

Companies Act 2006

Duties of company directors

Ministerial statements

DTI

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Introduction

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I know that the new statutory duties of directors set out in Part 10 of the Companies Act 2006 were keenly debated while the Bill was going through Parliament, and I am sure they will continue to be seen as one of the most significant parts of the Act.

During those debates, I and the other Ministers were questioned about the meaning of the provisions. Some of our responses and statements may be helpful to people interested in what the provisions mean, and I am pleased to be publishing this structured collection of what we believe are the most useful of them.

There are two ways of looking at the statutory statement of directors' duties: on the one the hand it simply codifies the existing common law obligations of company directors; on the other – especially in section 172: the duty to act in the interests of the company – it marks a radical departure in articulating the connection between what is good for a company and what is good for society at large.

Continuity

The statutory expression of the duties is essentially the same as the existing duties established by case law, the only major exception being the new procedures for dealing with conflicts of interest.

The simple high-level guidance for directors in the box on the following page illustrates the way in which the codification maintains continuity with the existing law: this advice on how a director has to live up to his position of trust is applicable to the pre-existing common law as well as to the new codification. For most directors, who are working hard and put the interests of their company before their own, there will be no need to change their behaviour.

Guidance for company directors–

- 1) Act in the company's best interests, taking everything you think relevant into account
- 2) Obey the company's constitution and decisions taken under it
- 3) Be honest, and remember that the company's property belongs to it and not to you or to its shareholders
- 4) Be diligent, careful and well informed about the company's affairs. If you have any special skills or experience, use them
- 5) Make sure the company keeps records of your decisions
- 6) Remember that you remain responsible for the work you give to others.
- 7) Avoid situations where your interests conflict with those of the company. When in doubt disclose potential conflicts quickly
- 8) Seek external advice where necessary, particularly if the company is in financial difficulty

Change

But compared with most text-book definitions of the common law duties of directors, the new statutory statement captures a cultural change in the way in which companies conduct their business. There was a time when business success in the interests of shareholders was thought to be in conflict with society's aspirations for people who work in the company or in supply chain companies, for the long-term well-being of the community and for the protection of the environment. The law is now based on a new approach. Pursuing the interests of shareholders and embracing wider responsibilities are complementary purposes, not contradictory ones.

I strongly believe that businesses perform better, and are more sustainable in the long term, when they have regard to a wider group of issues in pursuing success. That is a common-sense approach that reflects a modern view of the way in which businesses operate in their community: they interact with customers and suppliers; they make sure that employees are motivated and properly rewarded; and they think about their impact on communities and the environment. They do so at least partly because it makes good business sense.

The new expression of the duties is part of the wider recognition and encouragement of change in the Act. The enhanced business review, which for quoted companies must now include information on environmental, employee, social and community issues, is another key example that builds on the growing consensus that it is good business sense for companies to embrace wider social responsibilities.

I am sure that directors' duties will continue to evolve as times change and as societal norms are transformed. Corporate social responsibility has developed and evolved over time. The relationship between business interests and the wider world is changing all the time. The best way of achieving lasting cultural change is to go with the tide and the broad consensus of opinion.

Margaret Hodge

Notes on the ministerial statements

The quotations should be read in conjunction with the Act itself (available in hard copy at www.tshop.co.uk or online at www.opsi.gov.uk) and should not be regarded as a substitute for reading that Act or seeking legal advice. Full explanatory notes on the provisions of the Act are also available at www.tsoshop.co.uk and at www.opsi.gov.uk together with tables of origins and destinations for the Act's provisions.

It should be noted that on occasion the Parliamentary quotes have been edited in order to make it easier to read them. References to Hansard have been given so the full discussion can be seen if so desired.

Companies Act 2006 – duties of directors

Collated Hansard extracts from debates on Companies Bill (originally Company Law Reform Bill)

Background

“The law commissions and the Company Law Review concluded that a statutory statement of duties would be helpful...it is important that...flexibility and ability to note changing circumstances are not lost”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 242

“First...the origins of the general duties [is] ...that they are based in certain common law rules and equitable principles...the statutory statement replaces the common rule equitable principle...once the Act is passed, one will go to the statutory statement of duties to identify the duties to identify the duty the director owed”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 243

“...the main purpose in codifying the general duties of directors is to make what is expected of directors clearer and to make the law more accessible to them and to others”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 254

“We should remind ourselves that being a company director is a wonderful thing for the person who is a company director. But it is a position of great responsibility which involves running the affairs of a company for the benefit of other people. It is a heavy responsibility we should not water down”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 291

Interpretation by the courts

“The courts should be left to interpret the words Parliament passes”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 243

“Although the duties in relation to directors have developed in a distinctive way, they are often manifestations of more general principles...[it] is intended to enable the courts to continue to have regard to development in the common law rules and equitable principles applying to these other types of fiduciary relationships.

The advantage of that is it will enable the statutory duties to develop in line with relevant developments in the law as it applies elsewhere.”

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 244

Effect of codification

“One proposition [is] that the result of this codification will be increased litigation. That is not how we see it...as in existing law, the general duties are owed by the director to the company. It follows that, as now, only the company can enforce them. Directors are liable to the company for loss to the company, and not more widely. It is quite rare for companies to sue their directors for breach of duty. That may well continue to be the position.”

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 242

Effect of the provision of new duties

“[On] the provision of new duties, we do not see why that should lead to increased litigation either. For example...the need to have regard to the interests of employees as part of the main duty to promote the success of the company...was part of case law before becoming statute. It is an important principle, and plays a crucial part in business decisions ...however...there is not evidence of which we are aware that it has led to legalistic decision making by companies, or people turning away from bringing their talent to the world of enterprise. We have no reason to expect that there will be a greater degree of litigation on those duties than there is now”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 243

Statement of general duties

“The statement of general duties...is not intended to be an exhaustive list of all the duties owed by a director to his company. The directors may owe a wide range of duties to their companies in addition to the general duties listed. Those are general, basic duties which it is seen as right and important to set out in this way. The statement that these are the general duties does not allow a director to escape any other obligation he has, including obligations under the Insolvency Act 1986.”

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 249

Enlightened shareholder value

“The Company Law Review considered and consulted on two main options. The first was “enlightened shareholder value”, under which a director must first act in the way that he or she considers, in good faith, would be most likely to promote the success of the company for its members...The Government agrees this is the right approach. It resolves any confusion in the mind of directors as to what that the interests of the company are, and prevents any inclination to identify those interests with their own. It also prevents confusion between the interests of those who depend on the company and those of the members”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 255

“For the first time, the Bill includes a statutory statement of directors’ general duties. It provides a code of conduct that sets out how directors are expected to behave. That enshrines in statute what the law review called “enlightened shareholder value”. It recognises that directors will be more likely to achieve long term sustainable success for the benefit of their shareholders if their companies pay attention to a wider range of matters...Directors will be required to promote the success of the company in the collective best interest of the shareholders, but in doing so they will have to have regard to a wider range of factors, including the interests of employees and the environment”.

Alistair Darling, Commons Second Reading, 6 June 2006, column 125

Duty to promote the success of the company

“What is success? The starting point is that it is essentially for the members of the company to define the objective they wish to achieve. Success means what the members collectively want the company to achieve. For a commercial company, success will usually mean long-term increase in value. For certain companies, such as charities and community interest companies, it will mean the attainment of the objectives for which the company has been established”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 255

“...for a commercial company, success will normally mean long-term increase in value, but the company's constitution and decisions made under it may also lay down the appropriate success model for the company. ... it is essentially for the members of a company to define the objectives they wish to

achieve. The normal way for that to be done—the traditional way—is that the members do it at the time the company is established. In the old style, it would have been set down in the company's memorandum. That is changing ... but the principle does not change that those who establish the company will start off by setting out what they hope to achieve. For most people who invest in companies, there is never any doubt about it—money. That is what they want. They want a long-term increase in the company. It is not a snap poll to be taken at any point in time.”

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 258

“...it is for the directors, by reference to those things we are talking about – the objective of the company – to judge and form a good faith judgment about what is to be regarded as success for the members as a whole....they will need to look at the company’s constitution, shareholder decisions and anything else that they consider relevant in helping them to reach that judgement...the duty is to promote the success for the benefit of the members as a whole – that is, for the members as a collective body – not only to benefit the majority shareholders, or any particular shareholder or section of shareholders, still less the interests of directors who might happen to be shareholders themselves. That is an important statement of the way in which directors need to look at this judgement they have to make”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 256

“...we have included the words “amongst other matters”. We want to be clear that the list of factors [for a director to have regard to] is not exhaustive”.

Lord Goldsmith, Lords Grand Committee, 9 May 2006, column 846

“The clause does not impose a requirement on directors to keep records, as some people have suggested, in any circumstances in which they would not have to do so now.”

Margaret Hodge, Commons Committee, 11 July 2006, column 592

“The Government believe that our enlightened shareholder value approach will be mutually beneficial to business and society. We do not, however, claim that the interests of the company and of its employees will always be identical; regrettably, it will sometimes be necessary, for example, to lay off staff. The drafting ... must therefore clearly point directors towards their overarching objective. We have made it clear that [the clause] will make a difference, and a very important difference.

The words “have regard to” mean “think about”; they are absolutely not about just ticking boxes. If “thinking about” leads to the conclusion, as we believe it will in many cases, that the proper course is to act positively to achieve the objectives in the clause, that will be what the director’s duty is. In other words “have regard to” means “give proper consideration to”...

Consideration of the factors will be an integral part of the duty to promote the success of the company for the benefit of its members as a whole. The clause makes it clear that a director is to have regard to the factors in fulfilling that duty. The decisions taken by a director and the weight given to the factors will continue to be a matter for his good faith judgment.

Margaret Hodge, Commons Report, 17 October 2006, column 789

Duty to exercise independent judgement

“...the clause does not mean that a director has to form his judgement totally independently from anyone or anything. It does not actually mean that the director has to be independent himself. He can have an interest in the matter...It is the exercise of the judgement of a director that must be independent in the sense of it being his own judgement...The duty does not prevent a director from relying on the advice or work of others, but the final judgement must be his responsibility. He clearly cannot be expected to do everything himself. Indeed, in certain circumstances directors may be in breach of duty if they fail to take appropriate advice – for example, legal advice. As with all advice, slavish reliance is not acceptable, and the obtaining of outside advice does not absolve directors from exercising their judgement on the basis of such advice”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 282

Standard of care owed by a director

“...the standard of care which a director owes is enormously important...it is now accepted that the duty of care...is accurately stated in Section 214(4) of the Insolvency Act 1986....Under the clause you take account both of the general knowledge, skills and experience that may be reasonably expected of a person carrying out those functions and the general knowledge, skills and experience that that director has. It is a cumulative requirement...I want to emphasise the point that it is not making a change from what is already the common law”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 284

Duty to avoid conflicts of interest

“...the law already recognises that potential conflicts in certain circumstances are to be avoided...there is currently no absolute rule prohibiting directors from holding multiple directorships or even from engaging in business that competes with the company of which they are a director, but obviously a tension results from that degree of tolerance and the fiduciary duties which the director owes. The solution to it is...there is no prohibition of a conflict or potential conflict as long as it has been authorised by the directors in accordance with the requirements set out in [the Act]”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 288

“...we do not say that this should happen just because in the mind of a director it is all right; there should be a process for the company, through its members or directors, to make that decision, and that is what these new regulations permit”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 289

“Following consultation, the Government have already adjusted the provision...to use instead the expression “if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest”. This introduces the concept of reasonableness which makes the situation easier from the point of view of a director and avoids a very harsh test, although it is still a heavy duty and intended to be so.”

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 293

“So far as private companies are concerned, the default position is that the directors may authorise the matter unless there is a provision in the company’s constitution saying otherwise. In the case of a public company...[d]irectors may authorise the matter only if the company’s constitution includes provisions saying they can do so. It must follow that if the constitution does not do so, steps will have to be taken to amend it to that effect and the members of the company will be able to take a view about whether they think that is a good move”.

Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 294

“...the authorisation has to be given without relying on the votes of directors seeking the authorisation or any other director with an interest in it....Those directors cannot count towards the quorum either....[and] any requirements under the common law for what is necessary for a valid authorisation remain in force...Finally, in general terms, the directors who are giving the authorisation will need to comply with the general duties imposed on them. Those will include, specifically, the general duty...to act in such a way that in good faith they consider that authorisation is the course of action most likely to promote the success of the company”.

Lord Goldsmith, Lords Grand Committee, 9 February 2006, column 327

“...the duty does not apply if the situation cannot reasonably be regarded as being likely to give rise to a conflict of interest. If the matter falls outside the ambit of the company’s business, a real conflict of interest is unlikely”.

Lord Goldsmith, Lords Grand Committee, 9 May 2006, column 864

“...the company’s articles may contain provisions for dealing with conflicts of interests, and directors will not be in breach of duty if they act in accordance with those provisions. Examples might include arrangements whereby the directors withdraw from any board meeting at which the matters relating to conflicts of interest are discussed...our amendments will allow all the normal, perfectly acceptable, lawful ways in which companies and their directors deal with conflicts of interest to continue.”

Lord Sainsbury of Turville, Lords Report, 23 May 2006, column 722

Duty not to accept benefits from third parties

“...the purpose of the clause...is to impose on a director a duty not to accept benefits from third parties. It applies only to benefits conferred because the director is a director of the company or

because of something that the director does or doesn't do as director. The word "benefit"...includes benefits of any description, including non-financial benefits.

The clause codifies...[the] long-standing rule, prohibiting the exploitation of the position of director for personal benefit. It does not apply to benefits that the director receives from the company, or from any associated company, or from any person acting on behalf of any of those companies....I...draw attention to the fact that benefits are prohibited by the duty only if their acceptance is likely to give rise to a conflict of interest".

Lord Goldsmith, Lords Grand Committee, 9 February 2006, column 330

Duty to declare interest in proposed transaction or arrangement

"[This] clause...is deliberately intended to apply only to proposed transactions...if a company is told that a director has an interest in a proposed transaction, it can decide whether to enter into the transaction, on what terms and with what safeguards.

[As for] "a director is treated as being aware of matters he ought reasonably to be aware"...I believe that the test is objective – that is, one judges objectively whether this is a matter of which the director ought to be aware reasonably".

Lord Goldsmith, Lords Grand Committee, 9 February 2006, column 334

Civil consequences of breach of general duties

"...we take the view that the "duty to exercise reasonable care, skill and diligence" is not a fiduciary duty. It may be owed by someone who is a fiduciary. But that is not the same thing. ..It is important to keep to the principle that these are enforceable in the same way as any other fiduciary duty owed to the company by its directors."

Lord Goldsmith, Lords Grand Committee, 9 February 2006, column 336

Consent, approval or authorisation by members

“[The Bill] permitted director authorisation of what would otherwise be impermissible conflicts of interests [and]...required declarations of interest in proposed company transactions. In both those cases, the general duty no longer requires the consent of the members. The common law rules or principles that refer to the failure to have had a conflict of interest approved by the member of a company under certain circumstances need to be set aside....However...the company’s constitution can reverse the change and can insist on certain steps being taken requiring the consent of the members in certain circumstances”.

Lord Goldsmith, Lords Grand Committee, 9 February 2006, column 337

Indemnifying directors

“...the starting point for our reform package was a principle...that companies should be prohibited from exempting directors from, or indemnifying them against, liability for negligence, default, breach of duty or breach of trust in relation to the company. However the reform package also recognised that companies should be permitted to indemnify directors in respect of third-party claims in most circumstances...There are four main possible exceptions to indemnification: criminal penalties; penalties imposed by regulatory bodies: costs incurred by the director in defending criminal proceedings in which he is convicted; and costs incurred by the director in defending civil proceedings brought by the company in which final judgement is given against him”.

Lord Goldsmith, Lords Grand Committee, 9 February 2006, column 364

”[The Companies (Audit, Investigations and Community Enterprise) Act 2004]...closed an important loophole concerning the indemnification of directors by third parties. It used to be the practice in some groups that one group company would indemnify the director of another group company...in effect to circumvent the rule that the company could not indemnify its own directors. We take the view that... continu[ing] to make directors properly accountable for what they do in relation to the company...should stand”.

Lord Goldsmith, Lords Grand Committee, 9 February 2006, column 366

“It is also important to remember that at the same time as the loophole was closed, important reforms were introduced that permit all companies to indemnify directors against third-party claims, subject to... [certain] requirements. Although we agree that indemnification by a parent company of the directors is less likely to result in attempts at circumvention of the prohibition than indemnification by a wholly owned subsidiary company of the director of a holding company, we still believe there is scope for mischief. We cannot...accept [any] amendment”.

Lord Sainsbury of Turville, Lords Report, 23 May 2006, column 724

Shadow directors

“The law is still developing. It would not be right for the general duties not to apply at all to a shadow directors, but the law may develop in such a way that some do and some don’t. It is right to leave those areas, as now, to the courts...”

Lord Goldsmith, Lords Grand Committee, 9 May 2006, column 828