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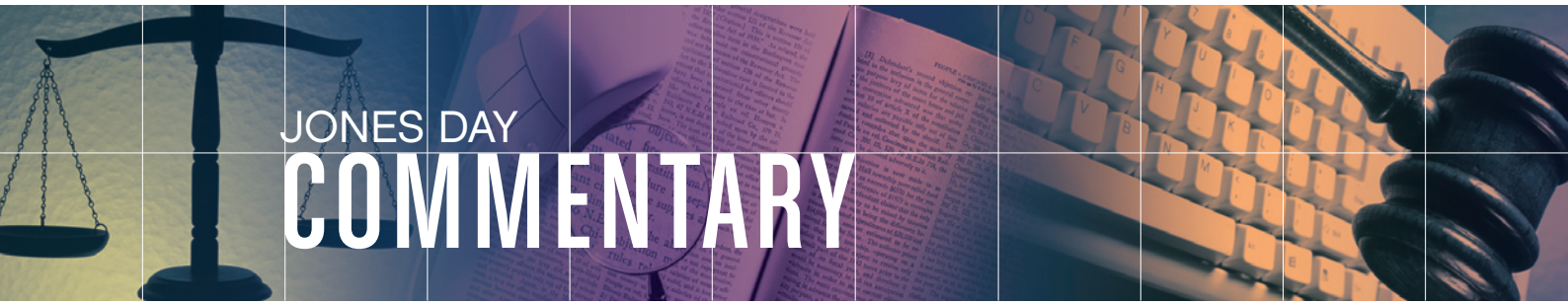

STATUTORY DUTIES OF DIRECTORS OF ENGLISH COMPANIES AS FROM 1 OCTOBER 2008

All directors of public and private companies incorporated in England and Wales are subject to certain duties and responsibilities under English law. These duties and responsibilities apply whether an English company's place of central management and control is within or outside England and Wales. The duties and responsibilities apply equally to all directors, and there are no derogations for non-executive directors, although a director's experience and specific functions in a company will influence the standard to which he is expected to exercise reasonable care, skill and diligence in performing his duties.

The law on directors' duties has been subject to change in recent months, and further changes come into force from 1 October 2008. Historically, directors' duties were derived from common law, and the fundamental duty of any director was to act in the interest of shareholders as a whole. The new rules are not inconsistent with this, but the overarching principle has been expanded upon by the Companies Act 2006 (the "2006 Act"), which provides a statutory framework for directors' duties. The provisions of the 2006 Act codify but do not entirely replace the previous case law, which will continue to be used to interpret and apply the statutory duties.

This *Commentary* is intended only to summarise the codified duties owed by a director to the company as from 1 October 2008. Directors will have many other duties, both under the 2006 Act (such as the duty to deliver accounts) and under a wide variety of other laws and regulations, such as insolvency and health and safety legislation.

In addition, directors of public companies whose shares or other securities are admitted to a securities exchange in the United Kingdom should be mindful of additional restrictions that apply (for example, in relation to the disclosure of information or dealing in the company's securities and complying with the Combined Code on Corporate Governance).

Directors also need to be mindful of those terms of the company's constitution which govern the internal proceedings of directors and apply restrictions on their authority which, if breached, can lead to personal liability.

We would be happy to advise on any of these further duties and responsibilities, generally or in relation to specific situations.

DIRECTORS' GENERAL DUTIES

The general duties imposed by the 2006 Act are summarised and explained below. Directors should be aware that, where more than one duty applies, they must comply with each applicable duty. For example, the duty to promote the success of the company will not authorise directors to breach their duty to act within their powers, even if they consider that action would promote the success of the company.

Duty to Act Within Powers (section 171 of the 2006 Act)

A director must act in accordance with the company's constitution and must only exercise his powers for the purpose for which they are conferred. For example, a director exercising his authority to issue shares for the principal purpose of diluting a particular member's shareholding, as opposed to the proper purpose of raising capital or other appropriate purposes, would be breaching this duty. The liability is strict: if the director's substantial purpose was not the purpose for which the power was conferred, it will not matter if he exercised the power in good faith or in the belief that it would promote the success of the company for the benefit of the shareholders as a whole.

For these purposes, a company's constitution includes the company's memorandum and articles of association, decisions taken in accordance with the articles and any members' resolutions and agreements affecting the company's constitution.

Duty to Promote the Success of the Company (section 172 of the 2006 Act)

A director must act in the way 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. "Success" is not specifically defined for these purposes, but the Government has stated that, in this context, it will usually mean "long-term increase in value" for commercial companies.

In discharging this duty, the director must have regard (*among other matters*) to:

- 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 the members of the company.

This is not an exhaustive list and, depending on the circumstances, there could be additional factors that the directors need to consider. This duty will apply to all decisions made by a director, not only to formal decisions made at board meetings.

The obligations arising under this duty are to "have regard to", *i.e.*, consider, relevant factors, including those mentioned above, when making decisions (whether such decisions relate to specific matters or the more general direction and strategy of the company). Some of those factors may have more importance to any particular decision than others, but as long as a director takes into account the relative merits of the applicable factors and comes to a conclusion *in good faith* that the success of the company will be promoted by his decision, he is likely to have discharged his duty properly.

The 2006 Act makes two specific qualifications to the duty to promote the success of the company for the benefit of its members as a whole:

- if the purposes of the company consist of or include other purposes, the directors' duty will extend to promoting the success of the company with a view to achieving those purposes; and

- such duty is subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company. Accordingly, the directors of a company facing financial difficulties will have an overarching duty to protect the interests of its creditors.

The question arises as to how to record appropriately the fact that directors have considered those matters required to be considered under the 2006 Act. Guidance on this has been produced for public companies by the GC100 group, which represents the general counsels and company secretaries of the FTSE 100. It recommends that companies refrain from documenting in board minutes the directors' consideration of each such matter, except where specific circumstances make it particularly relevant to do so (for example, where a matter under consideration is likely to have material environmental consequences). Instead, those members of management tasked with preparing board papers should consider all relevant factors and address them appropriately in the board papers so the directors can, after discussion, make a commercial judgment on an appropriately informed basis. It is important therefore that members of management preparing such papers are adequately trained in the requirements of the 2006 Act.

Duty to Exercise Independent Judgment (section 173 of the 2006 Act)

A director must exercise independent judgment. This duty will not, however, be infringed by a director acting in accordance with an agreement entered into by the company that restricts the future exercise of the directors' discretion or in a way authorised by the company's constitution (for example, if the constitution specifically provides for the delegation of certain powers by directors, as in the case of Table A articles). This duty will also not prevent directors from relying on advice, provided that the directors exercise their own judgment in deciding whether or not to follow the advice.

Directors who are appointed as representatives of significant shareholders or who are directors of other companies in the same field of business need to take particular care to ensure that their decisions are made independently in the interests of the company; whilst a director can listen to and take into account the views of others, his decisions must not be influenced by the interests of third parties. Such directors must also consider whether their circumstances give rise to a conflict situation which would require prior approval (see below regarding directors' duties relating to conflict situations under section 175 of the 2006 Act).

Duty to Exercise Reasonable Care, Skill and Diligence (section 174 of the 2006 Act)

A director must exercise the care, skill and diligence that would be exercised by a reasonably diligent person who has both:

- 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 (*i.e.*, an "objective" standard); and
- the general knowledge, skill and experience that the director in question actually has (*i.e.*, a "subjective" standard).

Whilst the objective test referred to above sets down the fundamental standard to which a director must exercise his duties, he must, in addition, bring to bear any particular skills and experience he may possess in order properly to discharge his duty. Regard must also be had to the director's role in the company; for example, a non-executive director will not generally be expected to have as close a day-to-day knowledge of the company's affairs as an executive director, and the advanced legal knowledge and experience of a legal director would not be expected of, say, a marketing director. Such a legal director would, however, be expected to bring his personal knowledge and experience of legal practice to bear in carrying out his own duties.

Directors have both collective and individual responsibility for ensuring they are sufficiently aware of the company's affairs in order to be able properly to fulfil their duties. This is an active obligation. It is, however, possible for a director to delegate the performance of his duties if delegation is permitted by the company's articles of association. The delegating director will be responsible for ensuring that the particular task is delegated to an appropriate person and for supervising that person's performance.

Duty to Avoid Conflicts of Interest (section 175 of the 2006 Act)

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. This applies, in particular, to the exploitation of property, information or opportunity, whether or not the company could take advantage of that property, information or opportunity. This duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company, since that is covered by the separate duty to declare to the company any interest in a proposed or existing transaction or arrangement with the company (see below).

A director will therefore be in breach of this duty if he is in a situation, or allows a situation to arise, which involves, or could involve, a conflict. This is unless the situation cannot reasonably be regarded as likely to give rise to a conflict of interest or the conflict situation was authorised in one of the ways mentioned below.

A conflict situation may be authorised:

- by the board of a company. For a private company, the board (excluding the conflicted director) is entitled to authorise a conflict unless there is an express prohibition on doing so in the articles of association of the company. If the company was incorporated before 1 October 2008, the directors must first be empowered to authorise such conflict situations by ordinary resolution passed by the members (companies incorporated after that date need not take that additional step). For a public company, this position is reversed, and the board may only authorise a conflict of interest if the company's articles of association expressly permit them to do so;
- by shareholder approval. This can be obtained either by unanimous shareholder consent or by special resolution; or
- under the company's constitution. Section 180(4)(b) of the 2006 Act allows companies to enshrine provisions for dealing with conflicts of interest in its articles of association (or other part of its constitution), and anything done in accordance with such provisions will not lead to a breach of this duty by a director.

A breach may subsequently be ratified by the company's members (by ordinary resolution), although the director, if himself a member, and any person connected with him, may not vote on the resolution.

In addition to considering conflict situations which could arise directly in relation to himself, each director should also consider if any of his connected persons holds positions that could lead to the director being in breach of this duty.

The following situations are examples of potential conflict that may arise:

- where a director is on the board of, is a significant shareholder in, or is himself a supplier to or customer of, or a major shareholder in, the company;
- where a director also has a role with one of the company's advisors;
- where a director accepts an appointment as a director with another company, especially one which is in a competitive field of activity;
- where a director is also a director of the company's pension trustee company or a trustee of the pension fund; and
- where a potential bidder for the company approaches a director and the director is offered a role with the potential bidding group.

Each situation requiring approval of the board (*i.e.*, where it is not authorised by the members or under the company's constitution) will, however, need to be considered by the board, and the decision to authorise the conflict by the board should be made only if, on balance, the board considers it in the best interests of the company to retain the services of the conflicted director in the relevant matter. Any such approval given may be given subject to such limitations or conditions as the board considers appropriate in the circumstances.

Directors who sit on multiple boards will always need to consider carefully whether they are in a position that can "reasonably be regarded as likely to give rise to a conflict" and should seek independent legal advice in the case of any uncertainty. Also, those directors appointed as

representatives of private equity investors should have particular regard to these rules (see Jones Day's separate *Commentary* entitled "Conflicts of Interest for Private Equity Portfolio Company Directors").

This duty will come into force on 1 October 2008 and applies to conflict situations which arise after that date (and so conflict situations that already exist at that date will not need to be separately authorised unless they lead to a further distinct situation giving rise to a conflict).

Duty Not to Accept Benefits from Third Parties (section 176 of the 2006 Act)

Directors must not accept any benefit from a third party which is conferred because of his being a director or his doing or not doing anything in his capacity as a director. This duty will not be infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. Benefits conferred by the company, its associated companies, or persons acting on their behalf, and benefits received from a person who provides the director's services to the company, are excluded.

This duty will continue to apply after a person ceases to be a director in relation to things done or omitted by him while he was a director. For example, a former director will be in breach of this duty if he exploits property as a result of knowledge gained during his time as a director and to do so conflicts with the interests of that company.

It should be noted that there is no "de minimis" that applies in relation to this duty. Unlike the duty to avoid conflicts of interest where conflicts can be authorised by the board, a director obtaining a benefit from a third party can only be authorised by the members of the company.

This duty will come into force on 1 October 2008.

Duty to Declare Interest in *Proposed* Transactions or Arrangements with the Company (section 177 of the 2006 Act)

Directors must declare to the other directors the nature and extent of any interest, direct or indirect, in a proposed transaction or arrangement with the company. The director need not be a party to the transaction for this duty to apply. For example, an interest of another person in a contract with the company may require the director to make a disclosure under this duty, if the other person's interest amounts to a direct or indirect interest on the part of the director. That would be the case if the director was economically interested in the other contracting party, for instance.

The declaration must be made before the company enters into the transaction or arrangement, and where a declaration of interest proves to be or becomes inaccurate or incomplete, a further declaration must be made if the company has not yet entered into the transaction or arrangement when the director becomes, or should reasonably have been, aware of the inaccuracy or incompleteness.

No declaration will be required:

- where the director is not aware of his interest or where the director is not aware of the transaction or arrangement (unless he ought reasonably to have been aware of the relevant matters);
- if the interest cannot reasonably be regarded as likely to give rise to a conflict of interest;
- if, or to the extent that, the other directors are already aware of the interest (and for this purpose the other directors are deemed to be aware of anything of which they ought reasonably to be aware); or
- if it concerns the terms of the director's service contract which have been (or are to be) considered at a board meeting or board committee.

There are no restrictions on the method for making such disclosures, but the 2006 Act makes specific provision for declarations to be made in writing or by way of a general notice of declaration. This general notice, which must state the nature and extent of the interest and the connection with the relevant person, can be made:

- in respect of interests of the relevant director (whether as member, officer, employee or otherwise) in a specified body corporate or firm, in which case he is regarded as interested in any transaction or arrangement that may, after the date of the notice, be made with that body corporate or firm;

- in connection with any other specified person, in which case he is regarded as interested in any transaction or arrangement that may, after the date of the notice, be made with that person; and
- only at a meeting of the directors or if the director takes reasonable steps to ensure it is brought up and read at the next meeting of directors after it is given.

This duty will come into force on 1 October 2008. If, however, a duty to disclose an interest in connection with a proposed transaction or arrangement arose under section 317 of the Companies Act 1985 (*i.e.*, before 1 October 2008), the duty of disclosure continues under that Act and not the 2006 Act.

Requirement to Declare Interests in *Existing* Transactions or Arrangements Entered into by the Company (section 182 of the 2006 Act)

A director must declare the nature and extent of his direct or indirect interest in an existing transaction or arrangement entered into by the company. Again, the director need not be a party to the transaction for this duty to apply. However, this obligation does not apply if or to the extent that the interest has already been declared under the duty to declare an interest in a proposed transaction or arrangement as described above.

The declaration must be made as soon as is reasonably practicable, and even if the declaration is not made as soon as it should have been, it must still be made. Where a declaration of interest proves to be, or becomes inaccurate or incomplete, a further declaration must be made.

No declaration will be required if any of the circumstances which exclude a director from having to make a declaration under section 177 of the 2006 Act apply.

In this case, declarations *must* be made:

- at a meeting of the directors;
- by written notice; or
- by general notice (see above).

This obligation (which, technically, is not one of the general duties of directors) will come into force on 1 October 2008.

CONSEQUENCES OF BREACH

The 2006 Act expressly states that the consequences of breaching the newly codified duties will be the same as the consequences for breaching the common law rule or equitable principle from which they are drawn.

The remedy for a breach of the duty of care, skill and diligence was usually damages. Remedies for breaches of other general duties included:

- an injunction;
- setting aside of the transaction, restitution and account of profits;
- restoration of company property held by the director; and
- damages.

A breach of duty could also have been grounds for the termination of an executive director's service contract, or for disqualification as a director under the Company Directors Disqualification Act 1986. These remedies will remain available for breaches of the newly codified duties.

In general, subject to certain exceptions, only the company may bring an action against a director to recover its losses for a breach of the duties referred to above. The 2006 Act also provides shareholders with a new derivative right of action that will enable shareholders to bring an action against a director on behalf of the company in respect of "a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company".

The 2006 Act includes a number of safeguards designed to prevent these provisions from being abused. For example, in order to bring a derivative claim, a shareholder must apply to court for permission to continue the claim. This permission will be refused if the court is satisfied that either:

- a person acting in accordance with the general duty to promote the success of the company would not seek to continue the claim; or
- the act or omission giving rise to the cause of action has been authorised or ratified by the company.

In addition, there are prescribed factors that the court must particularly take into account when considering whether to give permission, such as whether the shareholder is acting in good faith in seeking to continue the claim, and the court is also required to take into account the views of members who have no personal interest in the relevant matter.

Where proceedings for negligence, default, breach of duty or breach of trust are brought against a director, the court may relieve him from liability if it considers both that he has acted honestly and reasonably and that considering all the circumstances of the case, he ought fairly to be excused. A director may also apply to the court for relief where he has reason to expect that a claim may be made against him.

Although a company cannot exempt a director from any liability for negligence, default, breach of duty or breach of trust in relation to the company, it may indemnify the director against defence costs, or costs incurred in an application for relief, provided that the director repays the costs if he is unsuccessful.

LAWYER CONTACT

If you would like further advice or assistance in relation to directors' duties under the 2006 Act, please contact your principal Firm representative or the lawyer listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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