

United Kingdom

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1. Directors' duties

1.1 Nature of the duties

In the United Kingdom, directors owe fiduciary duties and a duty of care to their companies. Until 2007, these duties were derived primarily from case law and judicial interpretation of statutes. This meant there was room for uncertainty as to their precise nature and scope. The Companies Act 2006, for the first time, set out directors' duties in one place and sought to define them clearly. At the time it was enacted, the government stated that with one exception – a new duty – the duties are intended to reflect the existing law. Further, the new statutory provisions are to be interpreted according to the existing common law and equitable principles (Section 170(4) of the Companies Act 2006). In the past there had been confusion regarding to whom directors owe their duties. Section 170(1) of the Companies Act 2006 makes it clear that the duties are owed to the company. The duties are owed by all directors, whether elected and registered, de facto or shadow directors. The Companies Act 2006 sets out the directors' general duties in seven provisions, Sections 171 to 177, as follows.

(a) *Duty to act within powers*

A director must act in accordance with the constitution of the company (memorandum and articles of association), and exercise the powers vested in him only for the purposes for which they are conferred (Section 171). This is an existing fiduciary duty and is already fully established in law.

(b) *Duty to promote the success of the company*

A director must act in a way which he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole (Section 172). In doing so, he must have regard to the following, among other things:

- the likely long-term consequences of any decision;
- the interests of employees;
- the need to foster relationships with suppliers, customers and others;
- the impact of the company's operations on the community and environment;
- the desirability of the company maintaining a reputation for high standards

- of business conduct; and
- the need to act fairly between shareholders.

This is the new duty, which was the subject of much anticipation. As to how it may be applied, the first important consideration is that it is fiduciary in nature and therefore is regarded as part of the package of duties requiring that the directors act in good faith and with loyalty towards the company at all times. It is therefore not subject to any objective standard – if a director acts in a way he considers is in the best interests of the company (as long as that was in good faith), a court will not penalise him, even if the relevant course of conduct turned out to be ill advised (see, however, Section 174 of the Companies Act 2006).

This approach is likely to be reinforced by the courts' reluctance to reopen business decisions of boards – a court need only ascertain whether the directors, in good faith, considered they were promoting the success of the company by their actions. They will also need to show they took the list of six factors above into account.

It is important to bear in mind that the factors do not override the duty itself, but are subordinate to the duty, and no factor has greater weight than any other. However, in given situations, certain factors will be more obviously relevant than others. For example, the directors deciding that it is in the best interests of the company to embark upon a redundancy programme will need to have particular regard to the interests of employees and the impact of the decision on the community. The duty anticipates that there will be more than simply a reference in the relevant board minutes, requiring that steps be taken to weigh up those factors before the decision is finally taken. The more that is done, the less likely the directors' decision will be questioned.

Unfortunately, there has yet to be any reported judicial consideration of this duty and so the academic analysis remains untested.

(c) *Duty to exercise independent judgement*

The directors must exercise their powers on behalf of the company independently of influence from other parties, unless authorised by the company's constitution (Section 173). This is an existing fiduciary duty and is already fully established in law.

(d) *Duty to exercise reasonable skill, care and diligence*

A director must exercise reasonable skill, care and diligence (Section 174). This is the skill, care and diligence of 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 concerned (eg as finance director, chief executive, sales director etc); and
- the general knowledge, skill and experience that the director has (eg the number of years' actual experience, qualifications and training actually received).

This duty was originally contained within the restrictive confines of Section 214 of the Insolvency Act 1986, but in the last 15 years has been interpreted by courts to apply more generally to directors' conduct. This is now confirmed by Section 174 of

the Companies Act 2006. It is not a fiduciary duty and so contains an objective element (the first limb of the standard).

A director is to be judged partly by the standard reasonably to be expected of a director occupying his post. Unlike the standard applied in the United Kingdom to professionals, however, a court shall also take into account the director's actual circumstances before deciding whether he has failed to act with reasonable skill, care and diligence (the second limb of the standard). For less experienced or less educated directors, this may result in more relaxed treatment by the courts, but where directors are very experienced or highly qualified they may well find this results in a tougher stance taken towards their conduct.

If the factors listed in relation to the Section 172 duty to promote the success of the company are not properly taken into account by boards when making important decisions, where those decisions later turn out to be flawed, this could lead to allegations that the directors failed to exercise reasonable skill, care and diligence, so as to find them in breach of this Section 174 duty (irrespective of a breach of the Section 172 duty).

(e) *Duty to avoid conflicts of interest*

A director of a company must avoid a situation in which he could have a direct or indirect interest that conflicts with the interests of the company (Section 175). This is an existing fiduciary duty and is already fully established in law. However, the provision does simplify the rules, making it clear that the duty applies to the exploitation of any property, information or opportunity. Further, the duty is not breached when the company, by its board, has "authorised" the conflict in a vote that did not include the affected director, as long as it is permitted to do so by its constitution.

(f) *Duty not to accept benefits from third parties*

A director must not accept a benefit from a third party by reason of his being a director or his doing (or not doing) anything as a director (Section 176). This is an existing fiduciary duty and is already fully established in law. A breach of this duty is not capable of being "authorised" by the company; however, the provision makes it clear that the duty is not breached if a benefit is received that cannot reasonably be expected to place the director in conflict of interest with the company.

(g) *Duty to declare interest in a proposed transaction or arrangement*

Where a director has a direct or indirect interest in a proposed transaction or arrangement, he must declare the nature and extent of that interest to the other directors (Section 177). This is an existing fiduciary duty and is already fully established in law, although the new provision alters the position slightly, in that shareholder approval is now not required, unless the constitution says otherwise.

1.2 Standards of care

The majority of the above duties are specific and absolute – they do not depend on standards to determine whether they have been breached.

The duty to promote the success of the company is clearly to be applied subjectively, in the sense that the court will need to decide not whether a director's decision making was reasonable, but only whether as a matter of fact he thought in good faith that it would promote the success of the company, with regard to the factors.

However, as discussed above, the duty to exercise reasonable care, skill and diligence is expressly subject to a two-stage objective/subjective standard due to the general nature of the duty. In this respect, the intention is to ensure that a minimum standard of conduct is required of all directors.

1.3 To whom the duties are owed

As stated above, Section 170(1) of the Companies Act 2006 confirms that the duties are owed to the company. Duties are not owed to individual shareholders or individual creditors, although with regard to the latter, where a company is trading while insolvent, the directors must consider or act in the interests of creditors of the company as a whole. The factors listed in the duty to promote the success of the company refer to various groups of people whose interests should be taken into account, but the factors do not mean the duty is owed to such groups. The duty is owed only to the company and only the company can enforce it. Other duties may be owed to third parties – these are dealt with under section 2.

1.4 Common defences to and exemptions from liability

A director can seek to circumvent a possible claim by asking the company to ratify his breach of duty under Section 239 of the Companies Act 2006. Ratification is not new, but the act makes it clear that it can be granted only by a shareholder resolution, in which the director concerned and any connected person cannot participate. Once ratified, the conduct which was the subject matter of the ratification cannot be the subject of a claim brought by the company (either on its own behalf or by way of a shareholder derivative action). The procedure is not commonly used and if it is, it tends to be in smaller companies, but it may become more prevalent as a result of the new shareholder derivative action rights. In respect of claims for breach of a fiduciary duty, factual matters may very well be in dispute and so much will depend on the findings of fact by the court. Then the question whether the relevant conduct amounted to a breach of the duty will need to be addressed. In respect of the duty to promote the success of the company, the directors will defend on the basis they did consider, by reference to the factors, that they were promoting the success of the company. Evidence will be crucial; it will assist such a defence if board minutes and other internal documents can be produced to show that the issues really were considered. In respect of the duty to exercise reasonable skill, care and diligence, the director will need to show he met the two-stage standard of care. Even if the duty was breached, the question of whether the loss complained of was caused by such breach may be complex, particularly in cases of corporate collapse.

Even where directors are found to have been in breach of duty, or they anticipate a claim may be brought for breach of duty, they may ask the court to relieve them

from liability under Section 1157 of the Companies Act 2006. This provides that if the court considers that a director may be liable but acted honestly and reasonably, and having regard to all the circumstances of the case he ought fairly to be excused, the court may relieve him in whole or in part from liability. There appears to be an inherent conflict between this relief and the duty to exercise reasonable skill, care and diligence, as for the duty to have been breached the court must find the director had not acted “reasonably”, and so the relief could never apply. What is probably intended is that where directors are found to have been in breach of the duty to exercise reasonable skill, care and diligence in relation to a specific issue, they may nevertheless still be relieved if their general conduct as a director was honest and reasonable, taking into account the particular circumstances of the company (eg whether the director was operating under very difficult conditions), against which the negligence occurred. What is clear from the cases on the relief is that the court has significant discretion and each case is likely to turn on its own facts.

These defences relate only to claims brought by the company for breach of duties. Other defences will be applicable to claims by third parties/liquidators on behalf of creditors (see below).

2. Who can bring claims

This topic is closely related to the issue of to whom the directors owe their duties (ie the company). However, there are additional categories of claimant who can bring claims for breach of other duties.

2.1 The company (solvent)

As identified above, the duties are owed to the company and so the primary source of claims for breach of duty is the company. However, in the United Kingdom, claims are rarely brought by companies against their directors. This is because in a unitary board system, directors are unlikely to recommend to the company that a claim be brought against themselves. What is more common is that the company brings a claim against directors who have already retired from the board or have been dismissed. New directors are much more likely to bring a claim against the previous incumbents, particularly if it underscores the fact that they themselves inherited a problem rather than caused it. The process for deciding whether to bring a claim against a director is ultimately determined by the constitution of the company (ie the articles of association). It may be left to the directors to decide or a shareholder resolution may be required.

2.2 The company's liquidators

Liquidators of insolvent companies are a significant potential source of claims against the former directors. The Insolvency Act 1986 contains three causes of action that may be exercised by the liquidators, as follows:

- Section 212 – this enables administrators or liquidators to bring a claim for breach of any duty to the company, as if brought by the company. In other words, it simply enables insolvency practitioners to bring the company's claim as if it were still solvent.

- Section 213 – this enables the liquidators to bring a claim for fraudulent trading, whereby the business of the company is carried on with the intent to defraud creditors, or for any other fraudulent purpose, in the directors' full knowledge. The remedy is for the directors to contribute to the assets of the company available for distribution to creditors. In practice, it is rarely used because "wrongful trading" (see below) is easier to establish.
- Section 214 – this enables the liquidators to bring a claim for wrongful trading, whereby the company continues to trade beyond the point where the directors knew, or ought to have known, there was no reasonable prospect of avoiding liquidation. The standard of care applicable to the directors' conduct is the same as the two-limb standard for the duty to exercise reasonable skill, care and diligence. The remedy is for the directors to contribute to the assets of the company available for distribution to creditors and effectively represents the additional debts incurred after the point when they should have ceased trading. Establishing where such a point occurred can be a complex exercise requiring expert accountancy input.

Liquidators have broad powers to investigate the circumstances surrounding the liquidation and the directors' conduct. Often, prior to bringing a claim, a liquidator will summon the directors for an interview pursuant to Section 236 of the Insolvency Act. There are few legitimate grounds on which a director may refuse to attend, and the liquidators can obtain a court order requiring their attendance. In practice, directors negotiate the terms on which the directors voluntarily attend such meetings, but they may be recorded and a transcript produced.

2.3 **Minority shareholders on behalf of the company**

The principle of "majority rule" among shareholders is fundamental in English company law. Therefore, if a majority of shareholders do not support the company bringing a claim against the directors, it cannot usually proceed. Reflecting this, until the introduction of the Companies Act 2006, minority shareholders had only limited rights to bring claims on behalf of the company against the directors. Such limited rights were developed, and ultimately constrained, by case law. The claims, known as "shareholder derivative actions", could generally be brought only where two situations existed at the same time:

- The directors against whom the claim was to be brought by the company controlled a majority of the shares in the company, so as to prevent the company ever bringing a claim on its own behalf. This requirement is often referred to as "wrongdoer control"; and
- The conduct of the directors complained of was of an egregious nature, such as dishonesty, breach of fiduciary duty or acting in bad faith towards the company. Negligence was not sufficient.

Cases in which both of the above could be demonstrated were rare and this resulted in courts dismissing most at an early stage, which discouraged further development of the right on behalf of minority shareholders. However, the

Companies Act 2006 has, at least in theory, widened the scope for such actions to be brought.

Under Section 260 of the act, any shareholder may bring a claim against directors on behalf of the company, for negligence, default, breach of duty or breach of trust, and there is no requirement of “wrongdoer control”. Both historic restrictions have therefore been removed. The claim may be brought by a shareholder in respect of a matter which predated his becoming a member or in anticipation of a situation. Claims may be brought against former directors as well as present directors.

Is this likely to give rise to a significant increase in derivative claims? First, derivative claims are brought for the benefit of the company and so, if successful, the shareholder does not benefit personally (at least in any direct sense). This is likely to reduce the propensity for claims to be brought. Second, and crucially, Section 261 of the act provides that a shareholder must apply to the court for permission to continue the action, once issued.

At the hearing for permission – which will involve the shareholder bringing the action, the company and the proposed defendant directors – the court may:

- refuse permission to continue and dismiss the proceedings;
- give permission for the claim to continue on such terms as it considers appropriate; or
- adjourn the proceedings for further evidence. Permission will be refused where the court is satisfied that:
 - a person promoting the success of the company would not seek to continue the claim; or
 - the company has already ratified the alleged wrongdoing (see above).

Directors facing an unwanted shareholder derivative action can seek a ratification in order to stop it from proceeding beyond the permission hearing. Assuming there has been no ratification, the court will not automatically dismiss the claim but shall consider:

- whether the shareholder is bringing the action in good faith;
- the importance that a person promoting the success of the company would attach to continuing the action;
- the likelihood the company could still ratify the conduct complained of;
- whether the company has decided not to pursue a claim; and
- whether the shareholder could obtain redress by bringing an action in his own right.

In doing so, the court may seek evidence from other shareholders who are not connected with the matter as to whether the action should be allowed to continue.

The substantive merits of the claim are not expressly relevant to the granting of permission, although they are likely to affect the court’s attitude to factors such as whether someone promoting the success of the company would continue it and the likelihood of a ratification. Any action obviously brought to make mischief or a “political” point is likely to fail the “good faith” test and not be allowed to continue.

If leave to continue the action is given, the court is likely to order, among other

things, that the company indemnify the shareholder who has brought the action on its behalf, in respect of the past and future costs incurred.

Since October 2007 there have been nine reported cases brought under the new regime, an increase on pre-Companies Act 2006 patterns. At the date of compiling this chapter, only one has made it past the permission hearing. In that case, the size of the claim was influential in the court's decision to allow it to continue. In the rejected cases, it was held that a person promoting the success of the company would not have continued the action.

2.4 Shareholders on their own account

As stated above, directors owe their duties to the company and not to any individual shareholder. A shareholder bringing an action against the directors for breach of duty other than as a derivative action is likely to face an application to strike out the claim for disclosing no cause of action. Where a minority shareholder considers his rights have been unfairly prejudiced by the company, he may petition the court under Section 994 of the Companies Act 2006 for an appropriate order restraining the company from conducting itself in such a manner, or some other direction, such that the shareholder shall have his shares bought by other shareholders or the company at a price to be decided. Directors may find themselves party to such actions, either in their capacity as officers of the company or because they are also shareholders themselves, but not in respect of any alleged breach of their duties as directors. Shareholders are potentially able to bring claims against the directors in their capacity as investors who bought their shares based on misleading information. This is considered in section 2.5(c).

2.5 Third parties

Generally, when directors deal with third parties such as trading partners, suppliers and customers, they do so as officers of the company and it is the company against which any cause of action arises from such dealings. This is due to the principle that the company is a separate legal person and third parties should not be able to pierce the "corporate veil" unless there are exceptional circumstances. Where a company is insolvent or has no assets and there are aggrieved third parties, there is a greater likelihood of claims which allegedly fall within one of the exceptions.

(a) *Fraud*

Where a director, who is also the principal shareholder, has used the corporate entity to commit fraud against a third party, a court will allow the third party to pierce the corporate veil to recover from that director.

(b) *Assumption of personal responsibility*

Where, in making a misstatement to a third party, a director has assumed a "personal responsibility" to the third party, he may be liable. The scope for third parties to establish this is limited; in other words, courts require a very clear indication that a personal assumption of risk by a director was anticipated. This goes beyond any ordinary dealings as a director and would require, for example, the use of personal

stationery or oral statements that made it clear they were on behalf of the director himself and not the company.

(c) ***Investors who are mis-sold shares***

Directors may be liable, together with the company, to investors who suffer losses as a result of a misleading statement or non-disclosure in the company's share offering documentation. The liability position varies depending on the type of offering involved. Public offerings of shares on a market regulated by the Financial Services Authority (FSA), such as the London Stock Exchange, are governed by the Financial Services and Markets Act 2000. Under Section 90 of the act, the company and the directors may be liable to investors who suffer loss as a result of any misleading statement in the offering prospectus. Schedule 10 of the act contains a defence that the directors shall not be liable if they show they reasonably believed, having made such enquiries as were reasonable, that the statement was true and not misleading. Public offerings of shares on a non-regulated market, such as AIM, are not governed by the Financial Services and Markets Act 2000 and so liability for misleading statements in the offering documentation is governed by common law. There are few cases involving such liability, but it is arguable that the company would be liable to investors who suffer loss as a result of a misstatement, particularly where the identities of the investors were known to the company and the investors could show they relied upon the misleading statement. Whether the directors are liable would depend on their having assumed personal responsibility, as outlined above. The AIM rules require the directors to verify, in writing, the accuracy of the statements in the offering documentation. This arguably amounts to a personal assumption of responsibility, but the position has never been ruled upon by a court. Private sales of shares are likely to follow similar considerations as for non-regulated market offerings, except that liability for misstatements is more likely given that the particular purchasers of the shares will be known to the company, creating an obvious duty of care. Again, the directors' liability will depend upon a personal assumption of responsibility; in practice, this is secured via personal guarantees as to the accuracy of the information given. Liability for misleading statements in the company's reports is subject to a different regime, which has recently changed. The common law has not recognised a duty owed to prospective investors who rely on statements in company reports because their identities and motives are not known to the company, and so cannot be the subject of an assumption of responsibility. However, Section 1270 of the Companies Act 2006 introduced a new provision to Section 90A of the Financial Services and Markets Act 2000 to reflect the EU Transparency Directive, which provides that the company (only) can be liable to investors who buy shares in reliance upon a misleading statement or non-disclosure in a report if a director knew such statement was misleading. This creates an exception to the general position where a director dishonestly allows a misleading statement or non-disclosure to be made. The director himself cannot be liable to the third-party investors. By virtue of Section 463 of the Companies Act 2006, he can be liable only to the company.