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DIRECTORS: ROLE AND RESPONSIBILITIES

WHAT IS A DIRECTOR?

Although this may seem obvious, it is not necessarily just those people who are called 'directors' who will qualify as such. For instance, company law provides that a director includes 'any person occupying the position of director, by whatever name called'. This means that if, on the facts, a person is fulfilling the role of a director, then he or she may be deemed to be one and fully liable as such. Equally, if the directors are accustomed to act in accordance with the directions and instructions of a third party, that person may be deemed to be a 'shadow director' of the company and liable as such.

WHAT IS THE DIRECTOR'S ROLE?

Although companies are legal entities in their own right, they can only act through human agents. Company directors fulfil this role and the operation and management of the company is typically delegated to them. The directors' powers to manage the company are subject to the terms of its constitution and any restrictions that may be contained within it.

Directors exercise their powers principally through the board of directors, which is the body empowered and entrusted to 'direct' the affairs of the company. The board will meet periodically to consider matters relating to the management of the company and will make its decisions collectively through resolutions. However, in practice, the running of a company of any real size would be impossible if all decisions required a full board meeting. Whilst in small companies with few directors, day-to-day decisions can be taken at meetings of all of the directors, board meetings of larger companies are relatively infrequent and are generally used to discuss and formulate policy or to approve and authorise important transactions.

The operation of most companies is delegated to their executive directors, who are usually employed by the company under the terms of a service contract. Except in the smallest companies, it is common to appoint one or more non-executive directors, who are selected for their commercial experience and expertise, but who are generally not involved in the day-to-day running of the company and do not devote their whole working time to it. Their relative distance from the daily operations of the company gives them an objective overview, which operates to the benefit of members. In addition, for publicly quoted companies, the UK Corporate Governance Code 2018 and the Quoted Companies Alliance Corporate Governance Code for Small and Mid-Size Quoted Companies 2018 (QCA Code), both recently updated, preserve the requirement for the appointment of non-executive directors and impose greater accountability on directors.

WHICH DUTIES ARE IMPOSED ON DIRECTORS?

As directors have extensive powers, the law imposes certain duties on them to safeguard the rights of shareholders and others.

Directors' duties are now primarily set out in a statutory statement of directors' duties introduced by the Companies Act 2006 (Act). However, it is important to note that this statement is still not an exhaustive list of the duties of directors.

The seven main general duties owed by directors to a company are as follows:

- to act within powers;
- to promote the success of the company;
- to exercise independent judgment;
- to exercise reasonable care, skill and diligence;
- to avoid conflicts of interest;
- not to accept benefits from third parties; and
- to declare interests in proposed transactions or arrangements with the company.

The statement codifies (with some significant changes) and replaces the common law and fiduciary duties that have been developed by the courts in case law over many years. This case law remains highly relevant because the Act expressly states that in interpreting the statement, regard should be had to the case law that it replaces.

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Wider stakeholder engagement has been a key driver in recent corporate governance reform discussions. As a result, related reforms (taking effect from 1 January 2019) include for example:

- Large companies (including large private companies) will be required to include a 'section 172 statement' in their strategic report describing how the directors have had regard to the matters in section 172 of the Act (ie to promote the success of the company).
- Large and medium-sized companies (including private companies) with more than 250 UK employees will be required to include a statement in their directors' report explaining how the directors have engaged with employees, how they have had regard to employee interests and the effect of that on the business.
- Large companies (including large private companies) will be required to include a statement in their directors' report explaining how the directors have had regard to the need to foster the company's business relationships with suppliers, customers and others, and the impact of that on the business.
- The introduction of the Wates Corporate Governance Principles for Large Private Companies (Wates Principles), intended to provide large private companies with a voluntary framework when complying with the corporate governance reporting requirements outlined above. While aimed at large private companies, the Wates Principles will provide a useful tool for a wide range of companies (not just those covered by the new reporting requirement) to understand and adopt good practice in corporate governance.

There are various remedies that may be sought against directors for breach of their duties, depending upon the circumstances. These include both civil and criminal penalties, depending on the breach. For example, a director who commits a breach of duty may face civil action by the company for which he may be held personally liable to pay damages, or other orders. He may be the subject of investigation by a third party, such as the Department of Trade, for breach of any of his duties and may be disqualified for a period of up to 15 years under the Company Directors Disqualification Act 1986.

Actions can also be brought by shareholders in the name of the company with prior consent of the court.

OTHER SOURCES OF DUTIES

In addition to the general duties set out in the Act's statement of directors' duties, there are a number of other duties imposed upon directors - for example under health and safety legislation or by regulatory authorities in relation to publicly traded companies. The codified statutory position under the Act is by no means a 'one-stop shop' for a full understanding of all directors' duties.

Other legislation, such as the Financial Service and Markets Act 2000, the Insolvency Act 1986, the Corporate Manslaughter and Bribery Acts all impose additional duties. Breach of other types of regulation, such as those made under health and safety legislation, environmental legislation and data protection, can give rise to both civil and criminal action.

The assessment of whether a particular decision or course of action was negligent or non-compliant will always be a matter of detailed evaluation of the facts. For directors to protect themselves in advance they must ensure that decision processes are well documented, showing how and why decisions were reached. A defence to an allegation, that a decision was not reasonable or diligent, will be greatly assisted if the detailed reasoning is clearly set out in minutes with supporting papers showing how the decision was arrived at, any advice that was obtained and where appropriate consultation with relevant stakeholders, such as shareholders or possibly trade unions.

RESPONSIBILITIES ON INSOLVENCY

Directors of companies in financial difficulties face additional issues and directors of insolvent companies may be found liable for fraudulent or wrongful trading. This is a particularly nuanced area for directors to navigate so where a company is in (or approaching) financial difficulties directors should seek independent legal advice as soon as possible if they are to avoid potential personal liability under insolvency legislation. Liability can attach to the directors for fraudulent or wrongful trading if the company continues trading when

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insolvent and the interests of creditors are prejudiced. Notably, where a company is insolvent or approaching insolvency, the general duty to promote the success of the company is modified so that a director must instead act in the best interests of the company's creditors. Fraudulent trading occurs if, in the course of a winding up, it appears that any business of the company has been carried on with intent to defraud creditors or for any other fraudulent purpose. In such cases the liquidator can seek a court declaration that anyone who was knowingly party to the fraudulent business make a contribution to the company's assets. Only those who were knowingly parties to the fraudulent trading are caught by this offence: there has to be "actual dishonesty, involving, [...], real moral blame".

Directors of an insolvent company may be found liable for wrongful trading if it is established that, at a time before the company went into insolvent liquidation, the director knew or ought to have concluded, there was no reasonable prospect of the company avoiding an insolvent liquidation. There is no requirement for dishonesty by the director and a director's actions will be judged on the basis of what a reasonable director would have done in the circumstances with the same knowledge, skill and experience as the director in question. It will be a defence for a director to show that, after the point when he concluded (or should have concluded) that there was no reasonable prospect of the company avoiding an insolvent liquidation, he took every step a reasonably diligent director could be expected to take with a view to minimising the potential loss to the company's creditors. A director found liable for wrongful trading may be required to make a personal contribution to the assets of the insolvent company.

MITIGATING DIRECTORS' LIABILITY

In some cases, there may be opportunities for directors to mitigate their liability. In certain situations, the court may grant relief from liability if the director has acted honestly and reasonably; in other circumstances, the shareholders of the company may ratify unauthorised acts.

A company may (but is not obliged to) indemnify its directors in respect of certain proceedings brought against them by third parties. An indemnity can potentially cover both the cost of the claim itself and the costs involved in defending it but never the unsuccessful defence of fines imposed in criminal proceedings or penalties imposed by regulatory bodies.

Against this background, it is common for a company to take out directors' and officers' insurance on behalf of its directors. Policy cover and terms vary but typically deal with directors' liabilities arising from claims of negligence, breach of duty or other default. Standard policy exclusions include fraud, dishonesty and criminal behaviour but the directors should ensure they understand any limitations on cover and that insurance policies are kept under regular review.

OTHER RESPONSIBILITIES: LISTED COMPANIES

Directors of companies whose securities are listed on an investment exchange are subject to a further layer of regulation. For example, the Listing Rules of the UK Listing Authority impose a number of duties on the directors of a company listed on the Official List and the AIM Rules of the London Stock Exchange have the same effect in relation to that market. One requirement of the Listing Rules that is particularly important for such directors is that companies incorporated in the UK with a premium listing of equity shares must include in their annual reports and accounts a statement as to how they have applied the principles of good governance set out in the UK Corporate Governance Code, giving reasons for any non-compliance (frequently referred to as 'comply or explain'). Likewise, since new corporate governance requirements came into effect on 28 September 2018, boards of AIM listed companies have been required to adopt a recognised corporate governance code (typically selecting the QCA Code), explaining how the company complies with it and how it departs from it (together with an explanation of the reasons for any departures from the chosen code). Previously, AIM companies have not been required to do this.

It should be noted that although these corporate governance codes have been prescribed solely for publicly listed companies, they do provide helpful guidance, and are increasingly seen as relevant, to all companies on best practice in governance issues. The boards of all companies (however small) should give consideration to having in place a corporate governance framework which is suitable for the company's size, shareholders, stakeholders and business model, since

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this will lead to a more effective board and, in turn, to a more efficient and successful business.

FURTHER INFORMATION

For further information, please get in touch with your usual Penningtons Manches contact.

This briefing note is intended merely to provide a summary of the law in this area and is not a comprehensive guide. It is not intended to provide legal advice for specific cases. The law and practice in this note is stated as at December 2018.

FIND OUT MORE

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