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DIRECTORS' DUTIES UNDER ENGLISH LAW

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1. Introduction

This paper briefly outlines certain legal and regulatory aspects of directors' duties under English law when companies are solvent and when they are in financial difficulties. It highlights some areas of concern for directors under recent and proposed legislation, both domestic and cross-border.

2. Common Law, Statutory and Regulatory Duties

2.1 *Memorandum of Association and Articles of Association*

The Memorandum of Association sets out the objects of the company and governs its external affairs, whereas the Articles of Association govern the internal affairs of the company. The directors must comply with and ensure the company complies with the obligations and limitations contained in the Memorandum and Articles of the company.

2.2 *Common Law*

The directors are normally entrusted with management of the company. If the directors are in breach of their common law duties, they may incur civil liability to the company for any loss it suffers as a consequence. In addition, they may have to pay over any improper profit or advantage made at the company's expense. The basic duties of directors include the following:

- Duty of skill and care;

  A director must exhibit the skill and care which may reasonably be expected from a person in his position with his particular knowledge and experience. It is generally considered that the standard is now higher than previously required;

- Duty to act in good faith in the company's best interests;

  A director must act honestly and in good faith in what he considers to be the best interests of the company (which means the interests of all shareholders present and future, whilst the company is solvent). Under statute, the director must also consider the interests of employees;

- Duty to exercise powers for proper purpose;

  A director must exercise his powers for the purposes for which they are given and must not misuse his power or the opportunities of his position to benefit himself;

- Duty to avoid a conflict of interest;

  A director must refrain from putting himself in a position in which his duties to the company and his personal interests may conflict;

- Duty to avoid making secret profits;

  A director must not use his powers to benefit himself at the expense of the company, save with the knowledge and consent of the shareholders in general meeting. Any undisclosed or secret profit may have to be paid to the company;

- Duty not to misapply the company's assets;

  A director is a trustee of the company's property and he has a duty to ensure that the property is not misappropriated or misapplied;

- Duty of confidentiality;

  A director must not profit from or disclose the company's secrets or confidential information which comes into his possession.

2.3 *Statute*

The Companies Act 1985 (as amended) contains numerous provisions relating to the duties of directors and sets out sanctions for breaches of those duties. The directors of a company also need to be aware of their duties and the possible penalties under the Financial Services and Markets Act 2000, the Insolvency Act 1986 and the Company Directors Disqualification Act 1986.

2.4 *Stock Exchange Requirements and the City Code*

The directors of a company whose shares are listed on the London Stock Exchange are primarily responsible for ensuring that the company observes the requirements imposed on the company under the listing rules issued by the UK Listing Authority. Where the company is the subject of a take-over or is involved in the take-over of another company, the directors must ensure the company complies with the City Code on Take-overs and Mergers. This only applies if the target company is incorporated in the UK.

2.5 *Codes of Best Practice*

The Combined Code on Corporate Governance contains a set of principles of good governance and a code of best practice with which listed companies should comply. The Code was first produced by the Hampel Committee in 1998, and embraces the reports of three advisory committees (the Cadbury Committee (1992), Greenbury Committee (1995) and the Hampel Committee itself).

The Higgs Report (2003) recommended substantial revisions of the Combined Code, many of which have been adopted in the most recent version of the Combined Code. The Higgs Suggestions for Good Practice which emerged from the Higgs Report are annexed to the Combined Code.

The Combined Code is enforced either through the expectations of shareholders and certain investor bodies, or, more directly, by reference to the Listing Rules. In particular, the directors of a listed company are required to report and explain to its shareholders any areas of non-compliance with the general principles of corporate governance set out in the Combined Code.

3. Company Law Reform Bill

3.1 *The Bill*

The Bill, which is expected to come into force in 2007, codifies directors' duties with a view to reflecting in statute the current common law position, but with some significant changes. One of the main questions raised at the beginning of the Company Law Review process which led to the publication of the Bill was whether directors' duties should continue to be owed solely to the company, except in limited cases, or whether directors should be required as a matter of law to account directly to third parties, e.g. employees, suppliers and local communities. The conclusion was that the existing position should remain.

3.2 *Enlightened shareholder value*

However, the so-called "enlightened shareholder value" approach is reflected in the Bill which requires a director to act in any way he "considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole". The Bill requires a director in fulfilling this duty to have regard, so far as reasonably practicable, to a number of factors including:

- the long term consequences of any decision;
- the interests of the company's employees;
- the need to foster 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.

The main reason for codifying directors' duties is to provide an authoritative statement of what those duties are. The absence of such a statement and the complexity of case law in this area is considered not to be helpful to the business community, in particular to the individuals who are most affected by it. The critics of codification point to the lack of flexibility which it provides and uncertainties over the relationship between the statutory code and common law. Although the Bill states that the statutory duties replace the common law duties, it also provides that common law rules and equitable principles will apply in interpreting the statutory duties. The practical effect is likely to be that the decision making process for directors will become more onerous and that considerable care will need to be taken in documenting this process.

The duty to act in a way which would be most likely to promote the success of the company for the benefit of the members as a whole has given rise to some debate as to how this fits in with the duty of the directors when a company is in financial difficulties. The current common law and statute law provisions are explained later in this paper but this is not consistent with the concept of continuing to promote the success of the company for the benefit of its members. The Government accepted this point and included in the Bill wording to the effect that this duty is subject to any enactment or rule of law requiring directors in certain circumstances to consider or act in the interests of creditors of the company. Thus their duty to promote the success of the company will be tempered increasingly by an obligation to act in the interests of creditors as the company becomes or is likely to become insolvent.

3.3 Conflicts

There is also doubt over the scope of the duty imposed by the Bill for a director to 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". Under the current law, such matters must be authorised by members, but the Bill provides an alternative procedure requiring, in most cases, authorisation by directors. For private company whose constitution does not prevent this, authorisation may be given by directors who have no interest in the transaction. For public companies, authorisation must be permitted by the company's constitution, as well as being given by directors who are independent.

4. Duties of Directors of Companies in Financial Difficulties

4.1 *Common Law Duty*

The common law duty of a director when a company is insolvent or of doubtful solvency is to act in the interests of creditors, with a view to minimising the loss to the creditors of the company from time to time.

4.2 *Public Companies*

Directors of a public company have a duty under Section 142 of the Companies Act 1985 to convene a meeting of shareholders in certain circumstances if there is a serious loss of capital. The section provides that where the net assets of a public company are half or less than its called up share capital, the directors must, not later than 28 days from the earliest day on which that fact is known to a director, convene an extraordinary general meeting of the company for a date not later than 56 days from that day for the purpose of considering what, if any, steps should be taken to deal with the situation. A breach of these requirements can lead to the directors being liable to a fine.

4.3 *Listed Companies*

The primary obligation of the company under the Listing Authority's Disclosure Rules is to announce publicly all inside information which directly concerns the company and which is in its possession, without delay. Such information in respect of the company's information which relates to events, circumstances, changes in circumstances, transactions or trading which exists or occurs (or may reasonably be expected to exist or occur) that is not generally available and which a reasonable investor would be likely to use as part of the basis of any investment decision and is therefore likely to have a significant effect on the price of the company's shares or other securities. If a company is faced with an unexpected and significant event, a short delay may be acceptable if it is necessary to clarify the situation but, in certain circumstances, a holding announcement may be appropriate. It may be possible for the company to delay disclosure of information to prevent prejudice to the company's legitimate interests, provided that doing so does not mislead the public and confidentiality is ensured.

5. Personal Liability of Directors

5.1 *Delinquent Directors*

If in the course of a winding up anyone who has been involved with the promotion, formation or management of the company is found to have misapplied, retained or become accountable for any money or other property of the company, or been guilty of misfeasance or breach of a fiduciary or other duty in relation to the company, a court may on an application by the official receiver, liquidator or a creditor compel him to:

(a) repay, restore or account for the money or property of the company with interest; or

(b) contribute such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary duty or other duty as the court thinks just.

Breaches of duty which could be relevant here may include a director's involvement in the company granting a preference or entering into a transaction at an undervalue (which are explained below).

5.2 Fraudulent Trading

A court, on application by a liquidator in a winding up, can order that any person who was knowingly a party to carrying on the business of a company with intent to defraud creditors or any other person, or for any fraudulent purpose, be liable to make such contribution (if any) to the company's assets as the court thinks proper. Fraudulent trading is also a criminal offence carrying with it the threat of imprisonment, a fine or both. Such an offence may apply whether or not the company has been, or is in the course of being, wound up.

Fraudulent trading can arise when directors of a company allow it to incur credit when they know there is no good reason for thinking that funds will be available to repay the relevant debt when it becomes due or shortly thereafter. Thus directors would have to be reasonably satisfied that services or goods supplied to the company can be paid for on the due date.

5.3 *Wrongful Trading*

A court, on application by a liquidator in a winding up, can order that a director of a company which has gone into insolvent liquidation is liable to make such contribution (if any) to the company's assets as the court thinks proper if:

(i) before the commencement of the winding up, the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation; and

(ii) thereafter the director failed to take every step with a view to minimising the potential loss to the company's creditors which he ought to have taken.

The standard required as to what a director ought to know, the conclusions he ought to reach and the steps he ought to take is the standard of what would be known, reached or taken by a reasonably diligent person with the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as those of the director in relation to the company and with the general knowledge, skill and experience that the director has.

Not only do the wrongful trading provisions apply to directors or former directors (and there is no distinction for these purposes between executive and non-executive directors), but they also apply to shadow directors, who are people or companies in accordance with whose instructions or directions the directors of a company are accustomed to act.

5.4 *Voidable transactions*

Directors of a company may be in breach of duty if they permit the company to enter into certain types of transaction within a specified period before its insolvency. In appropriate circumstances, an administrator or liquidator may be able to apply to the court for an order that the parties be put back into the position they would have been in if the transaction had not been entered into, or require some other appropriate remedy.

A transaction at an undervalue can arise in particular if a company makes a gift or enters into a transaction on terms where the company receives no consideration or one which has a value which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the company. There are certain defences to a claim in respect of transactions at an undervalue and to be vulnerable they have to be entered into within a period of two years before the commencement of the winding up or administration of the company.

A preference occurs if the company does anything or suffers anything to be done in respect of a creditor or a guarantee or surety of the company's debts if it has the effect of putting that person in a position which would be better than if the transaction had not been carried out, assuming the company were to go into insolvent liquidation. The company must have been influenced in deciding to give the preference by a desire to produce the preferential effect, in order for the preferential transaction to be vulnerable. There is a presumption of such influence if the parties are connected. The vulnerability period is six months before the commencement of insolvency (if the parties are not connected) and two years if they are. The definition of connected is very wide and includes a transaction with directors or a major shareholder.

5.5 *Groups of companies*

It has to be borne in mind that if a company in difficulties is part of a group, the directors of each company will owe duties to that company. This can very easily give rise to a conflict if, for instance, the subsidiary is relying on the parent's support for finance and the directors of the parent are also directors of the subsidiary. Further, certain information may be given to them as directors of one company which is confidential to that company and may not be disclosed to directors of another company.

5.6 *Disqualification*

Apart from personal liability, where a director engages in fraudulent or wrongful trading or has been found guilty of other misconduct in connection with a company and is held to be unfit by the court, he may be disqualified by court order for a period of between two and fifteen years from acting as a director or from having any involvement in the promotion, formation or management of a company.

The Insolvency Act 2000 introduced provisions for a director who has committed misconduct to give an undertaking to the Secretary of State not to act as a director for a given period. This enables directors to minimise the time and expense of disqualification proceedings.

6. EC Regulation on Insolvency Proceedings

6.1 *Centre of Main Interests*

The legal framework within which directors work varies widely between European Union Member States, notwithstanding that the rules are aimed at curbing or preventing similar perceived abuses and misfeasance. Where a company's centre of main interests ("**COMI**") is found to be in a country other than that of its incorporation, the directors may find that compliance with the rules of the country of incorporation may not be sufficient to prevent them being liable for civil or criminal liability in the jurisdiction where COMI is established.

6.2 *Directors' Liability*

A wrongful trading action is brought by a liquidator and, as the applicable law in respect of the liquidator's powers will be English law, it would be open to an English liquidator to bring a wrongful trading action against directors of a foreign company which has its COMI in England. The converse may apply where an English company has its COMI in another EC jurisdiction. Should the legislative regime in the country in which COMI is established be harsher than those in the country of its incorporation, the directors may find that proper and legal behaviour under the law of the country of incorporation gives rise to civil or criminal liability abroad.

Directors of insolvent companies may be liable to disqualification under the Company Directors Disqualification Act 1986. Arguably this Act is not part of English insolvency legislation, so disqualification actions may fall outside the ambit of the EC Regulation. In any event, the power to bring proceedings is principally exercised by the Secretary of State for Trade and Industry and only occasionally by the court in pursuance of other remedies against delinquent directors. It should be noted, however, that the courts have the power to disqualify directors of foreign companies when those companies have been subject to insolvency proceedings in England. In other jurisdictions, however, *locus standi* to bring disqualification actions may be in the hands of the liquidator and disqualification provisions may form part of the substantive insolvency legislation.

7. UNCITRAL Model Law on Cross-Border Insolvency ("Model Law")

7.1 *Voidable transactions under the Model Law*

The Model Law, as it is to be enacted in England (and expected to come into force in April 2006), provides that upon recognition of a foreign representative by the English courts, the foreign representative is entitled to bring proceedings in respect of transactions at an undervalue and preferences. As explained above, there are certain periods before the onset of insolvency within which a transaction at an undervalue or a preference has to be effected for it to be challengeable in insolvency proceedings. The Model Law provides that the test for the insolvency is the commencement of the insolvency proceedings in the overseas jurisdiction.

The effect may be that a transaction which is thought to be safe in that administration or liquidation proceedings have not commenced in the UK within the relevant period, might turn out to be voidable if the proceedings overseas commenced within that period. The involvement of a director of a company in approving a transaction at an undervalue or a preference is a matter the court would take into account in considering whether a director should be disqualified from being a director of a company or involved in the management of a company under the Company Directors Disqualification Act 1986. In addition, as mentioned above, the approval of such transactions could lead to a claim for a contribution to the company's assets pursuant to a claim by a liquidator against a director for breach of duty. These are issues the directors will need to take into account when approving transactions, if it is possible that overseas insolvency proceedings may be commenced in respect of the company.

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This paper summarises certain matters in respect of the duties of directors of a company under English Law. It does not and is not intended to provide legal advice, which can be sought from Jonathan Rushworth or any other partner at Slaughter and May.