TaylorWessing

Companies Act 2006 - Directors' duties

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Introduction

The general duties which directors owe to their companies are now set out in statute, in the Companies Act 2006 (the Act). This marks a departure from past practice, where the general duties of directors arose from case law. In addition to this codification of directors' duties, the Act also makes some significant changes to directors' duties.

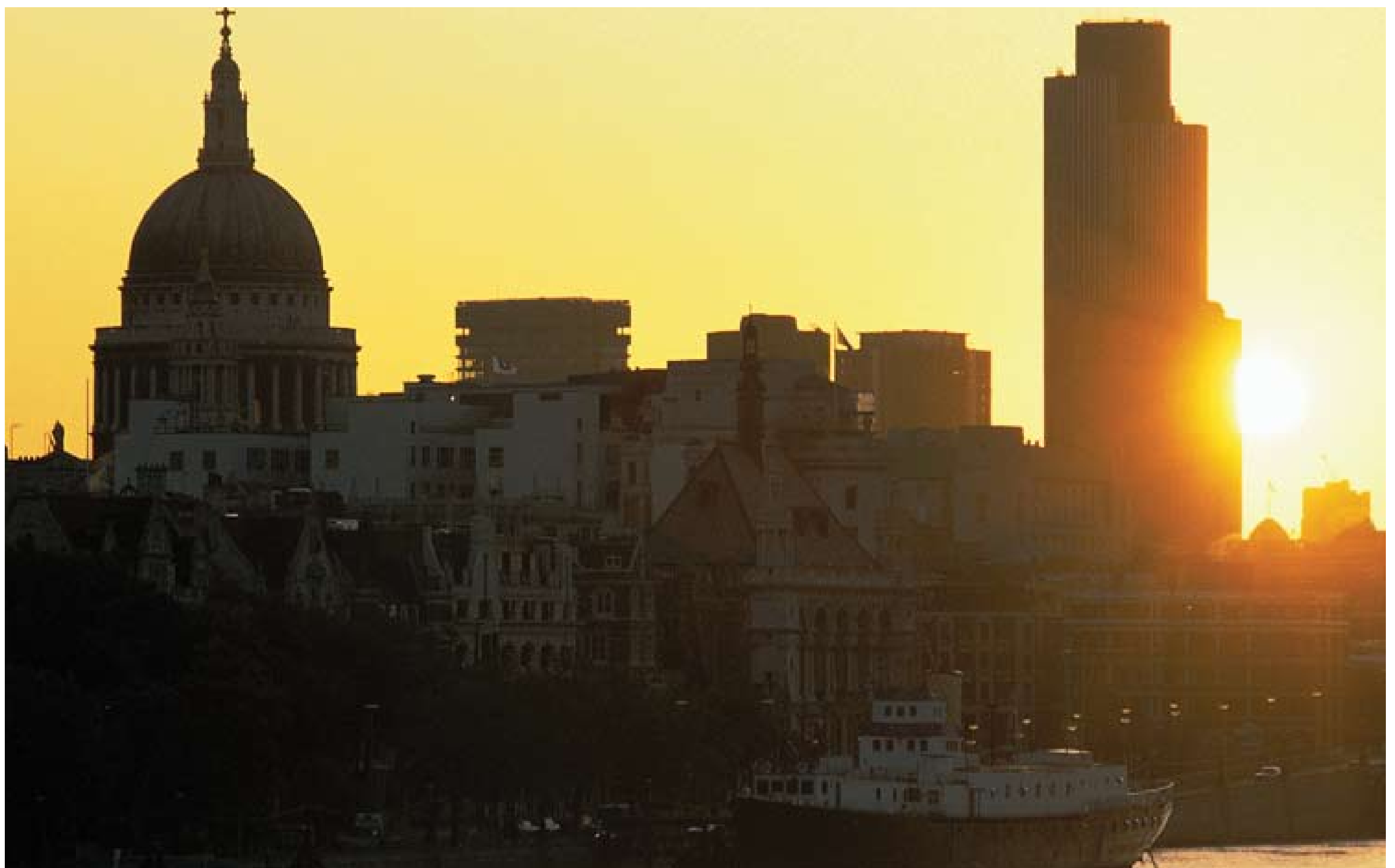
This statutory statement of the general duties of directors has changed the approach to directors' conflicts of interest. It also includes a duty to promote the success of the company, which seeks to enshrine in statute the concept of 'enlightened shareholder value'. This was described by the Minister of State for Industry and the Regions, in June 2007, as marking 'a radical departure in articulating the connection between what is good for a company and what is good for society at large'.

The Act also sets out new rules about how shareholders can bring claims against directors on behalf of a company for breach of their duties. These rules allow for more circumstances where a claim can be brought.

The Act also restates the statutory rules governing transactions with directors requiring shareholder approval, aligning the treatment of different transactions and making a limited number of changes.

Unless otherwise indicated, changes in the law referred to in this guide will take effect from 1 October 2007. The remainder are expected to take effect in October 2008. We anticipate that many companies will wish to review their articles of association to take account of the October 2008 changes.

This guide is intended to provide companies with a basis for briefing their directors and reviewing their procedures relating to board matters.



The new statement of directors' duties in brief

The statement of statutory duties of directors consists of seven separate general duties (set out in sections 171 to 177 of the Act), as follows.

- A duty to act in accordance with the company's constitution and only to exercise powers for the purposes for which they are conferred
- A duty to act in a way which a director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole
- A duty to exercise independent judgment
- A duty to exercise reasonable care, skill and diligence
- A duty to avoid conflicts of interest (other than in relation to a transaction or arrangement with the company – see below)
- A duty not to accept benefits from third parties
- A duty to declare to the other directors an interest in a proposed transaction or arrangement with the company.

The first four of these will take effect on 1 October 2007. The remaining three, which relate to conflicts of interest, are expected to take effect in October 2008. These duties are (with the exception of the duty to exercise reasonable care, skill and diligence) all fiduciary duties. They are expressed to replace the existing common law duties but will continue to be interpreted by reference to the body of case law in this area.

Also, requirements for the declaration of interests in existing transactions or arrangements with the company (set out in sections 182 to 187 of the Act) are expected to take effect in October 2008.

Duty to act within powers

A director must act in accordance with the company's constitution and only exercise powers for the purposes for which they are conferred.

A company's constitution, for these purposes, includes resolutions or decisions made by the company in accordance with the articles of association of a company, as well as the articles of association themselves.

This duty replaces similar common law duties.

Duty to promote the success of the company

A director must act in a way which that director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst 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 members of the company.*

This duty under section 172 of the Act is an extension of, and replaces, the common law duty on directors to act in good faith and in the interests of the company.

The decision as to what will promote the success of the company, and what constitutes such success, is one for a director's good faith judgment. This is intended to ensure that business decisions on, for example, strategy and tactics are for the directors, and not subject to decision by the courts, provided the directors are acting in good faith. A director acting in good faith should not be held liable for a process failure which would not have affected his or her decision on which course of action would best promote the success of the company.

This list of matters to which a director must have regard is not exhaustive, but highlights areas of particular importance, which are intended to reflect wider expectations of responsible business behaviour.

Directors will need to exercise reasonable care, skill and diligence (a separate duty – see below) in determining which matters are relevant to a particular decision and in weighing these up. On this basis, directors must then decide what they consider likely to promote the success of the company for the benefit of the members as a whole. For a commercial company, this will usually mean a long-term increase in value. It is important for directors to remember that they must act in the interests of the members as a whole, and not merely some of them.

Where a company is in financial difficulties, this duty to promote the success of the company for the benefit of members will be modified by a duty to act in the interest of creditors.

For certain companies, such as charities, whose purposes are expressed to be, or to include, matters other than the benefit of its members, the duty to promote the success of the company for the benefit of members must also be read as a duty to promote the success of the company in achieving those purposes.

Practical consequences

Companies will need to build into their internal procedures an awareness of steps required to meet the requirements of the duty to promote the success of a company, going beyond mere 'box ticking'. What form this takes is likely to vary between companies.

As a first step, all companies should ensure that their directors and those involved in preparing papers for board meetings (including the company secretarial team and managers reporting to the board) are aware of the duty and the non-exhaustive list of matters to which the directors must have regard under section 172(1) of the Act.

Directors should also try to document, where practicable, their fulfilment of this duty. The way in which, and extent to which, this is done will vary depending on the type of company and its board practices.

Companies will already minute some matters at greater length or in greater detail than others, and this will continue to be appropriate. A more detailed approach may be used, for example, where a decision is particularly important, a particular sensitivity arises, a third party (such as a bank or a regulator) wishes to have a copy of the minute or where the decision is likely to come under significant scrutiny. In such cases, companies should pay particular attention to the wording of the Act. At the very least, this will mean recording a matter as being considered most likely to promote the success of the company for the benefit of its members as a whole, where previously reference would have been to the best interests of the company.

It will frequently be helpful to add that this conclusion has been reached having regard, among other things, to the matters listed in section 172(1) of the Act. Circumstances, including the relevance of a matter to the decision being made, should determine whether detailed consideration of any of these matters should be minuted. Where there is a prospect of litigation, the question of maintaining legal privilege should be considered.

For board business not requiring detailed minutes, what is appropriate will depend on the type of company and its existing decision-making processes.

- For companies which have frequent board meetings and which have successfully incorporated an awareness of the requirements of the duty to promote the success of the company into their procedures, it should be sufficient to address the specific listed matters only where they are of particular relevance.
- Companies which use board papers prepared in advance of meetings to record the relevant considerations for particular board decisions (and then just minute the decision reached) should ensure that these board papers include consideration of the relevant statutory matters.
- For other companies, it will be helpful (at least in an initial period) for the directors to be reminded at the beginning of a board meeting of the need to exercise their duty to promote the success of the company for the benefit of its members as a whole, having regard, among other things, to the matters listed in section 172(1) of the Act, and to include a note to this effect in their minutes.

Companies should not find it necessary to minute a "tick list" of the section 172(1) matters for every decision to be made.

GC100 guidelines

The Association of General Counsel and Company Secretaries of the FTSE 100 (GC100) has published its own outline best practice guidelines for boards of public companies on these issues. Whilst these carry no legal weight and will not be appropriate in full for all types of companies, these guidelines may offer helpful guidance for many larger companies.

The GC100 guidelines suggest that it should be for the members of the management team responsible for preparing a board paper to ensure that each of the relevant matters, including those referred to in the Act, are properly considered. Those matters could then, if appropriate, be included in the paper or any presentation made. In this way, responsibility for considering relevant matters would be delegated to that management team. Directors would need to be satisfied that this had been delegated to appropriate people. Directors would also still need to use their business judgment in considering a proposal.

The GC100 guidelines suggest that if a matter is not relevant, it should not be necessary to state that fact and that board minutes should not be used as the main medium for recording the extent to which each of the matters listed in the duty were discussed. The guidelines also suggest that, where the nature of the decision being taken by directors is such that it is supported by a formal process, that process need only specifically record consideration of those duties where the particular circumstances make it particularly necessary or relevant, and that the default position should not be to include those references.

Conclusion

Whatever procedures are adopted, the most important thing is that a board should be confident that decisions are taken so as to promote the success of the company and having regard to the relevant matters. Companies will need to be pragmatic in the light of the risks and constraints they face in determining how they document this. We anticipate that for many companies following existing best practice this need not involve a large change in approach.

Duty to exercise independent judgment

A director must exercise independent judgment.

In practical terms, this duty is likely to be most relevant where a director wishes to bind himself or herself to a future course of action which might be seen as "fettering the discretion" of the director to make future decisions, or where directors or a board wish to delegate.

The duty to exercise independent judgment is not infringed by a director acting in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by its directors. It remains potentially a breach of duty for a director otherwise to fetter his or her discretion. When deciding whether to bind a company to a future course of action, the directors will need to fulfil their other duties, for example their duty to promote the success of the company (see above).

The duty to exercise independent judgment is also not infringed by a director acting in a way authorised by the company's constitution. It will, therefore, be open to a director to delegate provided this is authorised in the company's articles (which will generally be the case). A director must, however, continue to exercise judgment in deciding whether and how to delegate and whether to accept someone else's judgment on a matter. Although specific tasks and functions may be delegated, overall responsibility as a director cannot be.

Duty to exercise reasonable care, skill and diligence

A director of a company must exercise reasonable care, skill and diligence.

The care, skill and diligence required of a director is that 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 in relation to the company, and
- the general knowledge, skill and experience that the director has.

A director is, therefore, required to exercise not only the general knowledge, skill and experience he or she has (for example, a particular expertise in financial matters), but also the general knowledge, skill and experience that may reasonably be expected given his or her position and responsibilities to the company. This reflects the position reached in case law prior to the Act.

Conflicts of interest - Overview

The approach to actual or potential conflicts of interest of directors under the Act is to distinguish between (a) interests in ***transactions and arrangements*** with a company (which must be disclosed but do not need to be approved) and (b) ***all other conflicts*** (which will normally require approval by shareholders or (in some cases) by other directors). These requirements will come into force in October 2008, although transitional arrangements will limit the automatic application of this new approach for existing companies.

These provisions generally apply to indirect as well as direct interests. No definition is included for what constitutes an indirect interest and this will depend on the particular circumstances. This may, for example, include an interest of a director's spouse or another person connected with a director. The statutory definition of who is 'connected' with a director has been widened in the Act as regards family members. A more detailed consideration of who is a connected person is set out on page 13.

This new regime represents a change from the previous position where shareholder approval was generally required (although in many situations a process for dealing with conflicts was already built into the articles of association, so that shareholder approval was not required). As a result, many companies may wish to review their articles of association for October 2008, to take account of the new provisions.

The articles of association of a company will be important in regulating how directors' conflicts of interest are dealt with. The Act makes clear that anything done (or omitted) by a director in accordance with provisions in the company's articles of association dealing with conflicts of interest will not be a breach of duty.

Shareholder approval

If the conflict arises in relation to a transaction requiring shareholder approval (substantial property transactions, loans to directors, long-term service contracts or payments for loss of office), it is not necessary also to comply with section 175 (duty to avoid conflicts of interest) or section 176 (duty not to accept benefits from third parties) if (a) approval is given in accordance with the relevant statutory requirements, or (b) the matter is one for which approval is not needed.

Interests in transactions and arrangements with the company

If a director is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, or a transaction or arrangement that has been entered into by the company, the director must declare the nature and extent of that interest to the other directors. A director is not under an obligation to avoid having such interests.

The requirement to declare an interest does not apply where a director is not aware of the interest or of the transaction or arrangement in question. However, for this purpose a director is treated as being aware of matters of which he ought reasonably to be aware. Also, a director need not declare an interest:

- if it 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 it (and for this purpose the other directors are treated as aware of anything of which they ought reasonably to be aware), or
- if, or to the extent that, it concerns terms of his or her service contract that have been or are to be considered (i) by a meeting of the directors or (ii) by a committee of the directors appointed for the purpose under the company's constitution.

A declaration of an interest in a *proposed* transaction or arrangement may (but need not) be made:

- at a meeting of the directors
- by notice in writing sent to the other directors, or
- by general notice (of an interest in a specified body corporate or firm or of being 'connected' with a specified person), which must be given at a meeting of directors or which the director must take reasonable steps to secure is brought up and read at the next meeting of directors after it is given.

Declaration of an interest in an *existing* transaction or arrangement, however, must be made in one of the three ways noted above. There is no requirement to declare an interest in an existing transaction or arrangement, to the extent that the interest was declared as an interest in a proposed transaction or arrangement.

A transitional regime will apply from October 2008 in respect of existing companies, which will preserve the arrangements those companies have with regard to conflicts of interest arising from directors' transactions with the company. In practice, the articles of association of many companies will already permit a director to be party to a transaction or arrangement with the company, provided the director's interest has been declared. Where the articles do not permit this, shareholder approval would be required for an existing company.

The Act treats the obligation to declare interests in proposed transactions or arrangements as a fiduciary duty, carrying civil consequences for breach, including the possible unenforceability of the transaction by the director and a duty of the director to account for any profits. By contrast, the Act treats the obligation to declare interests in existing transactions or arrangements as a statutory duty where breach is a criminal offence but does not of itself affect enforceability.

The requirements to declare interests in transactions and arrangements set out above are supplemented by specific requirements concerning particular transactions with directors which require disclosure to shareholders and shareholder approval. These will apply from 1 October 2007. These are, broadly, a restatement of similar requirements under the previous Companies Act and relate to substantial property transactions, loans, quasi-loans and credit transactions, directors' long-term service contracts and payments for loss of office. These are considered in more detail on pages 10-12.

Conflicts not involving transactions and arrangements with the company

Duty to avoid conflicts of interest

A director of a company 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, unless the situation cannot reasonably be regarded as likely to give rise to a conflict of interest.

This applies, in particular, to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity). It also applies to circumstances where a director has duties to third parties which conflict with duties he owes to the company.

However, a director does not breach this duty if the matter has been authorised by the directors. The authorisation is effective only if (a) any requirement as to the quorum at the meeting at which the matter is considered is met without counting the director in question or any other interested director, and (b) the matter was agreed to without their voting or would have been agreed to if their votes had not been counted.

For a *private company* the directors will be able to authorise a conflict provided there is nothing in the company's constitution (in practice likely to be its articles of association) which invalidates such an authorisation. It is not necessary, therefore, for the articles of association of a private company to deal expressly with authorisation by the directors, but if there are express restrictions in the articles of association, these will still apply.

However, under transitional arrangements for existing companies, existing private companies will need to seek shareholder approval if they want to permit authorisation of conflicts of interest by directors.

For a *public company*, the directors will be able to authorise a conflict only if the company's constitution (in practice likely to be its articles of association) includes wording enabling the directors to authorise the matter. The authorisation must be given by the directors in accordance with that constitution. There is, therefore, a requirement for authorisation by directors to be dealt with expressly in the articles of association of public companies. Public companies will typically need to amend their articles of association to take account of this.

The Act also preserves the ability of shareholders (under the company's articles or under the general law) to authorise conflicts which would otherwise be a breach of this duty.

This duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company. These are subject to the obligation to declare an interest referred to on pages 6-7.

Particular attention should be given to the position of directors who hold more than one directorship, given the requirement to avoid a situation in which an interest "may possibly conflict" with the interests of the company. This could be dealt with by articles of association providing a mechanism for directors to obtain the approval of the board to multiple directorships, perhaps also providing for what should happen if a conflict actually arises in the future.

As has previously been the case, directors will need to consider seeking independent advice when potential conflicts arise. There may be situations where a conflict is such that a director cannot seek approval for a course of action, for example, because to do so would breach confidentiality to a third party. It may be necessary for a director not to participate in the relevant board discussions, or even resign.

Duty not to accept benefits from third parties

A director must not accept a benefit from a third party conferred by reason of (a) his being a director, or (b) his doing (or not doing) anything as a director, unless this cannot reasonably be regarded as likely to give rise to a conflict of interest.

This does not apply to benefits received from (or on behalf of) the company or other group companies. Nor does it apply to benefits paid by a third party which itself provides the services of the director to the company.

The Act also preserves any current ability of shareholders (under the company's articles and under the general law) to authorise conflicts, which would otherwise be a breach of this duty.

Shareholder approval and ratification

Shareholders may, in general, give approval in advance for anything to be done (or omitted) by directors that would otherwise be a breach of their general duties described above. This is subject to any additional requirements in the articles of association and to specific requirements of the law in particular cases. The Act imposes no particular requirements as to voting eligibility for such resolutions.

The Act preserves the current law on ratification after the event by shareholders of conduct by a director amounting to negligence, default, breach of duty or breach of trust in relation to the company. This can extend to former directors and shadow directors. This is subject to any additional requirements in the articles of association or statute imposing additional requirements for valid ratification or as to acts that are incapable of being ratified by the company.

However, in a change from the existing position, a decision by the company to ratify conduct by a director amounting to negligence, default, breach of duty or breach of trust in relation to the company must be passed by the shareholders without reliance on the votes of the director (if a shareholder) and of any shareholder connected with the director. This could give rise to difficulties in practice if a director and major shareholder (or a parent company) are treated as connected.

Therefore, where the ratification resolution is proposed as a written resolution (which will only be possible for a private company) the votes of the director (if a shareholder of the company) and of any shareholder connected with the director are disregarded, as they are not treated for these purposes as 'eligible members'.

Likewise, where the ratification resolution is proposed at a meeting, it is passed only if the necessary majority is obtained disregarding votes cast in favour of the resolution by the director and any shareholder connected with the director. This does not prevent the director or any such member from attending, being counted towards the quorum and taking part in the proceedings at any meeting at which the decision is considered.

The statutory definition of who is 'connected' with a director has been widened in the Act as regards family members. A more detailed consideration of who is a connected person is set out on page 13.

Transactions with directors requiring shareholder approval

Overview

The Act specifically sets shareholder approval as a requirement for certain transactions with directors. These are:

- substantial property transactions
- loans, quasi-loans and credit transactions
- long-term service contracts, and
- payments for loss of office.

These rules have been substantially redrafted in the Act, but in substance remain broadly as under the previous law. The most substantial change is that companies may, with the consent of shareholders, make loans or quasi-loans, enter into credit transactions, give guarantees or provide security in connection with a loan, to a director. Previously, these arrangements were prohibited, subject to certain limited exceptions.

These rules have been aligned wherever appropriate so as to achieve greater consistency of approach. They generally apply to transactions involving either a director of the company or a director of the company's holding company and, in some cases, persons who are connected with any such director. A more detailed consideration of who is a connected person is set out on page 13.

Where the director in question is also a director of a UK holding company, the transaction must be approved by the shareholders of both the company and the holding company (unless an exception applies). Shareholder approval is not required for any of these transactions by shareholders of a company which is itself a wholly-owned subsidiary or an overseas company.

Shareholder approval is by ordinary resolution, but the company's articles may require a higher majority or even unanimity. Particular voting requirements apply for payment for loss of office in connection with a transfer of shares.

Except in the case of substantial property transactions, a memorandum setting out certain particulars about the transaction requiring approval of the shareholders must be made available to the shareholders. If the approval is to be given by way of written resolution, the memorandum must be sent to the eligible shareholders at or before the time when the written resolution is sent to them. Special requirements apply for charitable companies.

None of these rules concerning transactions with directors now imposes any criminal penalties. Civil consequences in respect of substantial property transactions and loans, quasi-loans and credit transactions include the company having the right to cancel the transaction unless this is prevented by other events or the arrangement is affirmed by shareholder vote in the meantime. Even if shareholder affirmation occurs, other civil consequences remain, such as an obligation to account to the company for any gain and indemnify the company for any loss. Failure to obtain approval for a long-term service contract allows the company to terminate the service contract at any time by giving reasonable notice. Failure to obtain approval for a payment for loss of office results in the payment being held on trust by the recipient for the company and, in some cases, indemnification obligations.

Substantial property transactions

'Substantial property transactions' are transactions with a relevant person where the company buys or sells a non-cash asset where the value of the asset exceeds £100,000 or 10% of the company's net assets (based on its last set of annual accounts or called-up share capital if it has not yet produced any accounts). This applies to transactions involving either a director of the company or a director of the company's holding company or persons who are connected with any such director. No approval is required if the value of the asset is less than £5,000. The tests apply to the aggregate value of non-cash assets within an arrangement.

Under the Act, it is now permitted for a company to enter into a contract amounting to a substantial property transaction which is conditional on shareholder approval. A number of specific exceptions apply, including where a transaction is between a company and a person in his character as a member of that company or on a recognised investment exchange effected by the director or connected person through an independent broker.

Loans to directors, quasi-loans and credit transactions

The most substantial change in relation to transactions with directors is that companies will now be able, with prior shareholder approval, to make loans or quasi-loans, enter into credit arrangements, give guarantees or provide security in connection with a loan to a director. Previously, these loan arrangements were unlawful, subject to some limited exceptions.

In the case of a private company which is not in the same group as a public company, shareholder approval will be required for loans and related guarantees or security made by a company. However, this does not extend to transactions with persons connected with a director of the company or a holding company. As before, private companies are not restricted from making quasi-loans or entering into credit arrangements for directors.

In the case of a public company, or a private company which is in the same group as a public company, shareholder approval will be required for loans, quasi-loans, credit transactions and related guarantees or security made by the company. This extends to transactions with a director of, and persons connected with a director of, the company or a holding company.

These rules do not catch loans, quasi-loans, credit transactions and related guarantees or security to meet expenditure on company business. The total value of transactions under this exception made in respect of a director (and any person connected with him) must not exceed £50,000.

Nor do these rules catch small loans and quasi-loans, as long as the total value of such loans and quasi-loans made in respect of a director and any person connected to him does not exceed £10,000 or small credit transactions, as long as the total value of such credit transactions made in respect of a director (and any person connected with him) does not exceed £15,000.

There are also exceptions for intra-group transactions, credit transactions made in the ordinary course of the company's business on non-favourable terms and loans and quasi-loans made by a money-lending company in the ordinary course of the company's business on non-favourable terms.

Long-term directors' service contracts

Broadly, 'long-term directors' service contracts' are contracts under which a director is guaranteed at least two years of employment with the company of which he or she is a director, or with any subsidiary of that company.

The significant change under the Act is that approval is now required for service contracts longer than two years, as opposed to five years previously. This applies to contracts entered into on or after 1 October 2007.

A director's 'service contract' includes a contract of service, a contract for services and, in a change from the previous position, a letter of appointment as director. Failure to obtain approval allows the company to terminate the service contract at any time by giving reasonable notice.

Payments to directors for loss of office

'Payments for loss of office' are payments made to a director (or former director) to compensate the director for ceasing to be a director, or for losing (while a director or in connection with his ceasing to be a director) any other office or employment with the company or with a subsidiary of the company. They also include payments made in connection with retirement (either retirement as a director or retirement, while a director or in connection with his ceasing to be a director, from any other office or employment with the company or a subsidiary). In the case of loss of employment or retirement from employment, the employment must relate to the management of the affairs of the company.

Shareholder approval is required if a company wishes to make a payment for loss of office to one of its directors or a director of its holding company (in which case, approval is also required from the shareholders of the holding company).

Shareholder approval is also required if any person (including the company or anyone else) wishes to make a payment for loss of office to a director of the company in connection with (a) the transfer of the whole or any part of the undertaking or the property of the company or of a subsidiary of the company, or (b) a transfer of shares in the company or in a subsidiary of the company, resulting from a takeover bid.

These new rules for payments for loss of office catch a payment to a person connected with a director and a payment to any person at the direction of, or for the benefit of, a director or a person connected with a director.

The new rules reflect a number of changes from the previous position. These include extending the scope beyond loss of office as director, to payments for a loss of employment in connection with the management of the affairs of the company. They also include, for a takeover bid, no longer making disclosure of the arrangement an alternative to gaining shareholder approval.

It is important to note that shareholder approval is not required for payments for loss of office made in good faith to meet existing legal obligations or as damages for breach of such an obligation or by way of settlement or compromise of claims or pension payments, subject to some anti-avoidance provisions.

Connected persons

A number of the matters considered in this guide extend to persons who are 'connected' with a director of a company. The definition of who is 'connected' for these purposes is restated with some changes in the Act. The changes include widening the scope as regards family members to include a director's parents, children over 18, co-habitee and any children of the co-habitee who are under 18 and living with the director. The scope for a firm to be 'connected' is also widened, as before it referred only to Scottish firms.

The resulting definition of who is 'connected' with a director covers the following:

- The director's spouse or civil partner, parents, child or step-child (of any age), co-habitee and any children of the co-habitee who are under 18 and living with the director
- A body corporate where the director and persons connected with the director together control, or can exercise, more than 20% of the voting power in general meeting (excluding votes attached to treasury shares) or are interested in at least 20% (in nominal value) of the shares (excluding treasury shares) comprised in the equity share capital
- The trustee of a trust (excluding an employee's share scheme or a pension scheme) of which the beneficiaries or potential beneficiaries include any person who is connected with the director under any of the above provisions
- Any partner of the director, or a partner of any person who is connected with the director under any of the above provisions
- Any firm which is treated as a legal person under its local law:
  - (a) in which the director is a partner, or
  - (b) which has a partner who is connected with the director under any of the first three provisions above, or
  - (c) which has a partner which is a firm:
    - (i) in which the director is a partner, or
    - (ii) which has a partner who is connected with the director under any of the first three provisions above.

Shareholder litigation

The general duties outlined above are owed by a director to a company, and not directly to the company's shareholders. The Act allows a shareholder to bring a claim against a current or former director (including a shadow director) for an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director.

However, any such claim (known as a 'derivative claim') must be made on behalf of the company seeking redress for the company, not for the shareholder itself. Any damages awarded would go to the company, not to the shareholder bringing the claim. A shareholder can bring a claim in respect of conduct while it is a shareholder and prior conduct.

This new right to bring a statutory 'derivative claim' applies in a wider set of circumstances than was the case under the previous common law, meaning that it will be easier for shareholders to take directors to court. However, safeguards have been built into the Act requiring a shareholder to demonstrate a *prima facie* case and to apply for permission to continue a claim, before the claim can proceed to full trial. Matters to be taken into account by a court at this stage include whether a shareholder is acting in good faith and the views of independent shareholders.

The upshot is that the new regime places greater risks on directors. However, there are safeguards to prevent claims proceeding if they lack merit. Also, any damages awarded go to the company, not to the shareholder bringing the claim. It remains to be seen where the balance will lie, for example, between activist shareholders and special interest groups who may wish to bring a claim to put directors under pressure, and boards who will wish to see such claims struck out at an early stage where they lack merit.

If a claim arises from conduct occurring before 1 October 2007, it will only be allowed to proceed to the extent that it would have been allowed to proceed as a derivative claim under the law in force before 1 October 2007.

Relief from liability

Directors have the right, when a claim is made against them for negligence, default, breach of duty or breach of trust, to apply for relief from liability on the basis that they have acted honestly and reasonably, and that it is fair in the circumstances that they should be excused. The relevant provisions of the Act, which come into effect in 2008, do not change this.

Directors' indemnities and D&O insurance

Companies will continue to be allowed to indemnify their directors for the costs of proceedings brought by third parties, except those incurred in an unsuccessful defence against criminal proceedings and fines imposed in criminal or regulatory proceedings.

Companies will also continue to be allowed to pay the defence costs of directors as they are incurred, even where the claim is brought by the company itself, subject to a repayment obligation in many cases where a defence is unsuccessful. Companies will also continue to be allowed to purchase and maintain insurance for a director against liability for negligence, default, breach of duty or breach of trust.

New provisions have been introduced relating to indemnification of directors of pension trustee companies against liability incurred in connection with the companies' activities as trustee of an occupational pension scheme.

Many companies will wish to review existing directors' indemnities and directors' and officers' (D&O) insurance policies to consider whether these require updating generally or to take account of the new statutory derivative claim.

Checklist – Practical steps

The following practical steps may assist companies in ensuring that their directors comply with their duties under the Act:

1. Arrange a thorough briefing on directors' duties under the Act for directors and others concerned with the preparation of materials for consideration by the board.
2. On appointment, all new directors should be briefed on their duties under the Act.
3. The terms of appointment and description of the role of any director should specifically refer to their duties.
4. The terms of reference of any board or committee should reflect the duties, including the requirements of section 172 (duty to promote the success of the company).
5. Review any existing company policies to reflect compliance with the duties, e.g. update an ethics policy to reflect what is and is not acceptable in light of the duty not to accept benefits from third parties and update a corporate responsibility policy to reflect the matters listed in section 172(1).
6. Review the procedures for preparing papers and presentations for consideration by the board, the conduct of board discussions and the way this is minuted to ensure an appropriate overall approach in the light of section 172.
7. Review directors' indemnities and D&O insurance policies in the light of the terminology used in the Act and to take account of the procedural requirements for a derivative claim and the likely increased risks and the costs of such a claim being brought.
8. Review the company's articles of association to identify changes to be made in relation to actual or potential conflicts of interest. In particular, for a public company, consider the scope of authority and mechanisms for the board to approve conflicts of interest, including the question of approval of multiple directorships and what steps may be taken in the event a conflict actually arises. Also, for a private company, consider whether to limit the freedom of directors to authorise conflicts of interest.*
9. Review procedures for reminding directors at regular intervals to declare interests in potential and existing transactions and arrangements in accordance with the Act (including updating matters previously declared).*
10. Review procedures for ensuring that anyone connected with a director is aware of the obligation to declare interests and to notify the director accordingly.*

* Items 8 to 10 relate to changes due to take effect from October 2008

Detailed guides to further changes under the Companies Act 2006 coming into force in April and October 2008 will be available nearer those dates. If you would like a copy of these guides, please contact Debbie Cloake on email d.cloake@taylorwessing.com or Andrew Telling on email a.telling@taylorwessing.com or your usual contact at Taylor Wessing.

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