



Director's Guide

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Director's Guide

This Guide covers a wide range of topics that directors should be aware of, divided into five sections:-

Section 1 : Important information for directors

Section 2 : Legal powers, duties and responsibilities of directors

Section 3 : Insolvency and wrongful trading

Section 4: Directors responsibilities for health and safety

Section 5: Derivative actions

Section 6 : Insurance and other escape routes

Section 1: Important information for directors

Who can be a director; shadow and de facto directors; how directors are appointed; service agreements/letters of appointment; declaration of directors' share interests; retirement, removal and disqualification of directors; board roles and functions; the role of the board

Who can be a director?

It is easier to answer this question by explaining who may not be a director:-

- The auditor of the company may not also be a director
- The secretary of the company may not also be a sole director - there must be at least one other director
- A person who has been disqualified from being a director by the courts may not be a director
- a person who is under the age of 16 may not be a director
- a company must have at least one director who is a natural person (i.e. not a corporate director), unless they had no natural persons as directors as at 8th November 2006 in which case this requirement shall not apply until 1st October 2010

A company's articles of association may contain further restrictions as to who may or may not be a director, for example by specifying:-

- a higher minimum age for directors
- a maximum / retirement age for directors
- a shareholding qualification for directors
- a prohibition on anyone "of unsound mind" becoming a director
- a minimum or maximum number of directors

Shadow and “de facto” directors

Every person who is called a “director” will owe the legal duties and responsibilities of directors explored later in this guide. Any person “occupying the position of director, by whatever name called” will owe similar duties (“a de facto director”), even though a defect in the method of their formal appointment as a director may be discovered at a later date.

A “shadow director” - a person “in accordance with whose directions or instructions the directors of a company are accustomed to act” – will be treated as if he or she were a director and as such has similar duties to a director properly appointed.

How are directors appointed?

The process for appointing directors is set out in the articles of association of the company. Normally, there will be provision for the shareholders to appoint directors in general meeting or by written resolution. It is also common for the board of directors to have a right to fill board vacancies which occur between shareholder meetings or to appoint additional directors, such appointments are sometimes to be approved by the shareholders at the next general meeting or by written resolution.

Service Agreements / Letters of Appointment for Directors

It is possible to be a director without being an employee of the company. It is good practice for directors who are employees to have a service agreement which sets out the terms on which they are employed by the company and their compensation package. Directors who are not employees should receive a letter of appointment setting out the terms of their engagement and the fees they will be paid.

Declaration of directors’ share interests

When they are appointed, directors must formally notify the company of their shareholdings in the company, and any shareholdings of their spouse and children. After their appointment, they must keep the company advised of any changes to these holdings. The company is required to keep an up-to-date record of this information. Directors are also required by law to disclose their interests in contracts or arrangements involving the company (see Section 2 on conflicts of interest).

Retirement of directors

Retirement by rotation of directors is more common in public companies although it is found in private companies too. Retirement by rotation involves a proportion of the board (usually one-third each year) retiring at the next general meeting of the Company and then offering themselves for re-election by the shareholders. The perceived benefit of retirement by

rotation is that it gives the shareholders an opportunity to have their say if they are unhappy with the performance of a particular director. Most private companies decide not to have a retirement by rotation procedure, however, as it is often felt to be unnecessary layer of complexity and administration, particularly in companies where the directors of the company are also its owners.

Removal of directors by the shareholders

Under company law, the shareholders have the right to remove a director of the company by ordinary resolution of the shareholders in general meeting (an ordinary resolution requires the approval of more than 50% of the shareholders attending the meeting concerned and voting in favour of the resolution). This is an important right as it cannot be removed by the articles of association or a shareholders' agreement.

Disqualification of directors

A person's appointment as a director ceases **automatically** if they are declared bankrupt or disqualified by the courts from acting as a director.

Board Roles

The table below shows common roles found on a board of directors and a summary of the functions that might attach to that role.

| Board Role | Function |
|-------------------|--|
| Chairman | Overseer of board activities, responsible for chairing board activities and the AGM and acting as a spokesperson on behalf of the company. In some companies this may be a non-executive role performed by an outsider or former Managing Director. |
| Chief Executive | The senior full-time executive in a business. The title is purely descriptive and carries no legal significance or obligations. |
| Managing Director | A director who has been designated by his fellow Directors as Managing Director, and to whom they have delegated such managerial responsibilities as they consider necessary to carry out that leadership role. The Managing Director is accountable to the Board for his actions. |

| | |
|------------------------|---|
| Non-executive director | A Director of a limited company, but without day-to-day (executive) responsibilities. A Non-Executive Director (or NED) is usually appointed because of the additional skills, knowledge and experience he or she can contribute at Board level, and also to bring an objective or independent viewpoint to Board discussions. Despite the title, a non-executive director has the same legal duties and responsibilities as an executive director. |
|------------------------|---|

Individual members of the board may also be assigned specific operational responsibilities (e.g. Finance Director, Sales Director, Production Director). These executive directors will be accountable to the board for the parts of the business they are responsible for.

The Role of the Board – What does a proper board do?

Directs, Controls and Accounts for the business at the highest level

Directs - strategic decision making. This emphasises the distinction between strategy and day to day management. In a company where a number of the directors also have management responsibilities, it is vitally important that the board can distinguish when and where it should be discussing management issues and when and where strategy should be the focus.

Controls - overseeing management performance and monitoring achievement of objectives. This means that there has to be in place financial and personnel management systems that enable the board to fulfil this vital function.

Accounts - responsibility to stakeholders. In law the board has an ultimate duty to shareholders and other legal duties for example to employees, customers, creditors and so forth.

Section 2: Legal powers, duties and responsibilities of directors

General; Companies Act 2006 – codified statutory duties; further duties; miscellaneous

GENERAL

Legal powers, duties and responsibilities

The directors of a limited company must observe the limits placed on the company's powers in terms of its memorandum and articles of association. Although the board's powers are collective rather than individual, the board may delegate specific powers to individual directors or to committees of directors. In practice, individual directors carry out many of the company's activities (see Section 1 on board roles).

It is important to note that, although the directors of a company have collective powers and responsibilities, the legal duties owed by a director are owed individually. It is also important to remember that, in law, non-executive directors have the same duties and responsibilities as executive directors.

Sources of law on directors duties and responsibilities

From 1st October 2007, certain directors' duties have been codified in legislation, in the form of the Companies Act 2006 and these will run in conjunction with various common law duties which will still apply. In addition, both the memorandum and articles of association of the company and the terms of any service agreement may impose specific duties on directors. A director should be thoroughly familiar with the terms of both.

Directors have day to day duties of administration imposed under the Companies Acts (such as filing forms, submitting the annual return, preparation and filing of accounts etc.) but the Acts also impose duties in relation to such matters as loans to directors, conflicts of interest and transactions between or involving the company and its directors. These are explored later in this section.

Failure by directors to discharge their duties can lead to civil penalties, criminal penalties (fines or, for more serious matters, imprisonment) and may lead to disqualification as a director. It is also important to note that a director's duties of skill and care are owed to the company and (in general) *not* to individual shareholders or outsiders (although individual shareholders can bring actions against individual directors on behalf of the company in certain cases – see Section 5: Derivative Claims).

Honesty and the fiduciary nature of directorship

Directors have a fiduciary relationship with the company. Therefore, a high standard of honesty is therefore expected of them, as if they were trustees. The duty of honesty manifests itself in many ways, both under the general law and as set out in the Companies Acts.

COMPANIES ACT 2006 – CODIFIED STATUTORY DUTIES

The Companies Act 2006 sets out seven statutory duties that a director must comply with:-

1. Duty to act within powers
2. Duty to promote the success of the company for all the members' benefit
3. Duty to exercise independent judgement
4. Duty to exercise reasonable care, skill and diligence
5. Duty to avoid conflicts of interest
6. Duty not to accept benefits from third parties
7. Duty to declare interest in proposed transaction or arrangement with the company

These duties apply to all director (including shadow directors and de facto directors – see above).

1. Duty to act within powers

A director must act in accordance with the company's constitution and must only exercise his powers for their proper purpose. The company's constitution is defined in legislation as being the company's articles of association, decisions taken in accordance with the articles and other decisions taken by members (or a class of members) as long as they can be regarded as decisions of the company.

2. Duty to promote the success of the Company

This duty broadly replaces the existing fiduciary duty to act in the company's best interests. It also encompasses the principle of "enlightened shareholder value", meaning that Directors have to have regard to certain factors laid out in the Companies Act when making decisions.

If the purposes of the company are, or consist of purposes which are, not for the benefit of the members, then a Director has to act in the way they consider, in good faith, to be most likely to achieve these purposes.

In fulfilling this duty, a Director must have regard to, amongst other matters:

- The likely long term consequences of any decision;
- The interests of the company's employees;
- The need to foster the company's business relationship 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;
- The need to act fairly as between members of the company.

Note that this list of factors is neither exhaustive or a list of obligations that must factor into each and every decision of the directors. They are however illustrative of the types of issues that a board will be expected to consider when determining what is most likely to promote the success of the company.

3. Duty to exercise independent judgement

Directors must exercise independent judgement. This duty is not 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 which is exercised by the company's constitution. This duty does not prevent a director from delegating their powers in accordance with the company's constitution.

4. Duty to exercise reasonable care, skill and diligence

Every director owes a duty of skill and care towards the company.

Guidelines are given in legislation as to the level of skill, care and diligence that ought to be shown. The test is that a director must exercise the skill, care and diligence which would be exercised by a reasonably diligent person with both the general knowledge, skill and experience that may be reasonably 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 actually has. In applying the test, consideration must be given to the

functions of the director, including their responsibilities and the circumstances of the company. The duty is not a fiduciary one.

Other principles have emerged from court decisions, and these could be used to aid the interpretation of the legislation:-

- Directors need not demonstrate a greater degree of skill than that which may be reasonably expected from a person with their knowledge and experience.
- Directors cannot be expected to exercise skill which they do not possess. However, more is expected of directors who are experienced in a particular field (e.g. financial or legal background).
- A director who has a service agreement will have to be certain of the express terms of that agreement as they may impinge on or modify the general duties owed by the director to the company.
- The objective “reasonable man” standard for the degree of diligence required from a director *may* be reduced in certain cases (for example, directors with “honorary” appointments).

5. Duty to avoid conflicts of interest

The codified statutory duties under the Companies Act 2006 relating to conflicts of interest came into force on 1st October 2008.

These new statutory duties create a new, positive duty for directors to avoid unauthorised conflicts of interest (e.g. between personal and company concerns). The scope of the section is very wide, covering not only actual conflicts of interest, but potential ones as well.

The Act allows conflicts of interest to be authorised by directors instead of by shareholders. An ordinary resolution of the company should be passed by the shareholders to give directors this power to authorise conflicts of interest.

Passing this resolution will have the effect that, if there is a potential conflict of interest at any point in the future, directors will be able to vote on the matter provided they disclose their interests at the start of the meeting and have board approval.

All directors who face actual or possible conflicts of interest by virtue of their position must therefore either obtain authority of the board to act, or remove the possibility of conflict, or resign as directors.

It may therefore be prudent for the directors to agree a protocol for dealing with conflict of interest matters for example:

1. Matters where a declaration of the conflict by the director is sufficient, and the director is still allowed to vote on the matter;
2. Matters where the conflict is sufficiently serious for the director to absent himself from any discussion and not vote on the matter; and
3. Matters where the conflict is so serious that the director shall be encouraged to resign from the board.

Under this protocol the board could have the discretion to decide into which category the conflict matter belonged. Alternatively the board's discretion could be curtailed in certain circumstances – for example, if the conflict concerns a transaction above a certain value then the protocol could stipulate which category this falls within.

The duty will not, however, be infringed if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest.

In addition to the general duty to avoid conflicts of interest, certain specific instances of conflicts are addressed in the legislation and common law, in particular in relation to the duty to exercise powers for a proper purpose, loans to directors, substantial property transactions involving directors and the misapplication of property and secret profits.

6. Duty not to accept benefits from third parties

Directors must not accept any benefit (including a bribe) from a third party which is conferred because of his being a director or his doing or not doing anything as a director.

The only exceptions to this rule will be benefits that are so minor that they could not reasonably be thought to influence the director in any way.

Shareholders of a company may authorise the acceptance of certain benefits that would otherwise be a breach of this duty. Companies may therefore wish to amend their constitutions to allow directors to accept benefits under a specified value, for example to ensure that the acceptance of a certain level of corporate hospitality will not cause a director to breach the duty.

The duty will continue to apply after a person ceases to be a director in relation to things done or omitted by him before he ceased to be a director.

7. Duty to declare interest in proposed transaction or arrangement with the company

Directors must declare to the other directors the nature and extent of any interest (whether direct or indirect) in a proposed transaction or arrangement with the company. The director need not be a party to the transaction for the duty to apply.

Such declarations must be made before the company enters into the transaction or arrangement. The declaration may be made at a board meeting or by way of a notice in writing. It is then for the board to decide whether the director should be entitled to vote in the meeting (in accordance with the provisions in relation to the duty to avoid conflicts summarised above).

No declaration is required where the director is not aware of his interest or where the director is not aware of the transaction or arrangement in question. Further, a director need not make a declaration of interest if his interest cannot reasonably be regarded as likely to give rise to a conflict of interest or if the other directors are already aware of it.

FURTHER DUTIES

Duty to exercise powers “for a proper purpose”

Directors must exercise their powers *for a proper purpose* in good faith in the company’s interest and not for another purpose. For example, if a director used his powers to thwart a take-over bid which he objected to personally but which was in the best interests of the company, then that would be a breach of this duty.

Loans to directors

Shareholders may approve loans to directors provided that a note has been circulated to them disclosing the nature of the transaction, the amount of the loan, the purpose for which it is required and the extent of the company’s liability under any transaction connected with a loan.

Companies are, without shareholder approval, allowed to fund directors’ proper expenditure as part of their duties up to an amount of £50,000. There is also an exception for certain transactions if their value is less than £10,000.

Contracts with directors – substantial property transactions

Where a director of a company or a person connected with a director is to acquire an asset from the company or dispose of an asset to the company (a “substantial property transaction”), that transaction must be approved by, or be conditional on approval of, the shareholders of the company. A “substantial” asset is one where: (i) the asset’s value

exceeds 10% of the asset value of the company and has a value of more than £5,000, or (ii) the asset's value exceeds £100,000.

Misapplication of property and secret profits

Directors have a duty not to misapply company property for purposes other than the company's business. They must not seek to use company property to further their own personal interests or for personal profit.

MISCELLANEOUS

Taking professional advice

Liability will not attach to directors for mere errors of judgement. On difficult questions, however, directors must take professional advice as a failure to do so may amount to negligence.

In summary:-

- Directors are entitled to rely on independent professional advice and may be negligent if they fail to obtain this help
- The person giving the advice must appear to be qualified to do so
- On receipt of the advice the directors must exercise their own judgement on the strength and appropriateness of the advice given

Liability for the acts of others

It is unlikely that a director will be held liable for the acts of their individual co-directors simply by virtue of their position on the Board. They may, to a certain extent, rely on their co-directors and the officers of the company (e.g. the auditors), but the extent of that reliance will depend on circumstances such as the character of business, composition of the board, provisions of the articles of association, the normal practice of directors, and, particularly, the extent of their knowledge and experience. The smaller the board, the more a director should be aware of the acts of his co-directors.

There are no statutory rules to assist in calculating the extent to which any one director may rely on his colleagues. The courts have similarly been reluctant to set down general rules and the only safe course for a director to follow is to use his best endeavours to be aware of his fellow directors' actions. It is unwise for any director to abdicate responsibility because "someone else will take care of it" or even because "someone else is supposed to be doing it".

The articles of association usually contain an indemnity in favour of the directors. However, the Companies Act 2006 limits the indemnity to the extent of indemnifying them for the expenses of defending any proceedings against them where they are acquitted or judgement is in their favour. See Section 6 for more information on Directors and Officers Liability Insurance.

Ratification of acts of Directors by the members

Any act by the Directors that amounts to negligence, default, breach of duty or breach of trust in relation to the company may be ratified by a vote by the holders of a majority of the shares in the company (or such higher threshold as is set by the company's articles of association), excluding any shares held by the offending directors.

Section 3: Insolvency and wrongful trading

Definitions of insolvency and wrongful trading; directors' responsibilities; possible sanctions

Insolvency

The Insolvency Act 1986 contains no definition of "insolvency" as such but simply provides that action may be taken in certain cases if a company is "unable to pay its debts". There are several scenarios which may constitute such inability. It is essential that every director is aware of the financial position of their company.

Definitions

Wrongful Trading is a statutory concept under the Insolvency Act and should be entirely differentiated from that of **fraudulent trading** (which, as its name suggests requires intent and is outwith the scope of this guide).

Wrongful Trading:-

- applies to directors and shadow directors;
- becomes relevant in the event of an insolvent liquidation; and
- carries no need for fraudulent intent.

Responsibilities

When a director becomes aware that insolvent liquidation **may** be in prospect he must do everything possible to minimise the potential loss to the company's creditors. This is perhaps the strongest example of directors owing a duty to persons other than the company as a whole. Although the phrase **wrongful trading** is not defined in the Insolvency Act it is clear that personal liability may result from failure on the part of a director either to appreciate impending disaster when he ought to have known, or to take appropriate action once he became aware.

Sanctions

Directors who permit the company to trade wrongfully may be liable to make a contribution to the company's assets in a subsequent winding up. The court has discretion to fix the level of contribution. In the event of a director being responsible for **wrongful trading**, disqualification may also ensue under the Company Directors (Disqualification) Act 1986.

Further information

More detailed information on directors' duties and potential liabilities in insolvency is contained in the WJM guide entitled "Fraudulent Trading, Wrongful Trading and Disqualification".

Section 4: Directors responsibilities for health and safety

Organisations and directors responsibilities for health and safety; breach of health and safety responsibilities

Organisations and directors responsibilities for health and safety

Directors of all types of organisations in both the private and public sectors, have responsibilities for ensuring that health and safety risks arising from their organisation's activities are properly managed.

Health and safety law states that organisations must:

- provide a written health and safety policy (if they employ 5 or more people);
- assess risks to employees, customers, partners and any other people who could be affected by their activities;
- arrange for effective planning, organisation, control, monitoring and review of preventive and protective measures;
- ensure they have access to competent health and safety advice;
- consult employees about their risks at work and current preventive and protective measures.

Breach of health and safety responsibilities

If a health and safety offence is committed with the consent or connivance of, or is attributable to any neglect on the part of, any director, manager, secretary or other similar officer of the organisation, then that individual (as well as the organisation) can be prosecuted under the Health and Safety at Work Act 1974.

Directors cannot avoid a charge of neglect by arranging their organisation's business so as to leave them ignorant of circumstances which would trigger their obligation to address health and safety breaches.

Those found guilty are liable to fines and, in some cases, imprisonment. In addition, the Company Directors Disqualification Act 1986 empowers the court to disqualify an individual convicted of the offence in connection with the management of the company. This includes health and safety offences.

Directors should also be aware that under the Corporate Manslaughter and Corporate Homicide Act 2007, an offence will be committed by an organisation where failings by an organisations senior management are a substantial element in any gross breach of the duty of care owed to the organisation's employees or members of the public, which results in death. The maximum penalty is an unlimited fine and the court can additionally make a publicity order requiring the organisation to publish details of its conviction and fine. There is currently no individual liability for directors and managers under the Corporate Manslaughter and Corporate Homicide Act, however, the law may change in relation to this in the future.

Section 5: Derivative Claims

What are derivative actions; criteria for bringing them; what to base claims on; preparatory measures

What are derivative actions?

In broad terms, a derivative claim is a claim brought by a shareholder in the name of and for the benefit of the company, and so represents an exception to the general rule that the company is the proper claimant for a wrong done to it. This could include the member bringing an action against one or more directors for an alleged breach of their duties to the company.

What are the criteria?

Claims can be brought against directors, third parties and shadow directors. The applicant (who must be a member of the company) needs to show a prima facie case. Only the applicant can submit evidence at this stage. If there is an apparent case, the courts may determine that the respondent (i.e. the director, third party or shadow director) may also lead evidence before they decide if the case should proceed.

To guard against frivolous claims the courts are obliged to consider whether or not the applicant is acting in good faith, whether he is acting with a view to promoting the success of the company (as opposed to himself as an individual) or whether the action would be best brought by the shareholder as an individual. The provisions are still relatively new and so it is not yet clear if this will suffice to guard against frivolous or vexatious claims.

What can a claim be based on?

It is not enough for a claimant to bring an action based on a perceived 'bad decision' by a director. There must be an actual or proposed act or failure to act involving negligence, breach of duty or breach of trust.

What preparatory steps can be taken?

Directors should be aware of their statutory and common law duties. It is also important that directors check their insurance and indemnities to ensure that they are covered for the cost of dealing with and defending derivative claims. It is advisable that board meetings (and the minutes of those meeting) reflect the director's consideration of both their statutory and common law obligations.

Section 6: Insurance and other escape routes

Indemnities in favour of directors; directors and officers liability insurance; court powers

Indemnities under the articles of association

As already mentioned, the articles of association of the company will commonly contain a general indemnity in favour of directors against any liability attaching as a result of negligence, default or breach of duty. It is vital that any generally worded indemnity contained in the Articles is treated with caution. The Companies Acts severely restrict the scope of any such indemnity.

Directors and Officers Liability Insurance (DOL)

The statute also imposes restrictions on the type and scope of insurance cover which a company may take out for the benefit of its directors. While recent amendments in the law have increased the scope for a company taking out this kind of cover it is vital that relevant advice is obtained when cover is introduced so as to ensure that the nature of the cover which the company wishes to obtain for its directors is permitted in terms of the Companies Acts.

Court powers

The Companies Acts also permit the courts, in considering directors' liabilities, to grant relief where the director has acted honestly and reasonably and the court is of the view that he ought fairly to be excused. The power of the court to grant relief in these circumstances is limited to certain statutory liabilities and should not therefore be seen as a general safety net.

Conclusion

The law in relation to directors' duties and personal liability continues to develop. The generally held view is that it is likely that personal liability of directors will increase, rather than decrease, over the coming years, so directors would be well-advised to keep up to date with this area of the law.

We hope that this guide has provided a useful and informative general picture of the law in this area.

The information provided in this Guide is for general guidance only and represents our understanding of current law and practice. Wright, Johnston & Mackenzie LLP cannot be held responsible for any action or inaction taken in reliance upon the contents. Specific advice should always be taken on any individual matter.

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