

New Code of Directors' Duties - are you prepared?



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On 1 October 2007 a new statutory code of directors' duties will be introduced into UK law as a result of the Companies Act 2006 (the "Act").

This briefing note looks at the changes and how they will affect you and your business.

What will change from October 2007?

The Act will expand upon and codify the existing law into seven statutory duties which directors of all companies (whether private or public, traded or non-traded) must adhere to.

The seven duties are:

- To act within powers
- To promote the success of the Company
- To exercise independent judgement
- To exercise reasonable care, skill and diligence
- To avoid conflicts of interest (effective October 2008)
- Not to accept benefits from third parties (effective October 2008)
- To declare their interest in proposed transactions or arrangements (effective October 2008).

The duties are cumulative, not exhaustive, and accordingly a director must comply with each and every duty.

In addition to the new duties, the Act also introduces a statutory procedure which will allow shareholders to ratify a directors' negligence, default, breach of duty or trust by ordinary resolution (subject to anything contrary contained in the company's articles requiring a higher majority or unanimity). If the director is also a shareholder, however, his votes and the votes of any member connected with him will be disregarded in determining whether the resolution is passed.

Why a statutory code?

The law on directors' duties is currently set out in case law which has built up over many years and which was based on 19th century concepts, having little application to today's business world. In addition, the case law itself lacked clarity, making it difficult for directors to know what was expected of them.

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The government has therefore codified the existing law into these seven statutory duties which are intended to replace the existing case law and make the law on directors' duties more accessible. The DTI has been at pains to point out that the new duties do not prescribe how directors should run their companies – they merely give an indication of how directors are *expected* to behave.

The "central duty" – promoting the success of the Company

The duty which has perhaps received the most attention and which has been referred to as the "central duty" is the duty to promote the success of the company. This replaces the existing duty to "act in the best interests of the company". The DTI has said that this duty enshrines in statute what is commonly referred to as "Enlightened Shareholder Value" – a concept which has, until now, not formed part of UK company law. A director must therefore act in a way which he considers in good faith is most likely to promote the success of the company for the benefit of its members as a whole and, in doing so, have regard to all relevant factors, including six factors which are specifically set out in the Act. These factors are not exhaustive and the government has stressed that directors should not use these as a "box ticking exercise". The factors are:

- 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 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
- the need to act fairly between members of the company.

The directors also need to consider and act in the interests of creditors of the company in certain circumstances, as at present.

The Act does not provide any guidance on what should happen should there be any conflict between these factors or what weight to attribute to them. Suffice to say, the position will always depend on a variety of factors, including the type of company involved or the subject matter of the decision. Directors, however, cannot dismiss this duty as being too oblique or "wishy washy". The DTI has made it clear that it will not be sufficient to pay "lip service" to the factors and that, in many cases, directors will need to take action to comply with the duty.

What is clear, however, is that the six factors mentioned above are subsidiary to the overriding duty to promote the success of the company. For example, if taking into account the interests of the company's employees would run contrary to promoting the success of the company, the company's success will take precedence.

In practical terms, it is anticipated that the duty to promote the success of the company will not differ from the current duty to act in the best interests of the company although the introduction of the six factors mentioned above should focus the minds of directors on those areas which need particular consideration.

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Greater certainty for directors?

Although the statutory duties replace directors' existing common law duties, the Act provides that the courts, when interpreting and applying the statutory duties, must have regard to the common law rules and equitable principles which these duties replace. It is therefore arguable whether the new code provides the clarity and certainty for directors that it was designed for, or whether it will result in litigation as directors try to understand the interaction between the new code and existing law.

Additional paper trails?

There has been much discussion on whether this duty will create a requirement for an additional paper trail. The Government has insisted that this is not the case. However, in certain circumstances, directors will need to work closely with their legal advisers to ensure that the basis for decisions is recorded (whether in board minutes or in the content of any briefing papers prepared for the board), particularly if the subject matter of the decision could form the basis of a claim for breach of duty in the future.

To whom are the duties owed and who can enforce them?

The duties are owed by every person who is a director of a company (including shadow directors in some circumstances) to the company. Certain duties apply to persons who have ceased to be a director of the company. As is currently the position, only the company can enforce these duties.

However, in certain circumstances, members may be able to enforce the duties on behalf of the company by means of a derivative action. Common law has always allowed shareholders to raise a derivative action in the name of the company where there has been a wrongdoing against the company and the directors refuse to take any action against the perpetrator (quite often, the directors themselves) – this is often referred to as the rule in *Foss v Harbottle*. However, the circumstances in which a claim could be brought were limited. The Act provides a framework for shareholders to bring a claim on behalf of the company (a "**statutory derivative action**") and makes it easier for shareholders to sue directors for a broader range of misconduct than would be possible under common law.

Generally speaking, a shareholder will require the consent of the court to pursue a statutory derivative action. The statutory derivative action provisions of the Act have been criticised by many directors as likely to increase the risk of litigation. However, the involvement of the court in determining whether shareholders can raise the claim or continue the claim should provide a safeguard against any such actions that are without merit.

That said, only time will tell whether these provisions will lead to an increase in tactical litigation by activists or, indeed, result in directors being more cautious to avoid the possibility of court action.

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What do I need to do to prepare for the new laws?

Boards and company secretaries should familiarise themselves with the new code of directors' duties so that it can be considered and applied during the decision-making process.

They should review their internal policies and procedures, in particular focusing on:

- briefing all board members on the new duties being introduced by the Act
- reviewing the decision-making processes of the board and board committees to determine whether any changes require to be made
- reviewing the company's articles of association to ensure that the company can take advantage of the relaxations brought in by the Act
- reviewing the scope of directors' indemnities and D&O liability insurance to ensure they are appropriate
- new requirements relating to retention of minutes.

How can McGrigors help?

The McGrigors team can assist you with the above as well as providing practical and tailored advice to minimise any risks associated with the new provisions.

If you would like to discuss this briefing further, please get in touch with your existing contact at McGrigors.

Alternatively, please contact one of the three McGrigors partners overleaf.

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