AGM only if all the members who are entitled to attend and vote at the meeting agree. In the case of other general meetings, short notice must be supported by a majority of those members who have the right to attend and vote at the meeting and who together hold at least 90% of the nominal value of the voting shares (95% for a public company).

Every director is entitled to receive notice of any general meeting whether or not he or she is a member of the company.

Notice may be given in hard copy form, in electronic form or by means of a web site (section 308 CA 2006). These media may be combined, so that, for example, an e-mail may be sent to members to direct them to the posting of the full notice on the company's web site. The notice must include at least the following elements:

- the time and date of the meeting
- the place of the meeting
- the general nature of the business to be transacted at the meeting
- (in the case of a public company calling an AGM) the fact that the meeting is to be an AGM
- a statement, given 'reasonable prominence', of members' rights under section 324 to appoint a proxy to attend and speak at the meeting and to vote on their behalf.

The Act also contains procedural rules regarding quorum (section 318 CA 2006), voting (section 319 et seq CA 2006) and proxy voting (section 324 et seq CA 2006). These requirements may be supplemented by the provisions of a company's articles.

### **CALLING OF GENERAL MEETING ON SERIOUS LOSS OF CAPITAL**

---

- 8.24 The directors of a public company are required to convene a general meeting of their company whenever the net assets of the company fall to half or less of its called-up share capital to consider whether any, and if so what, steps should be taken to deal with the situation. (section 656 CA 2006).

### **CIRCULATION OF MEMBERS' STATEMENTS**

---

- 8.25 Members may require the directors to circulate, before a general meeting, a statement of no more than 1,000 words (section 314 CA 2006). To be entitled to do this, there must be an application to the company supported by members holding at least 5% of the votes that may be cast on the matters referred to in the statement, or by at least 100 members with the right to vote who hold shares on which an average of at least £100 has been paid up. Where a valid application is made, the directors must, as a rule, ensure that it is circulated. A company in receipt of an otherwise valid application may apply to the court under section 317 CA 2006 for permission not to have to circulate the resolution an order on the grounds that members are abusing their rights.
- 8.26 The expenses relating to the circulation of the statement must be paid by the requisitioning members unless the members collectively agree that they should be met by the company. Further, unless the members agree beforehand, the company need not circulate the statement unless the company's reasonable expenses are paid by the requisitionists at least one week before the meeting. In the case of an application relating to the AGM of a public company and where the application is delivered to the company before the end of the previous financial year, the expenses are always payable by the company.

### **CIRCULATION OF MEMBERS' RESOLUTIONS (PUBLIC COMPANIES)**

---

- 8.27 The members of a public company may require their company to table resolutions proposed by them at the next AGM (section 338 CA 2006). To be valid, a request to do this must be supported by members representing at least 5% of all the voting rights able to be cast on the proposed resolution or at least 100 members with voting shares on which an average sum per member of at least £100 has been paid up. Note that a resolution will not be acceptable, even if the above conditions are met, if it is defamatory, frivolous or vexatious, or would, if passed, be ineffective because of some inconsistency with the company's constitution or otherwise.
- 8.28 If the application is valid, however, and subject to any requirement for receipt of reasonable expenses, it must be circulated to members at the same time as the notice of the meeting is sent out to members, or as soon as is reasonably practical thereafter and must form part of the business to be transacted at the meeting.

- 8.29 The expenses of circulation must be met by the company if the application is received by the company before the end of the previous financial year. Where this is not the case, the company is not obliged to circulate the resolution unless it receives reasonable expenses from the requisitioning members at least six weeks before the date of the meeting or, if later, the date on which the notice is sent out. The members collectively can subsequently resolve that the expenses should be met by the company in which case the money can be returned.

#### **RESPONSIBILITIES OF QUOTED COMPANIES REGARDING POLLS**

---

- 8.30 Where a poll has been taken at a general meeting held by a quoted company, prescribed information about the results of that poll must be placed on the company's web site (section 341 CA 2006). Where the members of the company have made a valid request to the directors to obtain an independent report on a poll, the directors are obliged to appoint a person whom they consider to be appropriate (who is likely to be the company's auditor) to perform this task within one week of the date of the request being made. That person, the independent assessor, will have the right to demand information from a range of persons, including the company's directors, for the purpose of making his or her report. The company is responsible for placing the information about the appointment of the assessor prescribed by section 351 CA 2006 on its website.

#### **RECORDS OF RESOLUTIONS**

---

- 8.31 Every company is required to keep records concerning its general meetings and resolutions passed by it (section 355 CA 2006). These records must comprise:
- minutes of all proceedings at general meetings
  - copies of all resolutions passed otherwise than at general meetings
  - records of decisions by sole member companies.

- 8.32 These records must be kept for at least ten years and must be kept available for inspection at the company's registered office, or at some other location of which notice is given to the Registrar, by any member of the company. Members may also request copies of the records.

#### **FILING OF RESOLUTIONS**

---

- 8.33 The passing of all special resolutions passed by the company, and of other types of resolution and agreement deemed to affect a company's constitution – this will include any resolution to amend the company's articles – must be notified to the Registrar (section 30 CA 2006). Notice to the Registrar is also required where the constitution is amended by court order (section 35 CA 2006).

### **PROVISION OF INFORMATION TO MEMBERS**

---

- 8.34 In addition to the information that companies are required to make available via the statutory registers, any member may request an up-to-date copy of the company's articles, the company's certificate of incorporation and other specified constitutional information (section 32 CA 2006), may inspect copies of resolutions passed by the company and minutes of its general meetings (section 358 CA 2006) and may require a copy of the company's most recent annual accounts, directors' report and auditor's report (sections 431 and 432 CA 2006).

### **TRADING DISCLOSURES**

---

- 8.35 A company must comply with any regulations made by the Secretary of State under section 82 CA 2006 regarding the disclosure of information about the company at its premises and in its communications. The content of these regulations was likely to reiterate and update the corresponding provisions of the Companies Act 1985, which required the following disclosures:

- disclosure by the company of its name, in a conspicuous position and in legible letters, outside every office or place at which its business is carried on.
- disclosure of the company's name, again in legible characters, on all business letters and order forms of the company, on its web site, all notices and official publications, on all bills of exchange, promissory notes, endorsements, cheques and orders for money and on all invoices, receipts and letters of credit.
- disclosure in company correspondence and on its web site of (a) the company's place of registration and the number with which it is registered, (b) the address of its registered office, (c) in the case of an investment company, the fact that it is such a company, and (d) in the case of a limited company exempt from the obligation to use the word "limited" as part of its name or a community interest company which is not a public company, the fact that it is a limited company.
- disclosure on business stationery of the names of the company's directors shall not be made unless the names of all the directors appear.

### **REQUIREMENTS REGARDING SHARES AND DEBENTURES**

---

- 8.36 The Act contains specific requirements regarding procedures for the allotment of shares and debentures and the registration of share transfers.

### **ANNUAL RETURN**

---

- 8.37 Every company is required to complete and file with the Registrar an annual return, which must include prescribed particulars of the company's directors and shareholders (section 854 CA 2006).

### **IMPLEMENTATION**

---

8.38 Most of the provisions of the Act which are referred to in this Chapter take effect in October 2007. The principal exceptions are as stated below – NB where appropriate corresponding provisions of the Companies Act 1985 remain in force until then:

- Section 165 – Register of directors' residential addresses, discussed at paragraph 8.11 et seq – October 2008
- Section 270 et seq – Provisions regarding the company secretary, including the right for the private company not to have a company secretary, discussed at paragraphs 8.14 and 8.22 – April 2008

## 9. Directors' transactions with their company

9.1 The Companies Act 2006 contains strict rules on the circumstances in which directors may enter into financial bargains with their own company. These rules derive from the long-standing common law principle (now incorporated into statute law via the statement of general duties – see Chapter 6) – that directors must account to their company for any profit they make from their office. In many cases, the bargains between directors and their companies are not subject to an absolute prohibition but, rather, are subject to obligatory disclosure and approval – if they see fit – by the company's members. The principal rules in this area are set out in the following paragraphs.

### **LOANS ETC**

---

9.2 There are strict rules governing the circumstances in which directors may cause their companies to make loans or enter into other types of beneficial financial arrangement with them or people connected with them. A director who fails to observe these rules may be required to compensate the company.

9.3 The basic rule on loans is set out in section 197(1) CA 2006. This says that a company may make a loan to a director of the company or its holding company, or give any guarantee or provide security in connection with a loan made by any person to a director, only if the transaction has been approved by a resolution of the company's members (and, where the transaction is in favour of a director of the holding company, by a resolution of the members of the holding company). (No member approval is required in the case of a transaction entered into by a company which is a wholly-owned subsidiary of another UK company).

9.4 Before any such resolution can be passed, the company must prepare a memorandum setting out the following:

- the nature of the transaction
- the amount of the loan and the purpose for which it is required
- the extent of the company's liability under any transaction connected with the loan.

9.5 This memorandum must be made available to members before they consider the resolution. Where the resolution is to be passed at a formal general meeting, the memorandum must be made available for inspection at the company's registered office for no fewer than 15 days ending with the date of the meeting, as well as at the meeting itself. Where the resolution is to be passed by means of a written resolution, the memorandum must be sent or submitted to every member eligible to vote either before or at the same time as the resolution itself is sent to them.

9.6 In addition to the basic prohibition on the making of a loan, section 203 CA 2006 says that a company may not do either of the following things without obtaining prior approval from its members:

- take part in any arrangement whereby another person provides the prohibited loan and that other person obtains some benefit from the company or an associated company via the arrangement; or
- arrange for the assignment to it or assumption by it of any rights, obligations or liabilities under a transaction which, had it been entered into by the company, would have required members' approval.

9.7 Approval by the members of any arrangement falling within the scope of section 203 must follow the same process as outlined above for the granting of a loan. (Again, no approval is required if the company is a wholly-owned subsidiary).

#### **EXCEPTIONS**

---

9.8 There are a number of derogations from the basic rule in section 197(1) which mean that, in the circumstances specified, companies need not obtain the approval of their members before making a loan. The derogations are as set out in (a) to (g) below.

- (a) Where the company provides a director of a company or of its holding company, or a person 'connected' with any such director, with funds to meet expenditure already incurred or to be incurred by the director either for the purposes of the company or for the purpose of enabling the person concerned to perform his or her duties as an officer of the company; or
- (b) Where a company does anything to enable a person covered in i) to avoid incurring any such expenditure (section 204 CA 2006).

These derogations allow a company to advance funds to a director in respect of expenditure to be incurred on company business and to reimburse him or her in respect of expenditure already occurred. Funds provided must not exceed the value of the transactions entered into and are subject to an aggregate limit for all 'relevant transactions' (see below) of £50,000.

- (c) Where the combined value of the loan and all other relevant transactions or arrangements (see below) does not exceed £10,000 (section 207 CA 2006).
- (d) Where a company makes a loan to an associated body corporate or gives a guarantee or provides security for a loan to an associated company (section 208 CA 2006).
- (e) Where a company provides a loan to a director of the company or its holding company to enable that person to meet expenditure incurred or to be incurred in defending him or herself in any investigation by a regulatory authority or any action proposed to be taken by such an authority in connection with any alleged negligence, default, breach of duty or breach of trust by the director in relation to the company



or any associated company, or to enable any such director to avoid incurring any such expenditure (section 206 CA 2006).

- (f) Where the company provides a director of the company or its holding company with funds to meet expenditure incurred or to be incurred by him or her in defending any criminal or civil proceedings in connection with alleged negligence, default, breach of duty or breach of trust by the director in relation to the company or any associated company, or in connection with an application for relief from the court under section 661 or 1157 CA 2006 (section 205 CA 2006).

Derogation under section 205 is only possible, however, on the terms that:

- the loan must be repaid (or as the case may be the company's liability is to be discharged) in the event of the director being convicted in the proceedings, judgment being given against him in the proceedings or the court refusing to grant him relief on an application for relief
- repayment or discharge must take place no later than the date when the conviction, judgement or refusal to grant relief becomes final.

- (g) Where a company which is a 'money lending company' (ie a company whose ordinary business includes the making of loans) enters into a transaction with a director in the ordinary course of its business and the value of the transaction is not greater, and its terms are not more favourable, than it would be reasonable to expect the company to offer to a person unconnected with the company (section 209 CA 2006).

#### **ADDITIONAL RULES RELATING TO PUBLIC COMPANIES**

---

- 9.9 The foregoing rules relating to loans apply to private and public companies alike. Where a company is a public company or is 'associated' with a public company, however, there are further restrictions on its ability to enter into with a person who is a director of it or its holding company. The transactions subject to these further restrictions are as follows:

- (a) quasi-loans (section 198 CA 2006)
- (b) transactions with connected persons (section 200 CA 2006)
- (c) credit transactions (section 201 CA 2006).

(Transactions of any of these kinds are also subject to members' approval if they are undertaken in a manner covered by section 203 CA 2006 ('related arrangements' – see paragraph 9.6 above)).

- 9.10 A quasi-loan is a transaction whereby, in essence, the first party pays or agrees to pay an amount of money for a second party, or else reimburses or agrees to reimburse an amount of money paid by the second party, on condition that the second party pays back the first party for its financial support. In company terms, a company will make a quasi-loan to a director if it agrees to perform the function of the first party in relation to him or her.
- 9.11 A company will enter into a transaction with a connected person if it makes a loan or a quasi-loan to a person who is connected with a director of it or its holding company, or gives any guarantee or security for a loan or quasi-loan made to a connected person. A connected person for this purpose is any of the following:
- (a) members of the director's family
  - (b) a body corporate with which the director is connected (as defined in section 254 CA 2006)
  - (c) a trustee of a trust of which the director or a person covered by (a) or (b) is a beneficiary
  - (d) a trustee of a trust whose terms provide for the director to benefit from it
  - (e) a business partner of the director or of a person covered by (a), (b), (c) or (d)
  - (f) a firm in which the director is a partner or one of the partners is an individual or firm covered by (a), (b), (c) or (d).
- 9.12 A credit transaction is one where one party ('the creditor') performs any of the following functions:
- supplies any goods or sells any land under a hire-purchase agreement or a conditional sale agreement
  - leases or hires any land or goods in return for periodical payments, or
  - otherwise disposes of land or supplies goods or services on the understanding that payment (whether in a lump sum, in instalments or by way of periodic payments or otherwise) is to be deferred.
- 9.13 For the purposes of the restriction in section 201 CA 2006, a company would enter into a credit transaction with a director if it performed the function of the creditor with regard to a director of the company or of its holding company (or of a person connected with any such director) or gave a guarantee or provided security in connection with a credit transaction entered into by any person with such a director or connected person.

- 9.14 In respect of all three cases – quasi-loans, transactions with connected persons and credit transactions – public companies may only enter into them if the transaction concerned has been approved by resolution of the members. If a transaction is entered into for the benefit of a director of the company's holding company, then approval must be gained from the holding company as well. The approval process is similar to the process described in paragraphs 9.4–9.5 above for the approval of loans.
- 9.15 Again, no approval is necessary, in either of the three cases, where the company concerned is a wholly-owned of another company.

### **EXCEPTIONS**

---

- 9.16 The exceptions from the need to seek members' approval, discussed in paragraph 9.8 above with regard to loans, apply equally to quasi-loans and transactions with connected persons. They apply also to credit transactions with the following modifications:

(a) with regard to the exception for minor business transactions under section 207 CA 2006, a public company is exempt from the need to seek approval for a credit transaction under section 201 if

- the aggregate of the new transaction and any other relevant transactions or arrangements does not exceed £15,000 or
- the transaction is entered into by the company in the normal course of its business and the value and terms of the transaction are not greater or more favourable than it would be reasonable to expect the company to offer to a person of the same financial standing but not connected to the company.

(b) there is no exception for money lending companies from the requirement to seek members' approval.

### **AGGREGATE OF TRANSACTIONS AND ARRANGEMENTS**

---

- 9.17 It was stated above that some of the exceptions to the need to seek members' approval for loans and other transactions benefiting directors are subject to monetary limits: if the aggregate value of relevant transactions exceed these limits any new transaction will not be covered by the derogation and will need to go to the members for their approval.
- 9.18 To reiterate, section 204 CA 2006 (exception for expenditure on company business) says that approval by the members is not required unless the aggregate of the value of the new transaction and other 'relevant transactions and arrangements' exceeds £50,000. Section 207 CA 2006 (exceptions for minor and business transactions) says that approval by the members is not required for a loan (or a quasi-loan or a loan or quasi-loan to a person connected with a director) unless the value of the new transaction, taken together with other 'relevant transactions and arrangements' exceeds £10,000. The same section says that approval is not required for a public company to enter into a credit transaction unless the combined value of transactions exceeds £15,000.

### **CONSEQUENCES OF BREACHES OF THE RULES ON LOANS ETC**

---

- 9.19 Under section 213 CA 2006, where a company breaches the rules on the making of loans etc to directors and connected persons, the company is entitled to avoid the transaction. This right of avoidance is, however, lost where the money or asset provided by the company via the transaction can no longer be restored to the company, or where the company has already been indemnified for any loss or damage it has suffered because of the transaction concerned, or if the rights of a person who has acquired rights for value and in good faith would be affected by the avoidance.
- 9.20 However, whether or not the transaction can be avoided, the company will have rights to recover any benefit gained by parties as a result of the illegal transaction and to claim compensation for any loss it has suffered (section 213(3) CA 2006). The persons who are liable under this provision are as follows:
- (i) any director of the company or its holding company with whom the illegal transaction was entered into
  - (ii) any person with whom the company entered into the transaction who is connected with a director of the company or its holding company
  - (iii) the director of the company or of its holding company who is connected with a person covered by ii) and
  - (iv) any other director of the company who authorised the transaction concerned.
- 9.21 The above notwithstanding, a connected person will not be liable under (ii) in respect of any of the categories of illegal transactions if he or she can show that at the time of the entering into of the arrangement they did not know the circumstances of the contravention (ie the fact that the transaction had not been approved or was not to be put to the members for approval). Likewise, a director can put forward the same defence under (iv) (although as a director this will be a more problematic line of defence).
- 9.22 In respect of the provisions of sections 200 (loans or quasi-loans to connected persons), 201 (credit transactions) and 203 (related arrangements) directors will not be liable under (iii) above if they can show that they took all reasonable steps to ensure the company's compliance with the requirements of section 190. Note that this last defence is not available in respect of the making of loans or quasi-loans.

## **SUBSTANTIAL PROPERTY TRANSACTIONS**

---

9.23 As is the case with loans and similar transactions, companies may not generally enter into transactions with their directors whereby substantial assets of the company are transferred to the directors or vice versa.

9.24 Section 190 CA 2006 says that a company may only enter into an arrangement under which

- a director of the company or its holding company, or a person connected with such a director, acquires or is to acquire from the company, either directly or indirectly, a substantial non-cash asset; or
- the company acquires or is to acquire a substantial non-cash asset directly or indirectly from such a director or a person connected to them

only if that arrangement has been approved by a resolution of the members of the company or is conditional on the approval being obtained.

9.25 A substantial non-cash asset is defined by section 191 CA 2006 as one whose value is greater than £5,000 AND exceeds 10% of the company's asset value; or exceeds £100,000. (Asset value being either the value of the company's net assets as determined by the company's most recent statutory accounts or – if no statutory accounts have been prepared – the amount of the company's called-up share capital)

9.26 Where the director or connected person is a director of the company's holding company, or is a person connected with such a director, the arrangement will also be subject to approval by members of the holding company. This rule applies to private and public companies alike. Approval by the members is not, however, required in the following circumstances:

- if the company is a wholly-owned subsidiary
- if the transaction is one between the company and a director in his capacity as member of the company
- if the transaction concerns anything to which the director is entitled under his service contract or amounts to payment for loss of office
- if the transaction is one between a holding company and its wholly-owned subsidiary or between two wholly-owned subsidiaries of the same holding company
- where the company has entered into insolvent liquidation or administration
- where the company is listed on a recognised investment exchange under the Financial Services and Markets Act 2000 and the transaction has been effected through the agency of an independent broker.

### **CONSEQUENCES OF BREACHING THE RULES ON SUBSTANTIAL PROPERTY TRANSACTIONS**

---

9.27 Where a company breaches the rule in section 190, similar consequences apply as in the case of loans and other transactions (as described in paragraph 9.19). Broadly, the transaction is in the first instance voidable by the company. But whether or not this is possible in a particular case, specified parties will be liable to account to the company for any gain they have made from the transaction and will also be liable, on a joint and several basis, to indemnify the company for any loss or damage it suffers as a result of the transaction. The specified parties are

- (i) any director of the company or its holding company with whom the company entered into the arrangement
- (ii) any person with whom the company entered into the arrangement who is connected with a director of the company or its holding company
- (iii) the director of the company or its holding company with whom any such person is connected and
- (iv) any other director who authorised the transaction concerned.

9.28 As is the case with loans and similar transactions, the Act includes defences against charges of liability. A connected person who can show that, at the time of the entering into of the arrangement he or she did not know the circumstances of the contravention (ie the fact that the transaction had not been approved or was not to be put to the members for approval) will not be liable under (ii) above in respect of any of the categories of illegal transactions. Likewise, a director can put forward the same defence under (iv). A director who can show that he or she took all reasonable steps to secure the company's compliance with its obligations under section 190 will not be liable under (iii).

### **DECLARATION OF INTEREST IN COMPANY TRANSACTIONS**

---

9.29 As long as it does not cause a conflict, there is nothing to prevent a director from having a personal interest in a matter being dealt with by his or her company. For example, a director may own shares in a company with which his or her own company conducts business. However, any material personal interest held by a director must be formally declared to the company.

9.30 This long-standing rule now forms part of the statutory statement of directors' duties (dealt with more fully in Chapter 6). Declaration of interest may be required in two circumstances – before a transaction is entered into and after.

### **Prior declaration**

9.31 Section 177 CA 2006 says that if a director is in any way, either directly or indirectly, interested in a proposed transaction or arrangement with his or her company, it is that director's responsibility to declare the nature and extent of the interest to the other directors before the transaction being contemplated is actually entered into.

### **Subsequent declaration**

9.32 A director is also required to declare the nature and extent of any interest he or she has in a transaction where the company has already entered into the transaction concerned (section 182 CA 2006). This situation may arise, for example, when a director joins a company and discovers subsequently that a declarable interest exists. Where a director makes this discovery, disclosure must be made 'as soon as is reasonably practicable.'

9.33 In specified circumstances, neither prior nor subsequent declaration is necessary:

- where a director is not aware of having an interest
- where a director is not aware of the transaction under consideration
- where the interest cannot reasonably be regarded as likely to give rise to a conflict of interest
- where the other directors are already aware (or ought to be aware) of the interest concerned
- where the interest involves terms of his or her service contract that have been or are to be considered either at a full meeting of the directors or at a meeting of a board committee.

9.34 If an interest does not fall within any of these exceptions, it will stand to be declared formally. In the case of a prior disclosure, how this is done is a matter for the director concerned to decide, but the Act offers two alternative methods of doing this. First, the declaration may be made verbally at a meeting of the directors. Secondly, the director may give written notice under section 184 CA 2006 or a general notice of his or her personal interests under section 185 CA 2006. In the case of subsequent disclosure, the declaration must be made by one or other of these means.

9.35 Where a declaration of interest is made verbally to the other directors at a meeting, it is in the interests of the director making it that the declaration should be formally recorded in the minutes of that meeting.

9.36 As for the written notice under section 184, this may be sent either in hard copy form – and delivered by hand or post – or, if recipients have agreed, in an agreed electronic form, such as e-mail. This written notice will set out the nature and extent of the director's interest in the particular transaction which is under consideration.

- 9.37 Section 185 offers a more comprehensive method of declaring interest. Under that section, a director may give a general notice to the company that he or she has an interest in a specified company or firm (eg as a shareholder, director or employee) and should be regarded henceforth as being 'interested' in any transaction that the company might enter into with that other body. Similarly, a general notice might state that the director is 'connected' with a specified individual and should be regarded as being 'interested' in any future transaction between the two parties. However it is framed, the general notice must set out the nature and extent of the interest being reported.
- 9.38 The making of a general notice of this kind, even if it involves the disclosure of interests of a kind not likely to give rise to any conflict of interest, will probably be an advisable safeguard where directors have other business or investment interests outside the company or are connected to persons who might conceivably conduct business dealings with the company. It therefore saves directors the need to make individual declarations and addresses the possibility that a director might forget to make a declaration on a particular occasion.
- 9.39 In the case of a matter which calls for prior disclosure of interest, provided a director makes the required disclosure under section 177, the Companies Act will not require any transaction to which it relates to be approved by the company's members (section 180 CA 2006). Nonetheless, a company may if it wishes make provision in its own articles of association for separate approval to be required – where such provision is made, the company must comply with it and the transaction may be set aside if approval is not sought and obtained.

#### **Shadow directors**

- 9.40 The requirement in section 182 CA 2006 to declare an interest in an existing transaction applies equally to shadow directors, although they are not expected to make their declarations at formal meetings of directors and their notice must always be in writing (section 187 CA 2006).

#### **Failure to declare an interest**

- 9.41 A director who fails to declare an interest under 177 will be in breach of the duty owed to the company and it is for the company to consider taking action against him or her (section 178 CA 2006).
- 9.42 A director who fails to declare his or her interest in a existing transaction under section 182 commits an offence (section 183 CA 2006).

#### **Directors' service contracts**

- 9.43 Not all directors will have service (employment) contracts with their company. Where they do, the basic rule is that a contract should not guarantee the director employment for a period of longer than two years without member approval.



- 9.44 The Act requires that any service contract between a director and the company with a guaranteed term of employment of more than two years must be approved by resolution of the company's members (section 188 CA 2006). This does not apply where the employing company is a wholly-owned subsidiary.
- 9.45 Before a resolution can be passed, the company must prepare a memorandum containing the proposed extended service term and this must be made available to members before the resolution is considered. Where the resolution is to be passed by means of a written resolution, the memorandum must be sent to every member eligible to vote at or before the time that the resolution is sent. Where the resolution is to be considered at a formal meeting, the memorandum must be made available for inspection at the company's registered office for not less than 15 days before the meeting and then at the meeting itself.
- 9.46 If the company agrees to adopt contractual terms of longer than two years without seeking and obtaining members' approval, the provision is void and the contract is deemed to contain a term entitling the company to terminate it at any time by giving reasonable notice (section 189 CA 2006).

#### **IMPLEMENTATION**

---

- 9.47 The provisions discussed in this Chapter took effect in October 2007.

## 10. Consequences of breaches of directors' responsibilities

### INTRODUCTION

---

- 10.1 In most cases, the actions of a person acting as a director will be treated as being the actions of the company itself – the director will only be providing the necessary human intervention to give effect to the company's wishes and to comply with its legal commitments. This is consistent with the fundamental principle of company law that the actions of the company are separate from the individuals who own and control it. Where this principle holds, a failure on the part of a director to achieve the company's business aims or to cause the company to observe any legal requirement to which the company is subject will be treated as a failing on the part of the company and not him or herself.
- 10.2 Nonetheless, the shelter from personal responsibility is far from absolute and anyone acting as a director should be aware that there may be both criminal and civil repercussions for them where they fail to act in accordance with their duties. As far as civil liability is concerned, directors are accountable in all that they do to the persons who appointed them and who have entrusted them with the responsibility of looking after the company's assets and achieving its aims. Where they have misapplied company property or caused the company loss or expenditure as a result of misconduct, the company may require them to pay that money back or else to compensate it for its loss. Directors may also be held liable, this time to the company's creditors, where they fail to pay due regard to the legitimate interests of those creditors. Where directors are considered to have failed conspicuously to have met the standards that the law expects from them, the courts can disqualify them from acting as a director or in any way being involved with the management of a limited company for anything up to 15 years.
- 10.3 This Chapter looks at the various ramifications that can ensue where directors breach their responsibilities to their company and others. Both criminal and civil actions can be contemplated against individual directors in respect of their responsibility for the alleged wrong-doing. For this reason it is advisable that, wherever a director believes that a particular board decision would expose the company or the directors personally to litigation, and opposes the taking of that decision, that director should insist that this opposition, and preferably also details of his or her efforts to persuade colleagues not to take the decision in question, is formally recorded in the board minutes. Such action is specifically recommended in the Combined Code on corporate governance in the context of listed companies, but should be seen as constituting good practice generally.

### CRIMINAL SANCTIONS

---

- 10.4 The Companies Act and other statutes identify a large number of circumstances where failure to comply with statutory requirements may result in criminal sanctions being imposed on companies and their individual directors. A comprehensive list of the offences that directors may commit under the Companies Act 2006, and a summary of relevant offences under other statutes, is included here at Appendix 1.

## **PERSONAL LIABILITY**

---

10.5 The paragraphs below look at the circumstances in which individual directors may be made personally liable, either automatically under statutory or regulatory provisions, or via the courts.

### **(i) Enforcement of directors' obligations by the company**

10.6 Section 178 CA 2006 provides that the consequences of breach of the duties set out in sections 170-177 are the same as would apply had those duties not been set out in statute (and which will remain the same in the case of those common law duties that have not been transposed into statute via the statement of general duties). This means that, in respect of those duties that are treated as fiduciary duties the company may consider the following options:

- it can seek to recover any of the company's property which has been misapplied by the director, eg it can seek to recover dividends which have been paid to members in breach of the rules that say that dividends must only be paid out of distributable profits
- it can make the director account to the company for the profit he or she has made in breach of the fiduciary duty.

10.7 Faced with an alleged breach of a fiduciary duty the company may also seek to issue an injunction to prevent the act complained of from being committed in the first place or alternatively seek to rescind the contract.

10.8 Where the complaint is that the director has breached the duty of skill, care and diligence (now set out in section 174), the company can claim damages from the director where it has suffered loss as a result of the breach.

10.9 These remedies are therefore available to the company in respect of breaches by the directors of their general duties set out in sections 170–178 and of other breaches of duty that are not specifically covered in those sections.

### **(ii) Enforcement of directors' obligations by the members**

10.10 The 'proper plaintiff' rule has in the past acted as a restraint on the bringing of actions by a company's members against their own directors. This rule – otherwise known as the rule in *Foss v Harbottle* – holds that if the company wishes to enforce its rights through the taking of legal action, those proceedings must be brought by the body which has the right to take such action under the company's constitution. Invariably, the body entrusted with the power to bring legal proceedings in the company's name will be the company's directors.

- 10.11 Where the director or directors who have been at fault control the board, however, there is an obvious practical problem in getting the company to commence legal proceedings and in obtaining due compensation for the members. The courts have addressed this problem by allowing members of a company to bring legal proceedings in the name of their company via the so-called 'derivative action' procedure. (The derivative action refers to proceedings brought in the name of a company not by its directors but by its members or some of them).
- 10.12 The circumstances in which the derivative action may be used has, traditionally, been very limited in scope. It has only been allowed by the courts where the directors have refused to commence proceedings on a particular matter and the decision not to do so has amounted to a fraud on the minority, most obviously because the directors are aware that the outcome would be that they themselves would be sued and they want to avoid this happening. Even if the majority of members supported the action, an action would not be allowed if it did not meet the test of fraud on the minority, in the eyes of the court.
- 10.13 Under the Companies Act 2006, an important reform is made by the introduction of a new statutory right for members to launch legal actions in the name of their company. This reform could have the effect of making it easier for members to enforce the duties which directors owe to their companies.
- 10.14 Under section 260 CA 2006, any member of a company is eligible to bring a derivative claim in respect of any actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company (or a former director or a shadow director). Members can also seek to pursue an action as a derivative claim if they think that the company has not dealt with the claim properly.
- 10.15 Thus, any member can, in theory at least, cause his or her company to take legal action against one or more of its own directors (or former directors) for breaches of any of the general duties covered in Chapter 6 or any other duty owed by them, or else for negligence, default or breach of trust.
- 10.16 The introduction of this new right has provoked concerns that directors are now exposed to a much greater risk of litigation at the hands of dissatisfied shareholders. This concern has been greatest in respect of the requirement in section 172 CA 2006 for directors to promote the success of their company by, in part, having regard to a list of specified factors as well as to a vague category of 'other matters'. In theory, any individual shareholder who considers that a director has failed to take proper account of any one of these 'stakeholder' factors could try to present that failure as causing a breach of the director's duty to the company, and seek to base a claim on that alleged breach.
- 10.17 The Act has attempted to meet these concerns by placing restrictions on the circumstances in which members may bring derivative claims under section 260. Any member or members wishing to bring a claim will first have to seek permission (in Northern Ireland 'leave') from the court to continue the claim. The court will carry out the following assessments at that initial stage:

(i) it will consider whether the member or members, through the evidence presented, have made out a prima facie case for giving permission (leave): if it considers that no prima facie case has been made out, the application must be dismissed.

(ii) it will also seek to satisfy itself as to:

- whether a director who was complying with his duty under section 172 would seek to continue the claim being made
- (where the act or omission complained of has yet to occur) whether that act or omission has been authorised by the company
- (where the act or omission has already occurred) whether the act or omission was authorised by the company before it occurred or else has been ratified by the company since it occurred.

If the court is satisfied on any of the three grounds in ii) above, the application must again be dismissed.

10.18 Generally, the court will be required, when considering an application from a member or members, to take into account the factors set out in section 263(3) and (4). These include:

- whether the member is acting in 'good faith'
- the importance that a person who was acting in accordance with section 172 would attach to continuing the claim
- whether the company itself has decided not to pursue the matter that forms the basis of the claim
- any evidence before it of the views on the matter of members who have no personal interest in it
- the likelihood of the company authorising or ratifying the act or omission complained of.

10.19 The intention is that these obstacles will deter members' claims that are frivolous, unreasonable and unrepresentative while still allowing for substantial complaints to be taken forward. In weighing up the likelihood that members will bring claims for breaches of section 172 CA 2006 in particular, it should be remembered that, while there is a positive requirement for directors to 'have regard' to the factors covered in section 172(1), the law does not make any presumption as to the conclusions to which they should come in this process or to the weight they should attach to any of the specified factors. Further, directors owe their duties to the company as a whole and not to any individual shareholder or group of shareholders. For these reasons, unless those members who may wish to pursue a particular ground of complaint against directors are able to present it as one which has been detrimental to the interests of members as a whole, derivative claims are likely to prove difficult to pursue.

- 10.20 A second basis for bringing derivative claims is available under section 369 CA 2006. Specific provision is made for members to bring proceedings in the name of their company in order to enforce directors' personal liability in respect of unauthorised political donations or expenditure (see paragraph 10.27 below). NB both new grounds for derivative actions under the Companies Act 2006 take effect as from October 2007.

**(iii) Other grounds for personal liability under companies legislation**

**Pre-incorporation contracts**

- 10.21 Where persons enter into a contract in the name of a company before it has been formally brought into being by the process of registration, the contract will still be valid. Since, however, the company does not exist at that stage, it cannot be a party to the contract – the persons who enter into it, and not the company, are liable to fulfil it (section 51 CA 2006).

**Contravention of the rules on substantial property transactions**

- 10.22 As discussed in paragraph 9.23 et seq above, the Act contains rules which require the members of a company to give their approval to any substantial property transactions between the company and any of its directors. Where the necessary approval is not sought and obtained, every director who was a party to the transaction and every director who authorised it is liable to account to the company for any gain they made and, on a joint and several basis, to indemnify the company for any loss or damage resulting from the breach (section 195 CA 2006).

**Illegal loans**

- 10.23 As explained in paragraph 9.2 et seq above, the Act sets out the circumstances in which a company may and may not make a loan to or enter into other specified transactions with one of its directors. Under section 213 CA 2006, where a loan is made which infringes the rules set out therein, the company is entitled to be compensated. Any director of the company or its holding company who receives an illegal loan, as well as any director who authorised its payment, is liable to account to the company for any gain they have made and – on a joint and several basis – to indemnify the company for any loss or damage it suffers as a result of the transaction. Accordingly, where a company makes loans to its directors which are not properly authorised, all directors are liable on a joint and several basis to make good the company's loss.

**Ad hoc payments to directors**

- 10.24 The Act requires that certain types of ad hoc payments to directors in connection with the loss of their office must be approved by resolution of the members. There are certain exceptions to this rule – approval is not required where the amount of the payment does not exceed £200, where the payment takes the form of damages for breach of contract by the company, where it is in the form of a settlement of any employment-related claim by the director or where the payment is in the form of a pension. Further, no separate approval is required where the company is a wholly-owned subsidiary. Where a payment is made outside these exceptions, the recipient is deemed to hold the money on trust and the directors who authorised the payment may be jointly and severally liable to indemnify the company for any loss it suffers (section 222 CA 2006).

[Failure to call a company meeting](#)

- 10.25 Under section 304 CA 2006, the directors of a company are obliged to take the necessary steps to convene a general meeting of the company if the members present to them a valid request (for details see paragraph 8.23 above). They have 21 days to call the meeting and a further 28 days after that to actually hold the meeting. If the directors fail to do this, then the members may proceed to call and hold the meeting themselves. Any reasonable expenses incurred by the members in doing this must be reimbursed to them by the company and the company must in turn recover those expenses from the directors.

[Breach of rules on political donations](#)

- 10.26 Companies may only make political donations or incur political expenditure if those actions have been approved by their members under section 366 CA 2006. Where this rule is breached, the directors are jointly and severally liable to make good to the company the amount of the unauthorised donation or expenditure (with interest) and to compensate the company for any related loss or damage it sustains.
- 10.27 There is a specific entitlement for a company's members to bring proceedings against the directors so as to enforce the above rule. Proceedings may be brought by a group of members who hold at least 5% of the nominal value of the company's issued share capital (or if there is no share capital who amount to 5% of the company's membership) or who constitute at least 50 members. Notice must be given to the company of the intention to bring such proceedings and the directors may apply to the court to rule against the members' plans.

[Costs regarding the revision of defective annual accounts](#)

- 10.28 Where the published annual accounts of a company are considered to be 'defective', in the sense that they do not comply with the requirements of the Act, the Secretary of State (or the Financial Reporting Council) will be able to apply to the court for an order that the company must prepare revised accounts (section 456 CA 2006) Where the court agrees that the accounts were defective, it may additionally require the company's directors to bear all or part of both the costs of the application to the court and the company's 'reasonable expenses' of preparing the revised accounts.
- 10.29 In considering the imposition of personal liability on the directors, the court will first take into account which directors were party to the approval of the accounts held to be defective. Each person who was a director at the time of the accounts' approval is taken to be party to their approval unless that person can show that he or she took all reasonable steps to prevent their being approved. The court will then consider whether those directors who were party to the approval knew or ought to have known that the accounts did not comply with the requirements of the Act (or the IAS Regulation in the case of companies preparing accounts in accordance with IFRS). Based on this consideration of personal fault, the court may then exempt one or more directors from personal liability or order that each should pay different amounts based on the court's assessment of his or her proportionate share of the blame.

[False or misleading statements in company reports](#)

- 10.30 Directors are liable to compensate their company if the company suffers any loss as the result of any untrue or misleading statement in (or any omission from) the company's directors' report, directors' remuneration report or summary financial statement (section 463 CA 2006). But directors will only be liable in these circumstances if they knew that the statements concerned were untrue or misleading or if they knew that the omission concerned was a dishonest concealment of a material fact.

[Contravention of members' pre-exemption rights](#)

- 10.31 The Act contains a basic presumption that any new allotment of shares should be offered to existing members of a company before they are made available to others (section 561 CA 2006). This presumption may, however, be overridden with reference to individual allotments by means of a special resolution or, in the case of private companies, more generally by including provisions to disapply the statutory pre-exemption rights in the company's articles.

- 10.32 If directors of a company fail to observe members' statutory pre-emption rights where they still apply, members whose rights are infringed have the right to receive compensation. The company and every officer who is in default in failing to observe the pre-emption rights are jointly and severally liable to compensate any member who has suffered any loss, damage, costs or expenses arising from the failure.

[Irregular allotments of shares by public companies](#)

- 10.33 Section 578 CA 2006 contains rules on the allotment of shares by public companies. In particular, it provides for the situation where an allotment of shares is not fully subscribed: where it is not, any money received from applicants must be repaid within a specified period. Directors who breach these rules knowingly, or who authorise or permit others to commit the breach, are liable to compensate the company and the allottee respectively for any loss, damages, costs or expenses they incur.

[Doing business without a trading certificate \(public companies\)](#)

- 10.34 A public company needs to obtain a certificate of trading from the registrar before it is permitted to commence trading (section 761 CA 2006). Where it breaches this rule, the transactions it enters into are still valid but, if the company fails to comply with its obligations under them within 21 days of being called upon to do so, the directors will be jointly and severally liable to indemnify the other party for any loss or damage suffered.

[Illegal dividends](#)

- 10.35 Under section 847 CA 2006, if a member of a company receives a distribution from a company when, at the time it is made, he or she knows or has reasonable grounds for believing it is unlawful, that member is liable to the repay it to the company. While this rule applies to members generally, it is more likely that a member will be held to have the means to know or suspect that a distribution is illegal if he or she is at the same time a director of the company and party to the decision to make the distribution. Section 847 therefore has particular implications for director/shareholders. A director's ignorance of the law in this area was no defence: *It's a Wrap (UK) Ltd v Gula [2006] BCC 626*.



**Liability following disqualification**

- 10.36 Where a director has been disqualified from acting as a company director (or from being otherwise involved in the promotion, formation or management of a company) under the terms of the Company Directors Disqualification Act 1986 and breaches that restriction, the person concerned will not only commit a criminal offence but will assume personal liability. He or she will be jointly and severally liable, along with the company and any other person who may also assume liability, for all the debts and liabilities incurred during the time that they were acting in breach of the disqualification order.
- 10.37 In addition to the above, the Companies Act 2006 allows the Secretary of State to bring in new regulations that would have the effect of extending the restriction on acting as a director (or being otherwise involved in a company), and the provisions regarding personal liability when in breach, to persons who are subject to legal restrictions in some other country based on criteria of unfitness or misconduct.

**(iv) Liability for market abuse under Financial Services and Markets Act 2000 (FSMA)**

- 10.38 In the quoted company sector, the Financial Services Authority (FSA) has power under the above Act to impose substantial penalties for conduct amounting to 'market abuse'. This broad term is defined by the FSA as covering any improper conduct, such as the use of inside information (insider dealing) which undermines the UK financial markets or damages the interests of ordinary market participants. In the first case leading to successful convictions for market abuse under FSMA, a company issued a misleading interim statement which included income from non-existent contracts. Two directors of the company (the CEO and Finance Director) were not only imprisoned but were ordered to pay a total of £980,000 in compensation and costs. Directors have also been fined substantial amounts by the FSA for breaches of the Listing Rules, some of which effectively shadow directors' legal responsibilities: accordingly, the FSA's power of sanction amounts to a significant additional potential liability for directors. In April 2007, a former Finance Director was fined £30,000 for breaches of the FSA principles by failing to exercise due skill, care and diligence in carrying out his role and for failure to take reasonable steps to ensure the firm's accounting procedures and records complied with regulatory requirements. In particular, the director concerned was held to have failed to take reasonable steps to ensure that his company established and maintained adequate systems and controls relating to the making and retention of accounting records and to have failed to take reasonable steps to ensure that his company provided the external auditors with accounting records sufficient for the auditor's purposes. The FSA concluded overall that the directors' conduct in the case concerned resulted in the company being unable to monitor effectively its own financial position and to comply with its regulatory reporting requirements.

**(v) Directors' liabilities to creditors following the insolvency of their company**

- 10.39 The principle that the assets and liabilities of a company are technically separate from those of the persons who own and control the company holds good even where a company becomes insolvent because it cannot afford to pay its debts. In this situation, it is the company's shareholders and creditors who will have to bear the financial loss, and the directors who controlled the company and led it into insolvency will have no automatic responsibility to share the losses (unless they were also shareholders themselves in which case they will invariably lose the money they had invested in the share capital of their company).

10.40 This situation does, however, contain obvious scope for abuse. Some directors may choose to take advantage of the various protections afforded by company law by operating their companies with reckless or wilful disregard for the interests of their company's creditors and even their shareholders. The law has responded to this type of situation by adopting the long-established common law principle that, where it is just and equitable to do so, the 'corporate veil' can be temporarily pierced and companies and their officers can be dealt with as if they were not subject to the standard protections of company law in relation to the circumstances of the case. Thus, the reckless or unethical conduct of company directors can, in some circumstances, lead to their being made personally liable for the debts of their company.

10.41 As already stated, in normal circumstances directors will owe their duties and responsibilities to their company alone. It is the company that appoints them and places its trust in them, and the company that delegates powers to them. Consequently, any breach of duty on the part of the director is, as a rule, actionable by the company, acting through either the board of directors or, via derivative actions, the members. Where a company is in a state of insolvency, however, the law holds that the primary stakeholders in the directors' actions are the company's creditors, rather than the members, and it is to the creditors that directors owe their duties.

10.42 In the case of *Lonrho Ltd v Shell Petroleum co Ltd [1980] 1 WLR 627*, the House of Lords held that directors must always act in the best interests of their company, which interests are 'not exclusively those of its shareholders but may include those of its creditors'. The Court of Appeal, in *West Mercia Safetywear Ltd v Dodd [1988] BCLC 250*, expanded on this by ruling that directors of a company which is in an insolvent state must have regard to the interests of its creditors. Thus it is part of directors' fiduciary duties to their company that they act with due regard to the interests of their creditors during a period of insolvency. The court in *West Mercia* ruled thus:

'In a solvent company, the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. ... But where a company is insolvent, the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that through the medium of the company are under the management of the directors pending either liquidation, return to solvency or the imposition of some alternative administration'.

10.43 The following paragraphs set out some of the ways in which this principle of creditor primacy is applied where a company is in a state of insolvency.

#### Wrongful trading

10.44 The statutory provisions on 'wrongful trading', as now set out in the Insolvency Act 1986, were developed parallel to rules that have been developed by the courts since the 1980s to the effect that, when a company is insolvent or approaching insolvency, directors owe responsibilities not to the company's members (or not only to them) but rather to their creditors. The rules on wrongful trading constitute a strong warning to directors that they should be careful not to finance their company's continuing operations by unpaid debts to creditors.

- 10.45 This approach was put on a statutory footing under the Insolvency Act 1986, at least in respect of companies that have actually gone into insolvent liquidation. Section 214 IA 86 says that, where a company has gone into insolvent liquidation, the liquidator may apply to the court for an order to be made against one or more of the directors (or shadow directors) of the company to require them to 'contribute to the assets of the company'. The liquidator will do this if he or she considers that the directors have failed to pay due regard to the interests of their company's creditors in the run up to its liquidation.
- 10.46 Specifically, the court will consider whether a director knew, or ought to have concluded, that at some point prior to winding up the company had no reasonable prospect of avoiding insolvent liquidation. The court's assessment of this question requires it, on the basis of the evidence presented by the liquidator, to reconstruct the period leading up to the company's liquidation in order to identify a point in time at which a determination might have been possible as to whether there was 'no reasonable prospect' of avoiding liquidation. The assembly of this information will enable the court to identify what directors actually knew about the financial situation of their company (or what they would have known had they monitored the situation in the same way themselves at the time). If an appropriate point in time can be established, the court will then infer whether the directors knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation at that time.
- 10.47 In considering what they ought to have concluded, section 214(5) IA 1986 introduced a new, higher benchmark of skill and care into the law on directors' duties (a benchmark which is now applied to directors generally under section 174 CA 2006 – see Chapter 6 above). In accordance with this benchmark the court is expected to consider, when assessing the acts of any director:
- the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by the person against whom a declaration is sought and
  - the general knowledge, skill and experience that that person has.
- 10.48 Thus the court is required to apply, when making its assessment of a director's behaviour, not only the traditional, subjective test – the knowledge, skill and experience that he or she actually has – but also an objective standard: the knowledge, skill and experience that 'may reasonably be expected' from a person performing the director's functions. So in a situation where a director happens to be a qualified accountant, for example, the court will take into account, under ii), whether his or her professional skills were in fact brought to bear as they should have been in dealing with the financial implications of the situation. In these circumstances the contribution of a director who is a qualified accountant will be judged against a higher standard than that of a director who is not. But directors will also be judged under i) above – by virtue of this objective test, a director who has no financial background will still be expected to show the knowledge and skill which 'may reasonably be expected' of a director in his or her position. It may also be the case that the court will consider, under i), whether the accountant director has in fact displayed the knowledge, skill and experience that may reasonably be expected of a qualified accountant in the circumstances.

10.49 If the court can, on the basis of the facts of the case, establish that there was a point at which the directors of a company in insolvent liquidation either knew or ought to have concluded that insolvent liquidation was inevitable, it can proceed to make an order against the directors of the company to make whatever contribution to the assets of the company that the court thinks appropriate. Even where such a point can be identified, however, it is a defence for directors to argue that they took 'every step' they ought to have taken with a view to minimising losses to creditors. The term 'every step' is not defined but is likely to include, at least, the seeking of advice from a licensed insolvency practitioner.

10.50 The case of *Produce Marketing Consortium Ltd [1989] 1 WLR 745* underlines how important it is for directors to act in accordance with what they *should* know as much as what they *do* know in these circumstances. Produce Marketing Consortium had gone into liquidation in October 1987 after a gradual decline in profitability. One of the two directors accepted that he was aware in advance that liquidation was inevitable, but used the defence available to him, namely that by continuing to trade past that point the company was protecting its remaining assets, ie its stock, in the interests of creditors. It was held that the information that should have made the situation obvious to the directors was contained in the company's annual accounts for the year ending September 1985. Even though those accounts were not finalised until January 1987, the point at time at which the directors knew or ought to have concluded that insolvent liquidation was inevitable was reached in July 1986, since that was the deadline for the approval and submission of the company's annual accounts for 1985. Even without the information contained in the annual accounts, the directors should have been aware, from their financial stewardship of the business, of the deteriorating prospects for the company. The two directors were held liable to contribute £75,000 towards the company's debts.

10.51 For a wrongful trading liability to exist it must also be shown that the company was in a worse position at the date of actual liquidation than it would have been had the company ceased trading at the earlier point. If the company's position did not actually get worse no wrongful trading liability is created (*Re Marini Ltd [2004] BCC 172*).

#### Involvement in phoenix companies

10.52 Company law says that each company has a life of its own, separate from the persons who are its members and directors. When a company becomes insolvent and has to be wound up, creditors seeking to recover their losses will usually be able to look only to what assets remain within the company, and not to the personal assets of its directors: those directors are normally free to continue their business activities straight away by setting up new companies.

10.53 Creditors will often feel aggrieved at seeing the directors who have taken their company into insolvency – causing them to lose their money – freely setting up in business with a new company, free from the debts of the previous company. Their sense of grievance will be exacerbated when directors of an insolvent company form a new company that gives the outward appearance of simply carrying on the business of the insolvent company.

- 10.54 There is nothing in itself illegal or improper about directors of a failed company walking away and trying again with a brand new company. There is likewise nothing illegal about a new company being formed which has a very similar name to a company which has been dissolved. Nonetheless the law sees it as being against both the public interest and commercial ethics for directors of an insolvent company to continue their business activities in circumstances where they appear to be trying to delude past and prospective clients and customers into thinking that the defunct business is continuing.
- 10.55 A new company which is formed in these circumstances is often referred to as a 'phoenix company' because of the false impression it creates that a company has risen intact from the flames of insolvency.
- 10.56 Special safeguards exist to prevent directors of companies that have gone out of business from becoming involved in phoenix companies. Where a director becomes involved with such a company he or she will commit a criminal offence and may also be made personally liable for the debts of that company.
- 10.57 Under section 216 of the Insolvency Act 1986, certain restrictions on future activity are placed on persons who have been directors or shadow directors of companies at any time during the 12-month period leading up to the entry of those companies into insolvent liquidation. Such persons may not, within a five year period beginning on the date of entry into liquidation, be associated with any company or business that carries on its business under a 'prohibited name' without the leave of the court. A name is a 'prohibited name' if it is either the corporate name or trading name of the company that went into liquidation or a name so similar as to suggest an association with that company. Specifically, a person subject to these restrictions must not, without leave of the court:
- be a director of any other company which is known by a prohibited name either in its corporate name or business name
  - in any way, whether directly or indirectly, be concerned or take part in the promotion, formation, management of any such company
  - in any way, whether directly or indirectly, be concerned in or take part in the carrying on of business carried on by an unincorporated body under a prohibited name.
- A person who infringes these rules commits an offence (section 216 IA 86).
- 10.58 Thus, a person who has been a director of a company which has gone into liquidation needs to bear in mind both the corporate and business names of that company and of any new business with which he or she might be considering future involvement. For example, if ABC Ltd (trading as XYZ) goes into insolvent liquidation, the director risks committing an offence and assuming personal liability if he or she becomes involved in a new business with the corporate name XYZ Ltd and trading name ABC (or vice versa).

- 10.59 It must also be borne in mind that the restrictions on directors apply not only to acting in respect of new companies formed after another company has gone into liquidation – this is the common understanding of the term 'phoenix company'. The restrictions apply equally to acting in respect of existing companies and businesses. This means that persons who have been directors of two companies with similar names may find themselves in breach of section 216 once one of the two companies goes into insolvent liquidation. The restrictions can, therefore, have particular ramifications for group companies, many of which will have very similar names.
- 10.60 Where a director infringes the rules on prohibited names, personal liability for the debts of the 'new' business may be imposed under section 217. (This is in addition to the criminal sanction under section 216). A person who is involved in the management of the 'phoenix company' in breach of the restriction becomes personally responsible for all debts and liabilities of the company incurred while involved in its management. At the same time, any person who is legitimately involved in the management of a company (eg by being a director) but who acts, or is willing to act, on the instructions of a person whom he or she knows to be in breach of section 216 is also personally responsible for the company's debts and liabilities during the period in which this condition applied. Any person who is liable under section 217 is jointly and severally liable with the company and any other person held to be liable.
- 10.61 The provision in section 216 that the new name must not be 'so similar as to suggest an association' with the name of the insolvent company has understandably given rise to a considerable amount of litigation over the years.
- 10.62 In deciding whether a name is a 'prohibited name' for the purposes of the phoenix company rules, the Court of Appeal held that a comparison should be made of all the circumstances in which they were actually used, taking into account the types of products dealt in, the locations of the businesses, the types of customers dealing with them and the persons involved in the operation of the businesses. If this process did suggest an association between the two names, then any persons who were involved in the new business would be liable under section 217 (*Ricketts v Ad Valorem Factors Ltd [2004] BCC 164*).
- 10.63 In a similar case, *Revenue & Customs Commissioners v Walsh [2006] EWHC 1304*, an individual acted as a director of a company called Walsh Construction Ltd both before and after the insolvent liquidation of a company called SG & T Walsh Ltd. The court held that in deciding whether a company name was so similar to a prohibited name as to suggest an association with it, the test to be applied was whether the similarity between the two names was such that it was probable that members of the public, when comparing the names in the relevant context, would associate the two names with each other. Probability was to be assessed by the likely impact of the names on a reasonable person in the relevant commercial field, having regard to the way that the company names were likely to be used, the sort of customers who would use the companies and the context in which they would do so. In the case in question, the fact that the location of the two companies' registered addresses was the same and that the same person acted as company secretary for both companies was not significant to the decision as to liability – what was more relevant was that the two companies were both in the same trade and that both had the same trading address, telephone and fax numbers. The court held that these factors were likely to cause a customer

of the 'new' business to think that the two companies were closely associated and the defendant was therefore liable for the debts of the 'new' company.

- 10.64 It does not matter that the name adopted in the new business is a common one and widely used by other businesses in the locality. In *Commissioners of HM Revenue & Customs v Benton-Diggins [2006] BCC 769*, a company called Williams Hair Studio Ltd, which was used to conduct a hairdressing business, went into insolvent liquidation. The proprietor of the business proceeded to start up a new business, again offering hairdressing services, which also went into insolvent liquidation. The second business operated from the same premises as had been occupied by the insolvent company and was known as 'Williams' or 'Williams Hair Studio'. The court held that the name of the new business was so similar to the name of the insolvent company as to suggest an association with it – the fact that Williams was a common name and was present in the name of many other local businesses was beside the point. The director was made liable for the second company's debts of over £38,000.
- 10.65 As indicated above, section 216 IA 86 only imposes liability on a director if he or she acts in a prohibited capacity in relation to a company **without leave of the court**. It is open to any person who has been a director of a company which has gone into insolvent liquidation, and who is minded to become involved with a company or business which has or might have a 'prohibited name', to apply to the court for leave to do so. Any person who knows or suspects that the new business has a prohibited name should consider doing this. If leave is granted, then regardless of whether the 'new' company's name would otherwise meet the test of association (with the name of the insolvent company), the director will not be at risk of committing an offence or assuming personal liability in the event of the new company itself becoming insolvent.
- 10.66 There are three circumstances in which a director may act in what would otherwise be an illegal manner without obtaining leave of the court. These circumstances are set out in the Insolvency Rules (IR) 1986 and are as follows:
- where the 'new' company acquires the whole, or substantially the whole, of a the business of the insolvent company, via a process administered by the insolvency practitioner concerned (IR 4.228)
  - where a director applies for leave no later than 7 days from the date of entry into liquidation of his or her company: that director may act in respect of the 'new' company for a period of six weeks after that date or until the day on which the court rules on the application, whichever is the sooner (IR 4.229)
  - where the 'new' company was known by a prohibited name for the whole of the 12-month period ending with the entry into liquidation of the first company (and was not at any point during that period dormant) (IR 4.230).

10.67 The courts have discretion as to whether they may grant leave to act in response to each application made to them, and will take into account the merits of each case presented to them. IR 4.227 says that the court may call on the liquidator or any former liquidator for a report of the circumstances in which the company became insolvent, and the extent (if any) of the applicant's responsibility for its doing so. Thus, it can take into account the background to the company's insolvency and the individual director's conduct but the conclusion it reaches is a matter for it.

#### Misfeasance

10.68 Under section 212 IA 1986, a liquidator of a company has a wide power to recover money from directors or other officers of the company. The liquidator may bring proceedings on the ground that a director has misapplied or retained or become accountable for any money or other property of the company or is guilty of any misfeasance or breach of any fiduciary or other duty to the company. The wide power of recovery under section 212 means that it can be used by a liquidator in respect of any breach of directors' statutory or other duties to increase the amount of funds available for distribution to the company's creditors even where other avenues, such as wrongful trading actions, may not be possible. On an application under section 212, the court may order the director to repay, restore or account for the money concerned, or to contribute to the company such sums in compensation as the court thinks fit. The misfeasance provisions can be used, for example, to recover from directors personally sums which have been paid out by a company in breach of the Insolvency Act restrictions on preferential payments to creditors and transactions at an undervalue (*West Mercia Safetywear Ltd v Dodd [1998] BCLC 250*).

#### (vii) Liability to third parties

10.69 Directors may be held to owe a duty of care to third parties where by their conduct they assume personal responsibility for the information or undertakings they give. Directors may be at risk of doing this in the course of take-over negotiations. A personal duty of care will not be owed solely by virtue of the directors' compliance with their obligations under the Listing Rules and the City Code on Take-overs and Mergers, but it may be created where they provide what amount to personal assurances to the bidding company (*Partco v Wragg [2004] BCC 782*). Where a duty of care is held to exist, directors will be liable to the other party in respect of any negligent conduct on their part.

#### DISQUALIFICATION

---

10.70 A director may be disqualified from holding office as director, or from being otherwise involved in the management of limited companies, under the provisions of the Company Directors Disqualification Act 1986 (CDDA). Where a person has been disqualified under the CDDA, he or she may not – without special leave of the court – act as a director of any limited company or be concerned or take part in the management of a company. Disqualification orders may be imposed on companies as well as individuals, so those companies that act as 'corporate directors' of other companies may be barred in the same way as individuals.



10.71 The Act lays down a number of grounds on which a director may be disqualified, and provides for penalties to be levied in all cases. The grounds for disqualification are as follows:

- Where a director has been convicted of an indictable offence in connection with the promotion, formation, management or liquidation of the company, or with the receivership or management of the company's property (section 2 CDDA). The maximum period of disqualification on this ground is 15 years.
- Where a director has been persistently in default (meaning at least three defaults in the preceding five years) with regard to the Companies Act provisions relating to the submission to the Registrar of returns, accounts or other documents (section 3 CDDA). (Maximum period 5 years).
- Where a director has, in the course of the winding up of his company, been found guilty of an offence under section 458 of the Companies Act 1985 (fraudulent trading) [now section 993 CA 2006] or has otherwise been found guilty of any fraud in relation to the company or of any breach of his duty as a director (section 4 CDDA). (Maximum period 15 years).
- Where a director has been convicted of a summary offence following contravention of any requirement in companies legislation to file returns, accounts, or documentation with the Registrar of Companies (section 5 CDDA). (Maximum period 5 years).
- Where a company has gone into insolvent liquidation, administrative receivership or administration and an application for the disqualification of a particular director of the company has been made by the Secretary of State on the grounds that his conduct (taken alone or together with his record as director of any other company) renders him unfit to be concerned in the management of a company (section 6 CDDA). (Minimum period 2 years; maximum period 15 years).
- Where an application to disqualify is made by the Secretary of State on the grounds of unfitness following a report made on a company by official inspectors (section 8 CDDA). (Maximum period: 15 years).

10.72 Schedule 1 to the CDDA contains a list of factors to be taken into account by the court in deciding whether in any particular case a director may be regarded as unfit. These factors are reproduced as Appendix 2.

10.73 Under reforms brought in by the Enterprise Act 2002, the Secretary of State may, in lieu of instituting or continuing with an application for a disqualification order, accept an undertaking from the person concerned that he will not, for a period specified in the undertaking, be a director of a company or act in any of the other ways already discussed. Undertakings may be given only where the grounds on which an order may be sought are those specified in sections 6–8 of the Act, ie 'unfitness' based on the person's conduct as a director of a company which has gone into insolvency or which has been the subject of an investigation of its affairs.

- 10.74 The courts have discretion under the CDDA to determine what constitutes 'unfitness'. They have used a number of criteria to assess this. In *Re Bath Glass Ltd [1988] 4 BCC 130*, it was held that, to declare a director unfit, the court must be satisfied that the defendant has been guilty of a serious failure or failures, whether deliberate or through incompetence, to perform his or her duties. Furthermore, a director would be unfit if his actions were very far from those of a 'reasonably competent director'. Other specific criteria which at various times have been deemed significant for this purpose include (i) the amount of the company's debts, and in particular the amounts owing to the Crown, (ii) the number of companies with which a director has been involved which have gone into liquidation, (iii) breaches of commercial morality, (iv) gross incompetence and (v) recklessness.
- 10.75 In *Re Firedart Ltd [1994] 2 BCLC 340*, the presiding judge set out a series of individual matters which would cause him to arrive at a conclusion of 'unfitness'. These were trading whilst insolvent, taking personal benefits over and above any proper remuneration and failing to keep proper accounting records. The courts are also likely to take into account the respective backgrounds and qualifications of directors when deciding whether disqualification is appropriate (*Re Cladrose Ltd [1990] BCC 11*) – in this case, there had been a total failure on the part of the two directors of three insolvent companies to file accounts and returns; the director who happened to be a chartered accountant was disqualified while the other was not.
- 10.76 The courts will not issue a disqualification order against a director for the sole reason that he or she allowed the company to trade while it was technically insolvent if he or she reasonably believed that, despite the situation of actual or impending insolvency, there was a reasonable prospect of achieving a satisfactory outcome for the company's creditors and took adequate steps to achieve that outcome. In *Secretary of State for Trade and Industry v Gill [2006] BCC 725*, a furniture retail group went into administration with a substantial deficit for creditors. In the period leading up to the entry into administration, the directors had sought to find a buyer for the group companies. They allowed the group to continue to trade after taking legal advice that as long as they sought a 'corporate solution' and reasonably believed the company would avoid insolvency they would not render themselves unfit. The court held that, if a director is to be found to be 'unfit' in such a situation, then there must be some additional ingredient, which in this case would have been that at the time the director received advance payment from a customer, the director knew – or should have known – that there was no reasonable prospect that the company would avoid insolvency. Given the efforts that the directors in this case were found to be making to find the necessary 'corporate solution' to save the business, this additional ingredient was not considered to be present.
- 10.77 Ordinary commercial misjudgement is not in itself sufficient to justify disqualification (*Re Lo-Line Electric Motors Ltd [1998] BCLC 698*).

- 10.78 To harmonise the approach of the courts in imposing disqualification periods, the Court of Appeal laid down a set of guidelines (*Re Sevenoaks Stationers (Retail) Ltd [1990] BCC 765*). The period of disqualification which should be considered section 6 CDDA (unfitness) was made subject to three 'bands', according to the severity of defendants' conduct. Disqualification for periods of ten years or more should be reserved for particularly serious cases, to include cases where a director has already been subject to a disqualification order. Disqualification for between two and five years should be applied where, although disqualification was mandatory, the case was, relatively, not very serious. Disqualification for periods of between six and ten years should apply to serious cases that did not merit the top 'band'.

#### Consequences of transgression

- 10.79 Failure to observe the restrictions imposed by a disqualification order is an offence (section 13 CDDA). Further, breach of the terms of an order (by being a director of a company or by being in any way, directly or indirectly, concerned or taking part in the management of a company) may result in the offender being made personally liable for the debts and liabilities incurred by the company during the period when he or she was in breach. To guard against the possibility that a person who was subject to a disqualification order may seek to get involved with a company as a 'shadow director', any person involved in a company's management who is willing to act on instructions given to him or her by a person who he or she knows is subject to a disqualification order will also be personally liable for the company's debts.

#### Leave of the court

- 10.80 As indicated in paragraph 10.70 above, a person who is subject to a disqualification order may apply to the court for special leave to do any of the things that he or she is banned from doing by the order. The courts are likely to accede to such an application only where it can be proved that there is a demonstrable need for the director's services on the part of the company itself (*Re Gibson Davies Ltd [1995] BCC 11*) and even then it is likely that additional undertakings will need to be given to protect the public. The requisite need will not however exist for the sole reason that the defendant is the sole director and shareholder of a 'one person' company (*In Re Britannia Homes Centres Ltd [2001] 2 BCLC 63*).
- 10.81 In *Re Barings plc [2000] 1 WLR 634* it was held that, if leave of the court is to be given, then it must always be preceded by serious consideration of the matter and the reasons for granting it must be consistent with the reasons for making the disqualification order.

#### Overseas disqualification proceedings

- 10.82 Part 40 of the Companies Act 2006 allows the UK to place restrictions comparable to those discussed above on persons who are subject to restrictions on acting as a company director imposed under the law of any country outside the UK. Such restrictions, which would be introduced via regulations made under the Act, are likely to include the commission of an offence for breach of the terms of any restriction and the imposition of personal liability for the debts of a company with which the person concerned is involved.

## 11. Ratification of breaches and relief from liability

- 11.1 It will not automatically follow from any breach of a legal duty that the directors concerned will actually incur criminal or civil liability. Whether this happens will depend on whether proceedings are brought and, where they are and the court finds against the directors, whether the court will be prepared to excuse them. This Chapter looks at the different means by which directors may avoid liability for breaches.

### **RATIFICATION BY THE COMPANY OF BREACHES OF DIRECTORS' FIDUCIARY DUTIES**

---

- 11.2 The approach taken by the UK courts over many years has been that if it can be shown that the members of a company are in agreement about a particular matter then, unless the matter is illegal or outside the powers of the company, they – the courts – will not seek to get involved with it. This approach has manifested itself in the courts' recognition of unanimous shareholder agreements as being just as valid as resolutions passed in general meeting and in their refusal to intrude on matters of pure business judgement.
- 11.3 Also in keeping with this approach has been the practice of the courts with respect to the rights of members to ratify breaches of directors' fiduciary duties. At the root of this is the principle that directors owe their duties to the company itself: it follows that if the members of that company agree that the breach should be ratified, this should be sufficient evidence that the company does not wish to resort to litigation.
- 11.4 Where directors breach any aspect of their fiduciary duties to their company, the company's members can ratify the breach by passing a resolution to that effect (*Hogg v Cramphorn [1967] Ch 254*). By doing this, the members are not legitimising the action that constituted the breach. Rather, they are declaring definitively that the company will not be taking any enforcement action against the director or directors with respect to the matter in question.
- 11.5 Reflecting the principle that, where a company is in an insolvent situation the directors owe their duties to the company's creditors rather than its members, ratification by the members will not be permitted in those circumstances if it would have the effect of prejudicing the interests of the creditors (*West Mercia Safetywear Ltd v Dodd [1988] BCLC 250*). A company may not ratify a breach which 'constitutes a fraud on its creditors' (*Rolled Steel Products v British Steel Corporation [1986] Ch 246*). And no resolution to ratify directors' acts can be passed where the company has already gone into liquidation (*Precision Dippings Ltd [1986] Ch 447*).
- 11.6 Section 239 CA 206 provides a statutory basis for the ratification of directors' actions by a company's members. It applies to any motion to ratify conduct on the part of directors that amounts to negligence, default, breach of duty or breach of trust in relation to the company. The motion must be passed by the members, either at a formal meeting or by written resolution, but the majority vote must be achieved without counting the votes of the director or directors whose conduct is the subject of the resolution or of any member connected with them.

### **RELIEF FROM LIABILITY BY THE COURT**

---

- 11.7 Even where a director is proved to have failed to comply with a legal duty to which he is subject and the company itself has not ratified the breach, he may still be excused.
- 11.8 In any case where proceedings are brought against a director for negligence, default, breach of duty or breach of trust, the court has discretion to grant relief from liability. Under section 1157 CA 2006, relief may be granted by the court even if the director concerned is or may be liable for the breach on the facts of the case: if the court considers that the director acted honestly and reasonably, and in the light of all the circumstances of the case he or she ought fairly to be excused, then the court may relieve the director of liability wholly or in part and on such terms as it thinks fit. The courts have been prepared to grant relief in cases where there has been a technical breach of duty but the court is satisfied that the director concerned has acted honestly and reasonably (*Re Duomatic Ltd [1969] 2 Ch 365*). Any director who believes that proceedings will or may be brought against him may also apply to the court for relief on a pre-emptive basis.
- 11.9 The practice adopted by the courts in respect of the corresponding provision to section 1157 that appeared in the Companies Act 1985 has been that relief may be granted in respect of duties owed by the director to the company both under the Companies Acts and the common law. Accordingly, breaches of the general duties discussed in Chapter 6 and the statutory provisions listed in Appendix 1 may be excused by the courts if they see fit.

### **INSURING DIRECTORS AGAINST LIABILITY**

---

- 11.10 Companies may not provide an indemnity, or include provisions in their articles or in separate contracts, for the purpose of exempting directors from liability for their negligence, default, breach of duty or breach of trust (section 232 CA 2006). They may, however, insure their directors against any such liability to the company and, in the circumstances set out in section 234, to third parties.

## 12. Special cases

- 12.1 This Chapter looks at some particular implications of the law on directors' duties for directors of particular types of company.

### **SINGLE DIRECTOR COMPANIES**

---

- 12.2 The great majority of the limited companies registered in the UK are 'private' companies with no more than a handful of members. Very often the members and the directors of these companies are one and the same. Since 1990, it has been possible to form and run a limited company with just one member, in which case that single member will invariably be the company's sole director as well.
- 12.3 Those involved in the formation and management of very small, simple companies may sometimes find it difficult to appreciate that their business is a limited company at all: the business may 'feel' more like a partnership or even a sole trading business and it may seem strange to them to have to comply with the many technical compliance requirements of the Companies Act. But any business which chooses to incorporate is subject to the requirements of company law in the same way as any large company, and those who act as its directors must recognise that, even where they are the sole director, they are still subject to the various rules governing directors' conduct.
- 12.4 The case of *Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald* [1995] 3 WLR 108 underlines that statutory compliance requirements are still valid, however pedantic and inappropriate they may appear to be in the circumstances. The case concerned the director's responsibility under section 317 of the Companies Act 1985 (what is now section 177 CA 2006) to declare interests in transactions. An individual who was at the time the sole director of a private company authorised payment to himself of £100,000, which he claimed was due to him under his contract of employment. This was challenged when ownership of the company changed hands on the basis that the action constituted 'self-dealing' and the director had not made the necessary declaration.
- 12.5 The court held that, in the case of sole director companies, a sole director has to make the necessary declaration to himself and record the declaration in the minutes. If a meeting was attended by anyone else (eg the company secretary), the declaration had to be made out loud and in the hearing of those attending, and again had to be recorded.

### **Ratification of breaches**

- 12.6 Section 239 CA 2006 presents what is on the face of it a significant technical problem for single member/director companies. It says that, where the members wish to pass a resolution to ratify conduct that amounts to negligence, default, breach of duty or breach of trust, this must be done by means of a resolution in respect of which the votes of the director (if he or she is a member of the company) must be disregarded. By virtue of this provision, a single director, if also a member of the company, would not be able to vote on a motion to ratify his or her own breach – only other members (if any) would be allowed to vote. Section 239(6) provides, however, that the restriction in the section does not affect:

- the validity of any decision taken by unanimous consent of the members or
- any power of the directors to agree not to sue, or to settle or release a claim made by them on behalf of the company.

A single director/member company may, accordingly, make provision in its articles to allow its director to agree not to sue.

### Third parties dealing with single director companies

- 12.7 While those involved with very small or single-member companies may sometimes find it difficult to appreciate the significance of the corporate structure that they have decided to adopt, the same can be true of those dealing with such companies as clients or customers. This situation poses dangers for the directors of very small companies that they should be careful to pre-empt. Specifically, the danger is that the client or customer may get the impression, when dealing with the director of a very small company, that they are dealing with that person individually, rather than that person as the representative of the company. Where the company provides a service to a client or customer, and that service is delivered negligently, the client or customer may argue that a personal duty of care was owed to him and that the director should be liable personally for the negligent work.
- 12.8 This scenario was considered by the House of Lords in the case of *Williams v Natural Life Health Foods Ltd* ([1998] BCC 428). It concerned a company managed by a single director who was also the company's majority shareholder, the minority holding belonging to his wife. The company was set up to issue franchises for retail health food shops. It published documentation about the franchise concept which highlighted the director's personal experience in the health food business. One particular individual entered into an agreement to take on a franchise from the company, having been provided with financial projections for the expected turnover of the shop. He dealt at all times with an employee of the company and never with the directors personally. The turnover of the franchise proved to be substantially less than the projections had suggested and the shop ceased trading after 18 months. The franchisee sued the company for damages for negligent advice and, when the company itself went into liquidation, claimed damages from the director personally, arguing that the advice given was essentially his and not his company's.
- 12.9 The House of Lords did not rule out the possibility that a director could assume personal liability in such circumstances. It said that in a small, one-person company the director would almost inevitably possess the qualities essential to the functioning of the company. But this was not by itself enough to make the director personally liable for advice given through the corporate structure. What was needed, for a director to have personal liability, was for that director to act in such a way as to give a client or customer the clear impression that personal responsibility for the advice was being assumed and that it was reasonable for the client to rely on that. In this case, the fact that there had ever been any personal dealings between the director and the client was considered to be conclusive evidence that no personal responsibility was ever assumed.

- 12.10 That the *Williams* case went as far as the House of Lords should, however, serve as a warning to single-director companies that they may not always be able to count on the protection that the limited liability company structure provides, and that they need to be careful to ensure that they do not conduct their affairs in a way which causes clients to believe they are dealing with a sole trader business.

### **LISTED COMPANIES**

---

- 12.11 Listed companies, and their directors, are subject to the widest range of compliance obligations and the greatest exposure to personal liability. As well as the requirements of the Companies Act, directors of listed companies will be subject to the requirements of the Listing Rules of the London Stock Exchange and the extensive supervisory powers of the Financial Services Authority. These various requirements are too extensive to cover in this guide, but a crucial and fundamental feature of the Listing Rules is that they actually require companies to ensure that the directors collectively have appropriate expertise and experience for the management of the company's business.

### **Corporate governance**

- 12.12 Listed companies are subject to the non-statutory guidance on corporate governance set out in the Combined Code on Corporate Governance.
- 12.13 Under the Listing Rules listed companies are required to make a disclosure statement in two parts with respect to their compliance with the provisions of the Code: the statement should report firstly on how the company has applied the principles of the Code and, secondly, should confirm that the company complies with the code's detailed provisions or – where it does not – provide an explanation for that non-compliance.
- 12.14 The Code contains a great deal of good practice guidance on how directors of listed companies should structure their decision-making arrangements and how they should set about carrying on their functions as directors. It is essential reading for all serving and prospective directors of listed companies and an authoritative point of reference for corporate governance arrangements generally, including for private companies. Copies of the Code can be obtained from the Financial Reporting Council ([www.frc.org.uk](http://www.frc.org.uk)) Among the key provisions relating to the role and responsibilities of directors are the following:
- every company should be headed by an effective board which is collectively responsible for the success of the company.
  - where directors express concerns about particular matters that cannot be resolved to their satisfaction, they should ensure that those concerns are recorded in the board minutes.
  - companies should arrange for proper insurance cover to be taken out in respect of legal action against their directors



- the Code (and the supplementary guidance devised by Sir Derek Higgs) provides specific guidance on the roles of the chair of the board and of non-executive directors (NEDs)
- all directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge
- in order to help NEDs fulfil their duties, the letter of appointment should set out the time commitment expected from them
- directors should be supplied in timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. The chair is responsible or ensuring that the directors are provided by management with accurate, timely and clear information.

It is up to each individual NED to reach a view as to what is necessary in particular circumstances to comply with the legal duty of care, skill and diligence that he or she owes to the company.

#### **Liability for misleading information presented to the market**

- 12.15 As indicated in paragraph 10.30 above, section 463 CA 2006 makes company directors liable to compensate their company, in certain circumstances, where they allow published company reports to include untrue or misleading statements or omissions and where this causes loss to their company. Of potentially even more long-term significance to directors of listed companies are the changes to UK law that the Act introduces to implement the provisions of the *EU Transparency Directive (2004/109/EC)*.
- 12.16 Under section 1270 CA 2006, numerous changes are made to the Financial Services and Markets Act 2000. These include provision for companies listed on a regulated market to be made liable to compensate any person who acquires securities in a company on the strength of any preliminary statement or interim report or statement issued by it which contains an untrue or misleading statement or which omits mention of any matter that the law requires to be included in the report or statement in question. Where the acquirer suffers loss as a result of placing 'reasonable' reliance on the published information, the company will be liable to pay compensation if 'a person discharging managerial responsibilities' within the company either:
- knew the statement to be untrue or misleading or was reckless as to whether it was or not or
  - knew the omission to be dishonest concealment of a material fact.
- 12.17 These new rules are designed primarily to ensure that deliberately inaccurate or incomplete information is not released to the market. A company will not be liable in respect of information that turns out to be inaccurate despite the best efforts of the directors to prevent it from being so. Nevertheless, these provisions represent an area of substantial potential risk to quoted companies. Specifically, the provisions establish that information prepared and published for market purposes is intended to be information

on which current and prospective investors are entitled to rely for the making of their future investment decisions. This contrasts with the long-standing position in company law whereby the liability of directors in respect of company accounts is to the shareholders as a body and not to current or future individual investors: in particular, directors (and auditors) are not routinely liable to individual shareholders or prospective shareholders in respect of investment decisions made by them on the strength of published accounting information. While directors are not directly liable under the *Transparency Directive* rules, it is conceivable that the shareholders of companies that are obliged to pay compensation to investors as the result of issuing untrue, misleading or incomplete information to the market will in turn seek redress from their directors.

## Appendix 1

### TABLE OF STATUTORY DUTIES AND OFFENCES UNDER THE COMPANIES ACT 2006 AND OTHER STATUTES

The following table sets out a comprehensive list of statutory duties compliance with which is required under the Companies Act 2006 and other statutes, either by companies or by the directors personally. The details of the party who commits the offence in the case of non-compliance are shown in the second column. Where the obligation is imposed on the company and not the directors it will in any case be the responsibility of the directors to ensure that the company complies with the obligation. The table also includes stand-alone offences for which the company and/or its officers will be liable.

Where the table indicates that liability is to attach to 'every officer who is in default', an officer will be liable if he or she authorises or permits, participates in, or fails to take all reasonable steps to prevent the contravention concerned. Note that in several cases, eg the rules on the preparation of annual accounts and reports, compliance with the provisions of the Act requires compliance with the terms of regulations to be made under the Act.

| Provision of the act   | The parties who are liable                      | Additional remarks |
|--|---|--------------------|
| <b>Information relating to companies' constitutions</b>  |   |                    |
| Section 26: duty of company to send copy of amended articles to the Registrar  | The company and every officer in default        |                    |
| Section 30: duty of company to file with Registrar copy of resolutions and agreements affecting the company's constitution | The company and every officer in default        |                    |
| Section 32: duty of company to send to any member, on his or her request, constitutional documents                         | Every officer who is in default                 |                    |
| Section 34: duty of company to notify Registrar where its constitution has been amended by an enactment                    | The company and every officer who is in default |                    |
| Section 35: duty of company to notify Registrar where its constitution is altered by court order                           | The company and every officer who is in default |                    |
| Section 36: copies of company articles to reflect changes made by resolutions, enactments or court orders                  | Every officer who is in default                 |                    |

| Provision of the act   | The parties who are liable                      | Additional remarks |
|--|---|--------------------|
| Section 45: company's (optional) common seal to have its name engraved on it   | The company and every officer who is in default |                    |
| <b>Company names</b>   |   |                    |
| Section 63: private company which is exempt from having to include 'limited' in its name may not amend its articles so as to cease qualifying for the exemption                                  | The company and every officer who is in default |                    |
| Section 64: duty of company on order of Secretary of State to change its name on ground that it is no longer entitled to exemption from inclusion of 'limited' in its name                       | The company and every officer who is in default |                    |
| Section 68: duty of company to change its name on direction from the Registrar   | The company and every officer who is in default |                    |
| Section 75: direction from the Secretary of State to change company name on the basis of misleading information provided to the Registrar  | The company and every officer who is in default |                    |
| Section 76: direction to change company's name where it gives a misleading indication of its activities  | The company and every officer who is in default |                    |
| <b>Trading disclosures</b>   |   |                    |
| Section 82: Failure, without reasonable excuse, to comply with regulations to require the disclosure by companies of specified company information on their premises and in their communications | The company and every officer who is in default |                    |

| Provision of the act   | The parties who are liable                      | Additional remarks |
|--|---|--------------------|
| <b>Register of members</b>   |   |                    |
| Section 113 (duty for company to keep a register of members), section 114 (duty to give notice of any change in location of the register), section 115 (duty to keep index where there are more than 50 members), section 118 (failure to allow inspection of register or provision of copy), section 120 (provision of information on most recent change to the register) and section 123 (entries in the register relating to single-member companies) | The company and every officer who is in default |                    |
| <b>Specific requirements regarding directors</b>   |   |                    |
| Section 156: Failure to comply with a direction from the Secretary of State to appoint another director or directors (because it is a public company which does not have the minimum requirement of two directors or because it has a sole director which is itself a limited company)   | The company and every officer who is in default |                    |
| Section 162 (duty to keep a register of directors and allow inspection of it), section 165 (duty to keep register of directors' residential addresses) and section 167 (duty to notify Registrar of changes to the register)   | The company and every officer who is in default |                    |
| Section 182: failure to declare nature and extent of director's interest in a transaction or arrangement entered into by the company   | The director in default                         |                    |

| <b>Provision of the act</b>  | <b>The parties who are liable</b>               | <b>Additional remarks</b> |
|--|---|---------------------------|
| Section 228 (duty for company to comply with the requirements regarding the keeping of directors' service contracts) and section 229 (right of members to inspect and receive copies of those contracts)   | Every officer who is in default                 |                           |
| Section 231: terms of contract between company and sole member/director to be set out in written memorandum or recorded in minutes of next director's meeting  | Every officer of the company who is in default  |                           |
| Section 246: failure to correct register of directors where Registrar decides, under section 245, to place a director's home address on the public record, instead of his or her service address, and gives notice of that action to the company | The company and every officer who is in default |                           |
| Section 248: requirement to keep minutes of directors' meetings  | The company and every officer who is in default |                           |
| <b>Provisions regarding the company secretary</b>  |   |                           |
| Section 272: failure by public company to comply with direction from the Secretary of State to appoint a company secretary   | The company and every officer who is in default |                           |
| Section 275: duty to keep register of secretaries  | The company and every officer who is in default |                           |
| <b>Provisions regarding meetings and resolutions</b>   |   |                           |
| Section 291: procedural requirements regarding written resolutions   | Every officer who is in default                 |                           |
| Section 292: failure to circulate valid written resolution and accompanying statement presented by members within 21 days  | Every officer who is in default                 |                           |

| Provision of the act  | The parties who are liable  | Additional remarks  |
|---|---|---|
| Section 315: duty to circulate members' statements  | Every officer who is in default   |   |
| Section 325: duty to include in notices of general meetings a reference to each member's right to appoint a proxy   | Every officer who is in default   |   |
| Section 326: certain invitations to members to appoint specified persons as proxies   | Every officer who is in default   |   |
| Section 336: failure by public company to hold an AGM within 6 months of the end of its financial year  | Every officer who is in default   |   |
| Section 339: failure by public company to circulate a valid members' resolution   | Every officer who is in default   |   |
| Section 341: duty of quoted company to place on its website prescribed information on polls taken at its general meeting and section 343: requirement to appoint an independent assessor to report on the results of a poll | Every officer who is in default   |   |
| Section 350(1): provision of information to independent assessor  | Directors and any other persons who are required to provide information on request to an independent assessor | No offence committed if it is not reasonably practicable to provide the required information or explanation |
| Section 350(3): statements given to an independent assessor which are misleading, false or deceptive in a material particular   | Directors or any other persons required to give information to the independent assessor                       |   |
| Section 351: placing of information on independent assessor on company website  | Every officer who is in default   |   |

| Provision of the act  | The parties who are liable  | Additional remarks  |
|---|---|---|
| <b>Company records</b>  |   |   |
| Section 355: duty of company to keep records of resolutions   | Every officer who is in default   |   |
| Section 357: duty of single-member company to keep records of decisions                                 | The member concerned  |   |
| Section 358: Records and resolutions to be kept for ten years and made available for inspection         | Every officer who in default  |   |
| Section 387: duty of a company to keep accounting records   | Every officer who is in default   | It is a defence for a person to show that he or she acted honestly and that in the circumstances in which the company's business was carried on the default was excusable |
| Section 388(1–3): duty of company to keep accounting records at specified location                      | Every officer who is in default   | It is a defence for a person to show that he or she acted honestly and that in the circumstances in which the company's business was carried on the default was excusable |
| Section 388(4): duty of company to retain accounting records for set periods                            | Every officer who fails to take reasonable steps to secure compliance or intentionally causes any default to be made  |   |
| <b>Accounting and reporting</b>   |   |   |
| Section 412: duty for directors to disclose information about matters connected with their remuneration | Any director or person who has been a director in the previous 5 years  |   |
| Section 414: annual accounts to comply with requirements of the Act (or the IAS Regulation)             | Every director who knew that a set of accounts that had been approved did not comply, or was reckless as to whether they did or not, and failed to take reasonable steps to secure compliance or, as the case may be, to prevent the accounts from being approved |   |



| Provision of the act  | The parties who are liable  | Additional remarks |
|---|---|--------------------|
| Section 415: duty to prepare directors' report  | Every person who was a director of the company immediately before the end of the period for filing accounts and returns and failed to take all reasonable steps for securing compliance with that requirement   |                    |
| Section 418: false statement included in directors' report regarding information made available by directors to the auditor | Every director who knew that the statement was false, or was reckless as to whether it was or not, and failed to take reasonable steps to prevent the report from being approved  |                    |
| Section 419: directors' report to comply with the requirements of the Act   | Every director who knew that the report did not comply with the requirements of the Act, or was reckless as to whether it complied or not, and failed to take reasonable steps to secure compliance with the requirements or, as the case may be, to prevent the report from being approved |                    |
| Section 420: duty to prepare directors' remuneration report (quoted companies only)   | Every person who was a director immediately before the end of the period allowed for filing the company's accounts and reports for the year in question and who failed to take reasonable steps to secure compliance  |                    |
| Section 421: duty to disclose matters that may need to be disclosed in the remuneration report                              | Every director and any person who has been a director of the company in the previous five years who is in default   |                    |

| Provision of the act   | The parties who are liable   | Additional remarks |
|--|--|--------------------|
| Section 422: approval and signing of directors' remuneration report  | Every director who is a party to the approval of a report which does not comply with the requirements of the Act, who knew that it did not comply or was reckless as to whether it complied or not, and who failed to take reasonable steps to secure compliance or, as the case may be, to prevent the report from being approved |                    |
| Section 423: duty to circulate copies of annual accounts and reports) or section 425: time allowed for sending out copies of accounts or reports | The company and every officer who is in default  |                    |
| Section 429: summary financial statements  | The company and every officer who is in default  |                    |
| Section 430: annual accounts and reports of quoted companies to be made available on a website   | Every officer who is in default  |                    |
| Section 431: right of member or debenture holder of unquoted company to request copies of last accounts and reports                              | The company and every officer who is in default  |                    |
| Section 432: right of member or debenture holder of quoted company to request copies of last accounts and reports                                | The company and every officer who is in default  |                    |
| Section 433: name of signatory to be stated in published copies of accounts and reports  | The company and every officer who is in default  |                    |
| Section 434: auditor's report to be published along with the accounts  | The company and every officer who is in default  |                    |
| Section 435: statement to be appended to published non-statutory accounts; auditors' report not to be published with non-statutory accounts      | The company and every officer who is in default  |                    |

| Provision of the act   | The parties who are liable  | Additional remarks  |
|--|---|---|
| Section 438: duty of directors to lay accounts and reports of public companies before general meeting                                  | Every person who was a director of the company before the end of period allowed for laying the accounts   | It is a defence to prove that the person took all reasonable steps to secure compliance; it is not a defence to prove that the accounts and reports were not prepared   |
| Section 440(1): notice of intention to seek members' approval of directors' remuneration report  | Every officer who is in default   |   |
| Section 440(2): requirement for directors to put a resolution on the remuneration report to a vote                                     | Every existing director   | It is a defence to prove that a director took all reasonable steps to secure compliance   |
| Section 450: approval and signing of abbreviated accounts  | Every director who was a party to the approval of abbreviated accounts that do not comply with the requirements of regulations to be made on the form and content of abbreviated accounts and who knew that they did not comply, or was reckless as to whether they did or not, and failed to take reasonable steps to prevent them from being approved |   |
| Section 451: default in filing accounts and reports with Registrar   | Every person who was a director immediately before the end of the period allowed for filing   | It is a defence to prove that the person took all reasonable steps to secure that the filing requirements would be complied with by the end of the period; it is not a defence to prove that the accounts were never prepared |
| Section 486: failure by private company to give notice to Secretary of State of its failure to appoint auditor within given time-frame | The company and every officer who is in default   |   |
| Section 490: failure by public company to give notice to Secretary of State of its failure to appoint auditor within given time frame  | The company and every officer who is in default   |   |

| Provision of the act  | The parties who are liable  | Additional remarks   |
|---|---|--|
| Section 501(1): auditor's rights to request information and explanations (from, inter alia, officers and employees of the company and its subsidiaries)   | Any person who knowingly or recklessly makes a statement to an auditor (oral or written) pursuant to the latter's right to require information or explanations under sections 499 and 500, which is misleading, false or deceptive in a material particular |  |
| Section 501(3): auditor's rights to information – duty to comply without delay  | Any person covered by sections 499 and 500 (including directors and employees)  | No offence if it was not reasonably practicable for the person to comply   |
| Section 501(4): auditor's rights to information – duty of parent company to obtain information from its overseas subsidiaries   | The (parent) company and every officer who is in default  |  |
| Section 505: requirement to state name of the company's auditor and the name of the firm's senior statutory auditor in the published audit report (NB exemption from section 505 may be possible under section 506) | The company and every officer who is in default   |  |
| Section 512: notice to be given to the Registrar of resolution passed to remove auditor   | The company and every officer who is in default   |  |
| Section 517: notice to be given to Registrar of resignation of an auditor   | The company and every officer who is in default   |  |
| Section 518: duty of directors to convene a meeting of members pursuant to request by a resigning auditor   | Every director who fails to take reasonable steps to convene the meeting  |  |
| Section 520: company to take specified action following receipt of statement by a departing auditor of the circumstances connected with his ceasing to hold office  | Every officer who is in default   | It is a defence for a person to show that he or she took all reasonable steps and exercised all due diligence to avoid the commission of the offence |

| Provision of the act  | The parties who are liable  | Additional remarks  |
|---|---|---|
| Section 523: company to notify 'appropriate audit authority' of any cessation of office by an auditor before the expiry of his term of office. (NB the appropriate audit authority will be the Financial Reporting Council in the case of a listed company audit and, in other cases, the auditor's licensing body) | The company and every officer who is in default                         | It is a defence for a person to show that he or she took all reasonable steps and exercised all due diligence to avoid the commission of the offence  |
| Section 528 (duty for quoted company to publish on its website members statements of audit concerns) and section 529 (duty for quoted companies to draw attention to those statements in the notice for the general meeting at which the annual accounts are to be laid   | Every officer who is in default   |   |
| <b>Provisions regarding shares</b>  |   |   |
| Section 542: allotment of shares with no fixed nominal value  | Every officer who is in default   |   |
| Section 549: directors not to exercise any power of the company to allot shares except in accordance with section 550 (where there is only one class of shares in existence) or 551 (where authorised by the company)   | Any director who knowingly contravenes, or permits or authorises breach |   |
| Section 554: duty to register an allotment of shares  | The company and every officer who is in default                         |   |
| Section 557: offences under section 555 (duty of company to file a return of the allotment of shares with the Registrar) and section 556 (duty of unlimited company to file return of allotment of shares with new rights)  | Every officer who is in default   | Any person liable under this provision may apply to the court for relief, which may be granted if the court is satisfied that the omission was accidental or due to inadvertence or that it is 'just and equitable' to grant relief |

| Provision of the act  | The parties who are liable   | Additional remarks  |
|---|--|---|
| Section 572: misleading, false or deceptive statement in directors' statement concerning a resolution to disapply shareholders' pre-emption rights  | Any director who knowingly or recklessly authorises or permits the inclusion of such a statement in the directors' statement |   |
| Sections 580–9: provisions regarding permissible means of payment for shares  | The company and every officer who is in default  |   |
| Section 597: duty of public company to file with the Registrar a valuation report regarding non-cash consideration for shares   | Every officer who is in default  | Any person liable may apply to the court for relief; this may be granted if the court is satisfied that the omission was accidental or due to inadvertence or that it is 'just and equitable' to grant relief |
| Section 602: notification to Registrar by public companies of passing of resolution to approve the transfer of a non-cash asset to a subscriber during the first two years of a company's existence   | The company and every officer who is in default  |   |
| Section 607: breach of public company prohibitions in section 593 (allotment of shares for non-cash consideration) and section 598 (agreements or transfer of non-cash assets)  | The company and every officer who is in default  |   |
| Section 619 (duty of company to notify Registrar of alteration of its share capital), section 621 (duty of company to notify Registrar of the reconversion of its stock into shares), section 625 (duty of company to notify Registrar of the re-denomination of its share capital), section 627 (duty of company to notify Registrar of a reduction of capital in connection with re-denomination) | The company and every officer who is in default  |   |

| Provision of the act   | The parties who are liable                      | Additional remarks |
|--|---|--------------------|
| Section 635: duty of company to file with the Registrar any court order issued following a formal objection made by members to a variation of class rights   | The company and every officer who is in default |                    |
| Section 636 (duty of company to file with the Registrar notice of the assignment of a name or other designation to a class of its shares), section 637 (duty to notify Registrar of particulars of any variation of share rights), section 638 (duty to notify Registrar of particulars of any new class of members), section 639 (duty of company without a share capital to notify Registrar of any new name or designation given to any class of its members) and section 640 (duty of non-share company to notify Registrar of any variation of members' class rights) | The company and every officer in default        |                    |
| Section 643: duty of directors to make a solvency statement in support of a resolution to reduce company's share capital – offence committed if directors make the statement without reasonable grounds for the opinions expressed in it and deliver it to the Registrar   | Every director who is in default                |                    |
| Section 644: duty of company to file with Registrar resolution and supporting documents concerning a reduction of share capital  | The company and every officer who is in default |                    |

| Provision of the act  | The parties who are liable                         | Additional remarks |
|---|--|--------------------|
| Section 647: intentionally or recklessly concealing from the court the name of a creditor who would be entitled to object to a reduction of the company's capital, or misrepresenting the nature or amount of the company's debt, or being 'knowingly concerned' in any such activity | Any officer of the company who commits the offence |                    |
| Section 656: duty of directors of public company to call general meeting where its net assets fall to half or less of its called-up share capital – offence committed where a director knowingly authorises or permits non-compliance or the continuing non-compliance                | Every director who commits the offence             |                    |
| Section 658: general prohibition on company acquiring its own shares  | The company and every officer who is in default    |                    |
| Section 663: duty of public company to notify Registrar of the obligatory cancellation of its shares  | The company and every officer who is in default    |                    |
| Section 667: failure by public company to cancel its shares in the circumstances specified in section 662   | The company and every officer who is in default    |                    |
| Section 680: the giving by a company of prohibited financial assistance for the purchase of its own shares  | The company and every officer who is in default    |                    |
| Section 689: duty of company to notify the Registrar of the redeeming of any of its redeemable shares   | The company and every officer who is in default    |                    |



| Provision of the act  | The parties who are liable   | Additional remarks |
|---|--|--------------------|
| Section 703: duty of company to keep copy of the contract or memorandum of terms relating to a market or off-market purchase of its shares for 10 years and to make them available for inspection | The company and every officer who is in default  |                    |
| Section 707: duty of company, having purchased its own shares, to deliver return to the Registrar   | Every officer who is in default  |                    |
| Section 708: duty of company, having cancelled shares, to deliver return to Registrar   | The company and every officer who is in default  |                    |
| Section 715: duty for directors to make statement in prescribed form in connection with proposed payment out of capital for purchase or redemption of own shares                                  | Every director who is party to the making of the statement where there are no reasonable grounds for making it |                    |
| Section 720: director's statement and auditor's statement to be kept available for inspection   | The company and every officer who is in default  |                    |
| Section 722: duty of company to file with Registrar copy of court order issued following any application to cancel a resolution to make a payment out of capital                                  | The company and every officer who is in default  |                    |
| Section 732: offences under sections 724–32 regarding treasury shares   | The company and every officer who is in default  |                    |
| Section 741: duty of company to register allotments of new shares   | The company and every officer who is in default  |                    |
| Section 743: duty of company to notify Registrar of location of its register of debentures  | The company and every officer who is in default  |                    |
| Section 746: duty of company to allow inspection of its register of debentures  | The company and every officer who is in default  |                    |

| Provision of the act   | The parties who are liable                      | Additional remarks |
|--|---|--------------------|
| Section 749: duty to give copy of debenture trust deed to debenture holder on request  | Every officer who is in default                 |                    |
| Section 767: duty of public company to obtain trading certificate before commencing trading or exercising borrowing powers   | The company and every officer who is in default |                    |
| Section 769: duty of company to issue certificates following allotment of shares or debentures   | Every officer who is in default                 |                    |
| Section 771: duty of company to register or refuse a share transfer within two months  | The company and every officer who is in default |                    |
| Section 776: duty of company to issue certificates on transfer of shares or debentures   | Every officer who is in default                 |                    |
| Section 780: duty of company to issue certificates on surrender of share warrants  | Every officer who is in default                 |                    |
| Section 798: issue of shares in contravention of restrictions imposed by the court   | The company and every officer who is in default |                    |
| Section 804: duty of company to comply with members' request to investigate ownership of its shares  | Every officer who is in default                 |                    |
| Sections 806 and 807: duty of company to notify Registrar of location of report of investigation into ownership of its shares and to make such report open to inspection | The company and every officer who is in default |                    |
| Sections 808 and 809: duty of company to keep register of information about interests in its shares and to keep it available for inspection                              | The company and every officer who is in default |                    |
| Section 810: duty to keep index of register, where appropriate   | The company and every officer who is in default |                    |

| <b>Provision of the act</b>   | <b>The parties who are liable</b>  | <b>Additional remarks</b>  |
|---|--|--|
| Section 813: refusal of company to allow inspection or copy of register   | The company and every officer who is in default  |  |
| Section 815: unauthorised deletion of entries in the register   | The company and every officer who is in default  |  |
| Section 819: duty of company to retain register after it ceases to be a public company  | The company and every officer who is in default  |  |
| <b>The annual return</b>  |  |  |
| Section 858: duty of company to file annual return with the Registrar   | The company, every director, the company secretary (where appointed) and every other officer | It is a defence for a director or secretary to prove that he or she took all reasonable steps to avoid the commission or continuation of the offence. NB in the case of continued contravention, an offence is committed by officers who were not responsible for the initial breach |
| <b>Charges</b>  |  |  |
| Sections 860 and 862: duty of company to deliver to the Registrar particulars of charges it creates and charges on property acquired            | The company and every officer who is in default  | The equivalent Scottish offences appear in sections 878 and 880  |
| Section 876: knowingly and wilfully authorising or permitting the omission of an entry that should be made in the company's register of charges | The officer who commits the offence  | The equivalent Scottish offence appears in section 891   |
| Section 877: duty of company to notify the Registrar of location of its register of charges and to make it available for inspection on request  | The company and every officer who is in default  | The equivalent Scottish offence appears in section 892   |
| <b>Arrangements and reconstructions</b>   |  |  |
| Section 897: statement connected with meeting about arrangement or reconstruction   | The company and every officer who is in default  |  |
| Section 898: duty of directors to provide information relevant to the statement   | The director who is in default   |  |

| <b>Provision of the act</b>  | <b>The parties who are liable</b>  | <b>Additional remarks</b>   |
|--|--|---|
| Section 900: duty of company to notify Registrar where a court order is made to sanction a reconstruction or amalgamation  | The company and every officer who is in default  |   |
| Section 901: company articles to reflect substance of court order  | The company and every officer who is in default  |   |
| Section 953: failure to comply with rules about take-over bid documentation  | Directors and officers of the company  | The offence is committed if a director or officer knew that the document concerned did not comply or was reckless as to whether it complied, and failed to take all reasonable steps to secure that it did comply |
| Section 980: company seeking to buy out minority shareholder – formal notice to offeree  | The company  | It is a defence for the company to prove that it took all reasonable steps to secure compliance   |
| Section 984: notice concerning sell-out rights of offerees   | Every officer who is in default or to whose negligence the fault is attributable                       | It is a defence for the officer to prove that he or she took all reasonable steps to secure compliance  |
| <b>Fraudulent trading</b>  |  |   |
| Section 993: fraudulent trading  | Every person who is knowingly a party to the carrying on of the business by the company in that manner |   |
| <b>Orders of the court following unfair prejudice actions</b>  |  |   |
| Sections 998 and 999: duty of company to deliver copy of court order affecting company's constitution to the Registrar; duty to ensure that the terms of the order are reflected in the company's articles | The company and every officer who is in default  |   |

| Provision of the act   | The parties who are liable                      | Additional remarks  |
|--|---|---|
| <b>Provisions regarding strike-off and restoration to the register</b>   |   |   |
| Sections 1004 and 1005: offence to make application to the Registrar for voluntary strike-off of company in prescribed circumstances | The person who makes the application            | It is defence for the person to prove that he or she did not know, and could not reasonably have known, of the existence of the facts of the contravention  |
| Section 1006: duty to make copies of application for voluntary strike-off available to specified parties                             | The person who has made the application         | It is a defence for the person to prove that he or she took all reasonable steps to perform the duty. NB if the non-compliance is due to an intention to conceal information, the offence is deemed to be a aggravated offence  |
| Section 1007: copies of application to be made available to new members, employees, etc  | Directors                                       | It is a defence for a director to prove that i) he or she was not aware of the application having been made or ii) he or she took all reasonable steps to perform the duty. NB if the non-compliance is due to an intention to conceal the fact of the application having been made, the offence is deemed to be a aggravated offence |
| Section 1009: circumstances in which the company's application for voluntary strike-off must be withdrawn                            | Directors                                       | It is a defence for a director to prove that i) he or she was not aware that the company had made an application or ii) that he or she took all reasonable steps to perform the duty  |
| Section 1033: matters causing a company to have to change its name following restoration to the register                             | The company and every officer who is in default |   |

| Provision of the act   | The parties who are liable                      | Additional remarks |
|--|---|--------------------|
| <b>Dealings with the Registrar of Companies</b>  |   |                    |
| Section 1093: duty of company to cooperate with the Registrar to resolve inconsistency of material on the public record  | The company and every officer who is in default |                    |
| Section 1112: offence for any person to deliver or cause to be delivered to the Registrar, for Companies Act purposes, or to make a statement to the Registrar, any statement which is misleading, false or deceptive in a material particular | The person who is in breach                     |                    |
| <b>Company records</b>   |   |                    |
| Section 1135: records to be capable of being reproduced in hard copy form  | Every officer who is in default                 |                    |
| Section 1138: duty of company to take adequate precautions to guard against falsification and to facilitate the discovery of falsification   | Every officer who is in default                 |                    |
| <b>Documentation</b>   |   |                    |
| Section 1145: right of member to require receipt of documents in hard copy form  | Every officer who is in default                 |                    |
| <b>Business names</b>  |   |                    |
| Sections 1193 and 1194: carrying on business in the UK with a name which suggests links with government or public authorities or which contains 'sensitive' words or expressions to be set down in regulations                                 | Any person in breach                            |                    |
| Section 1197: prohibition on use of inappropriate words or expressions to be set down in regulations   | The person in breach                            |                    |

| Provision of the act   | The parties who are liable | Additional remarks  |
|--|----------------------------|---|
| Section 1198: business not to be carried on under a name which gives so misleading an indication of the nature of its activities as to be likely to cause harm to the public   | The person in breach       |   |
| <p>Note that a number of statutory offences which company directors and other officers may commit are not consolidated into the 2006 Act but remain in force under the Companies Act 1985. These are as follows.</p> |                            |   |
| Section 448: offence of obstructing the exercise by company inspectors or investigators of their rights to enforce a search warrant  | Any person                 |   |
| Section 450: destroying, mutilating or falsifying company documents  | Any officer in breach      | It is a defence to prove that the officer had no intention of concealing the state of affairs of the company or to defeat the law |
| Section 451: giving false information to inspectors in response to an official request for information   | Any person in breach       |   |
| Section 453A: obstructing inspectors and investigators from gaining access to company premises   | Any person in breach       |   |

Additional statutory offences of which company directors should be aware include the following.

### **COMPANY INVESTIGATIONS UNDER THE COMPANIES ACT 1985**

---

The provisions regarding official company investigations under Part XIV of the Companies Act 1985 have not been consolidated into the 2006 Act. The provisions of that part contain a number of offences connected with failure to cooperate with the inspectors or investigators.

### **TAXATION OFFENCES**

---

Where a company commits an offence under the VAT Act 1983 and it appears to HMRC that the company's action is attributable to the dishonesty of a director, HMRC may serve notice on that director to recover all or part of the penalty from him or her as if he or she were personally liable for the penalty. The company is then assessed only on the balance. A director may also incur personal liability under tax legislation by, inter alia, failing to comply with an order from a VAT tribunal; by contravening the rules on National Insurance contributions; and by making false statements in a tax return.

### **THEFT ACT 1968**

---

A director may be made liable for a number of serious offences under the Theft Act. These offences include false accounting and making a false statement to creditors.

### **CONSUMER PROTECTION LAW**

---

There are many individual statutes covering consumer protection issues, and many of these contain provisions for directors to be held liable for offences. The statutes include the Trade Descriptions Act 1968, the Fair Trading Act 1973, the Consumer Credit Act 1974, the Weights and Measures Act 1985 and the Consumer Protection Act 1987.

### **INSOLVENCY ACT 1986**

---

There are numerous offences that may be committed by directors who take their companies into liquidation. These are set out in sections 206–11 of the Insolvency Act 1986. They include:

- destruction or falsification of company records
- transactions in fraud of creditors
- misconduct in the course of winding up, which includes failure to disclose and hand over the company's books, papers and property
- falsification of the company's books



- making material omissions from the company's statement of affairs
- making of false representations to creditors.

### **INSIDER DEALING AND MARKET ABUSE**

---

An individual who deals in UK listed securities with 'inside information' commits the offence of insider dealing under the Criminal Justice Act 1993. Additional offences are encouraging others to commit insider dealing and disclosing the price-sensitive information other than in the course of one's office, employment or profession. Under the Financial Services and Markets Act 2000 (FSMA), it is also an offence to make misleading statements to the market or otherwise to engage in misleading conduct. Note that, in addition to the criminal offences under that Act, the Financial Services Authority has the power under the FSMA to impose substantial financial penalties for market abuse (see Chapter 10 section 10.5 above).

### **PROCEEDS OF CRIME ACT 2002**

---

This Act contains a widely drawn definition of money laundering, essentially covering involvement with the proceeds of all or any criminal acts, and a series of offences related to money laundering that may be committed by any person.

### **FRAUD ACT 2006**

---

The Fraud Act 2006 contains three new statutory offences of fraud. Under these new offences, fraud can be committed by a person by:

- dishonestly making a false representation
- dishonestly failing to disclose information which he or she is under a legal obligation to disclose
- dishonestly abusing a position he or she occupies which requires him or her to safeguard, or not to act against, the financial interests of another person

in all cases with the intention of making a gain for him- or herself or causing loss to another.

Each of these new offences is clearly capable of being committed by company directors in the performance of their functions.

The same Act also extends the maximum penalty for participation in fraudulent business carried on by a company from seven years' imprisonment to ten.

## Appendix 2

Matters to be taken into account by the courts in determining whether a director is unfit to hold office (taken from Schedule 1, Company Directors Disqualification Act 1986)

### **(A) MATTERS APPLICABLE IN ALL CASES**

---

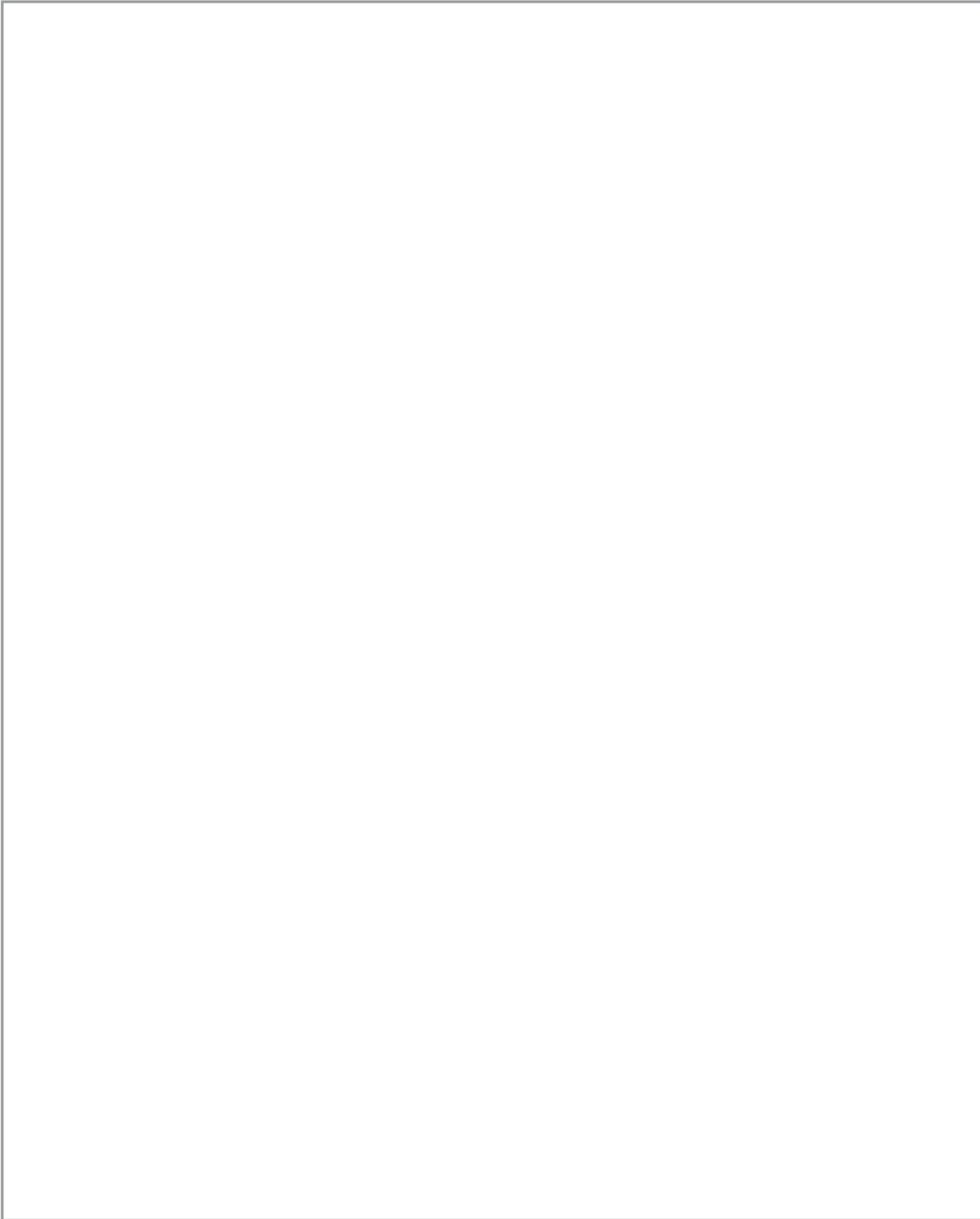
- 1 Any misfeasance or breach of any fiduciary or other duty by the director in relation to the company.
  - 2 Any misapplication or retention by the director of, or any conduct by the director giving rise to an obligation to account for, any money or other property of the company.
  - 3 The extent of the director's responsibility for the company entering into any transaction liable to be set aside under Part XVI of the Insolvency Act (provisions against debt avoidance).
  - 4 The extent of the director's responsibility for any failure by the company to comply with any of the following provisions of the Companies Act, namely:
    - (a) section 221 (companies to keep accounting records);
    - (b) section 222 (where and for how long records to be kept);
    - (c) section 288 (register of directors and secretaries);
    - (d) section 352 (obligation to keep and enter up register of members);
    - (e) section 353 (location of register of members);
    - (f) section 363 (duty of company to make annual returns); and
    - (h) sections 398 and 703D (company's duty to register charges it creates).
  - 5 The extent of the director's responsibility for any failure by the directors of the company to comply with:
    - (a) section 226 or 227 of the Companies Act (duty to prepare annual accounts), or
    - (b) section 233 of that Act (approval and signature of accounts).
-

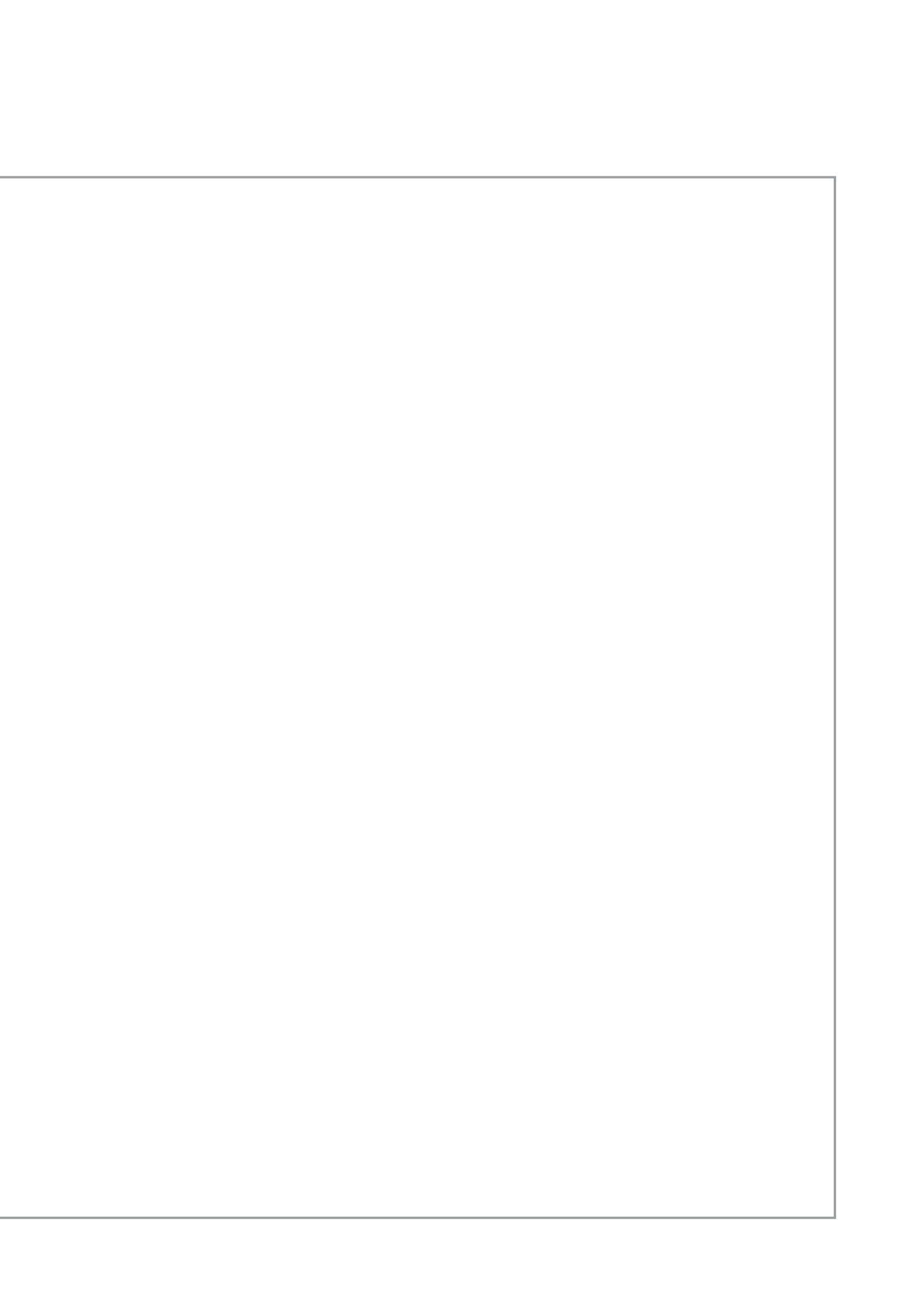
**(B) MATTERS APPLICABLE WHERE COMPANY HAS BECOME INSOLVENT**

---

- 6 The extent of the director's responsibility for the causes of the company becoming insolvent.
- 7 The extent of the director's responsibility for any failure by the company to supply any goods or services which have been paid for (in whole or in part).
- 8 The extent of the director's responsibility for the company entering into any transaction or giving any preference, being a transaction or preference—
  - (a) liable to be set aside under section 127 or sections 238 to 240 of the Insolvency Act, or
  - (b) challengeable under section 242 or 243 of that Act or under any rule of law in Scotland.
- 9 The extent of the director's responsibility for any failure by the directors of the company to comply with section 98 of the Insolvency Act (duty to call creditors' meeting in creditors' voluntary winding up).
- 10 Any failure by the director to comply with any obligation imposed on him by or under any of the following provisions of the Insolvency Act:
  - (a) paragraph 47 of Schedule B1 (company's statement of affairs in administration);
  - (b) section 47 (statement of affairs to administrative receiver);
  - (c) section 66 (statement of affairs in Scottish receivership);
  - (d) section 99 (directors' duty to attend meeting; statement of affairs in creditors' voluntary winding up);
  - (e) section 131 (statement of affairs in winding up by the court);
  - (f) section 234 (duty of anyone with company property to deliver it up);
  - (g) section 235 (duty to cooperate with liquidator, etc).

NB the above references to sections of the Companies Act 1985 will be changed in due course to the corresponding references of the Companies Act 2006.





**TECH/TP/CDD**

ISBN: 1 85908 434 6

**ACCA** 29 Lincoln's Inn Fields London WC2A 3EE United Kingdom / +44 (0)20 7059 5980 / [www.accaglobal.com](http://www.accaglobal.com)