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The Shifting of the Duties of Company Directors under the Companies Act 2006: Superficial or a Significant Change in the Law

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ABSTRACT

This paper critically assesses whether the enactment of the Companies Act 2006 in England makes a real difference to the duties of company directors. By deducing evidence of court rulings in several cases, the paper suggests that the Companies Act 2006 was necessary to safeguard the governing documents of companies. The paper however, rejects the notion that the Act provides new ways of dealing with company directors in that it simply merged various pre-existing laws and also codified the common law rule of duty of care.

Keywords: English Law, Company Law, Company Directors, Common Law

INTRODUCTION

It is important to acknowledge that the control of discretionary power has been a task faced frequently by administrative law. In consequence a considerable body of case law and academic comments has emerged over the past decade, which addresses the questions intrinsic in the judicial control of discretionary powers exercised by 'public' bodies and public office holders including directors of corporations and companies.[1] It is logical to infer, therefore, that company law, when it too has to face the questions raised by judicial control of discretionary power, leans towards much from administrative law.

A large body of the commentators has observed that, parallels between the control of private and public power have been drawn before, but, somewhat strangely, there has been no sustained attempt in England to use relevant elements of public laws to further understanding of how private law, and in particular company law, might control discretionary power vested in a company board, or in a directory.[2] In the light of the foregoing argument, I shall attempt to pin down the issue as to whether the enactment of the Companies Act 2006 constitutes significant changes in the law.

THE PLACE OF DIRECTORS IN A COMPANY

The need for a company to appoint directors is probably as vital as the need to incorporate the firm. According to Halsbury's Laws of England:

[1] Sealy, L. S and Rider, B.A (2007). The Realm of Company Law, A Collection of Papers in Honour of Professor Sealy by the University of Cambridge. University of Cambridge Working Papers.
[2] ibid

> "The true position of directors is that of agents for the company. As such they are clothed with the powers and duties of carrying on the whole of its business, subject, however, to the restrictions imposed by the articles and any statutory provisions. The intention of the company may be established by its directors, even if acting informally, depending upon the nature of the matter under consideration, the relative positions of the directors in the company, and generally all the circumstances of the case".[3]

Ideally, directors do not act in isolation, therefore, company directors are mutually interdependent with shareholders, who rely on directors to manage the enterprise competently, without taking personal benefits, loyally and on the basis that so far as practicable shareholders are kept informed on matters that are relevant to the company. In the same vein, directors rely on the shareholders to maintain their investment in the company and exercise their powers in respect of decision-making reserved for them in a favourable manner. The legally enforceable duties of directors underpin shareholders' reliance, while directors' reliance is grounded in optimistic, but unenforceable expectations of shareholder support.[4]

DIRECTORS' DUTIES BEFORE THE ENACTMENT OF THE 2006 ACT

Prior to the Companies Act 2006, the delimitation of the scope of power of company directors was confined to the express provisions of the articles of association of the company and Table A,[5] and directors' duties were governed by common law and some statutory requirements which were spread amongst various pieces of legislation. That is, the duties of directors including duty of care and skill are enshrined in the common law rules and equitable principles and also in statutes such as the Companies Act 1985 (the 1985 Act) as amended by the Companies Act 1989. However, these principles though have been well established, they lacked certainty and were not easily accessible.

Historically, the powers of company directors have often been treated under the rule of equity and, the courts do place the directors under fiduciary duties in respect of their use as in *Spackman v Evans*[6] and in *Re London & Provincial Starch Company (Gower's Case)*[7].

By the same token, in *Bristol & West Building Society v. Mothew*[8]; the court characterised '*a fiduciary*' as a person who undertakes to act for another in circumstances that give rise to a relation of trust and confidence.

Appropriate review of *'proper purpose doctrine'* enable the courts to decide as to whether the exercise of a particular power is *'ultra vires'*[9] in ruled in the case of

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[3] See Halsbury's Laws of England/Companies (Volume 7(1) (2004 Reissue) Paras 201-1000; Volume 7(2) (2004 Reissue) Paras 1001-2008)/2. Companies Regulated By The Companies Act 1985/(20) Directors' Duties And Liabilities/(I) In General/1083.

[4] Demott, A (1999) Law And Contemporary Problems, Vol. 62: No. 3, 1999.

[5] See the Companies (Tables A to F) Regulations 1985, SI 1985/805, Schedule, Table A art 70; and para 1085 note 1 post. The directors may also, by power of attorney or otherwise, appoint any person to be the agent of the company for such purposes and on such conditions as they determine, including authority for the agent to delegate all or any of his powers: art 71. As to Table A generally see para 385 ante and Companies Act 2006 ss 171[#8209]177.

[6] [1868] LR3 HL 171

[7] [1868] 6 Eq 77

[8] [1998] 1 Ch

Rolled Steel Products (holdings) Ltd v. British Steel Corporation[10] *and in Hazell v. Hammersmith LBC;*[11]

> "Proper purpose doctrine is concerned with judging the propriety of a purported exercise of power by one or more directors in the light of the purposes, or ends, for which the power in question is used. This means that the doctrine focuses on the objectively ascertained purposes for which the power was conferred, rather than on the desirability, however determined, of the end intended by those purporting to exercise the power, or on possible alternative means of achieving the same end".[12]

The guiding principle of common law has always been that "the directors as a body are under an equitable duty to act *bona fide* in what they consider is in the interests of the company and not for any collateral purpose"[13] for example in *Re Smith & Fawcett Ltd*[14], the court held that directors must act *'bona fide'* in what they consider - not what the court may consider - is in the interests of the company'. Hence, a director as an individual is in a fiduciary position in relation to his company. This has various consequences of equity in that, any contract in which he has an interest adverse to that of the company is voidable in the absence of disclosure, or of authorized in the company's constitution.[15]

In *Regal (Hastings) Limited v Gulliver [1967] 2 AC 134,* and, in *Bamford v Bamford [1970] Ch 202)* it was held that directors' powers should not be exercised to obtain a personal profit.[16] In *Bamford* the directors issued shares to frustrate a takeover bid which was a misuse of their powers. The fact that they were honest and well-intended did not prevent this being a breach of the duty of good faith, since they were mistaken as to the interests of the company as a whole (shareholders are entitled to receive bids), but the transaction being voidable was nevertheless capable of being ratified by the company as the injured party, in the absence of any director's personal gains.[17]

However 'the interests of the company' fails to tests of generic usage in several instances. In *Charterbridge Corporation Ltd v Lloyds Bank Ltd*[18] and, in *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd*[19], it was held that the

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[9] According to Sealy, L. S and Rider, B.A. The Realm of Company Law, A Collection of Papers in Honour of Professor Sealy by the University of Cambridge. University of Cambridge Working Papers; the term *'ultra vires'* is used in the context of company law referring to limitations on the capacity of the company itself and also refers to the limitations on the directors capacity. A director acting outside the 'approved' scope of powers is regarded as acting *'ultra vires'*.

[10] [1986] Ch 246

[11] [1992] 2 AC 1. In this Hammersith LBC case, the Borough is treated as company in that the doctrine of 'ultra vires' applies not only to companies but also to corporations.

[12] Sealy, L. S and Rider, B.A. K, ibid, op. cit.

[13] Sealy, L.S (2001) Cases and Materials in Company Law, 7th edition, London: Butterworths, p.299

[14] [1942] Ch 304, [1942] 1 All ER 542, CA

[15] Ibid, p. 260

[16] Adapted from citation of HMRC at http://www.hmrc.gov.uk/manuals/insmanual/ins48305.htm

[17] With the Companies Act 2006 - What Happened to "Best Interests"? Relation to the Company Directors Disqualification Act 1986 Opinions written by Tolleys Directors Duties on the web at: http://www.companylawforum.co.uk/ posted on Wednesday, 14 November 2007)

[18] [1970] Ch 62

[19] [2003] 2 B.C.L.C. 153

interests of the company may refer to the interest of the corporate body as a separate entity or to those of the shareholders collectively. In essence, prior to the enactment of the 2006 Act, the legal position was that:

> "Directors must act in a way that they believe to be in the interests of the Company and its shareholders, both current and future, as a whole. This duty is owed to the Company itself, and not to individual shareholders. The current Companies Act states that directors are to have regard to the interests of the company's employees in general, as well as the interests of shareholders, but this duty is not owed directly to employees".[20]

Lawyers have always argued that, it is generally upon trust principles that directors are made accountable for their handling of the affairs of the company including dealings with company's property and, like trust property, assets wrongfully disposed of by the directors may be traced into the hands of third parties who have knowingly received it. However, individual directors, unlike individual trustees, may not normally receive property directly into their hands, and their control over company assets arises from the delegation under the articles of association which the shareholders have willingly conferred upon them, not from any strict liabilities imposed by the trust instrument or beneficiaries under disability.[21] Hence, "directors are constructive trustees of misapplied assets and must account strictly for losses which the company suffers"[22]. For example, in *Re Duckwari Plc (No 2)*[23]*;* the company acquired a property asset in circumstances where one of its directors was in breach of the fiduciary obligations (expressed in statutory form as CA (1985, s 320 now CA 2006, s 190) to obtain shareholders' consent for the transaction in which he was an interested party.

The property subsequently fell in value while in the company's ownership. It was held that; the director was personally accountable for the loss, pound for pound, as a fiduciary was obliged to restore assets, or their equivalent value, as if trust funds had been misapplied.[24]

The same principle applies if the asset increases in value. By imposing a person-to-person fiduciary responsibility of a corporate officer it becomes possible to follow assets into the hands of others who are "fixed" with the breach of trust he is treated as having committed.

The issue here is the degree of awareness of the breach that is required to make the third party a constructive trustee. Liability with the benefit of hindsight is a wonderful thing, but a workable distinction has to be drawn between persons who dishonestly receive assets knowing them to be derived from wrongdoing and those who deal with directors in good faith and are not put on enquiry by any suspicious circumstances. More recently, courts have moved away from the "knowing receipt"

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[20] Companies Act (2006) – Directors' duties, GC100 Net Article adapted from the internet at: http://ld.practicallaw.com/1-217-4955

[21] With the Companies Act 2006 - What Happened to "Best Interests"? Relation to the Company Directors Disqualification Act 1986 Opinions written by Tolleys Directors Duties on the web at: http://www.companylawforum.co.uk/ posted on Wednesday, 14 November 2007)

[22] ibid

[23] [1998] EWCA Civ 1795

[24] ibid

test to assess simply whether it is unethical or unconscionable for the third party, in all the circumstances including the business context, to be allowed to retain, at the company's expense, what has become vested in him[25] as in *BCCI (Overseas) Ltd v Akindele*[26].

DIRECTORS' DUTIES UNDER THE 2006 ACT

The Companies Act 2006 restates, with some changes, almost all of the provisions of the Companies Act 1985 (with the exception of Pt 14 (ss 431-453C)), together with the company law provisions of the Companies Act 1989 and the Companies (Audit, Investigations and Community Enterprise) Act 2004.[27] Prior to the enactment of the 2006 Act, there was no minimum age of a director stated in legislation. With effect from 1 October 2008 the minimum age is 16 years. Any directors who are under this age on 1 October 2008 ceasing to be directors and Companies House will automatically update the public register.

The most significant advantage of the Companies Act 2006 is that it codified all the various pieces simplified the directors' fiduciary duties and places a list of such duties in one place. As simply put by *Lord Goldsmith:*

> "…the main purpose in codifying the general duties of directors is to make what is expected of directors clearer and to make the law more accessible to them and to others".[28]

It is argued that the doctrine of "interests of the company" contained in the new law is not significantly different from the previous common law requirements. For instance, Section 172 of the Companies Act 2006 requires directors to exercise their duties to promote the success of the company. Specifically, section 172(1) provides that: "A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

(a) The likely consequences of any decision in the long term,
(b) The interests of the company's employees,
(c) The need to foster the company's business relationships with suppliers, customers and others,
(d) The impact of the company's operations on the community and the environment,
(e) The desirability of the company maintaining a reputation for high standards of business conduct, and
(f) The need to act fairly as between members of the company.

Historically, case law on disclosure and the director's fiduciary duty of loyalty has been unclear, leaving unanswered the awkward issue of balancing the individual's right not to incriminate themselves on the one hand, with the employer's interests on

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[25] ibid
[26] [2001] Ch 437(CA)
[27] See Halsbury's Laws of England/Companies (Volume 7(1) (2004 Reissue) Paras 201-1000; Volume 7(2) (2004 Reissue) Paras 1001-2008)/2. Companies Regulated By The Companies Act 1985/(20) Directors' Duties And Liabilities/(I) In general/1083.
[28] Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 254

the other. In *Sybron Corporation v Rochem Limited*[29], the Court of Appeal established that in some circumstances, a senior employee may be under a duty to disclose the misconduct of other employees to their employer, even if this means revealing their own misconduct in the process. This principle was affirmed in *British Midland Tool Limited v Midland International Tooling Limited and others [2003] All ER (D) 174.* In *Item Software v (UK) Ltd v Fassihi [2005] 2 B.C.L.C. 91,* the issue was developed and clarified to great extent.[30]

In *Item Software,* the defendant was a salaried director of the claimant company, which distributed software products. He was paid monthly in arrears. When the claimant was renegotiating its contract with its main customer the defendant secretly approached the customer, proposing to divert the contract to a company that he had established for his own benefit.[31] The Court of Appeal held that *Fassihi's* position as a director and his fiduciary relationship with his employer meant he had a duty to act in what he, in good faith, considered to be the best interests of the company. This duty included an obligation to disclose his misconduct to his employer. Accordingly, the court said:

> "One route by which it might be concluded that *Fassihi* had a duty to disclose his own wrongdoing is that no logical distinction can be drawn between a rule that an employee must disclose his own wrongdoing and a rule that he should disclose the wrongdoing of fellow employees even if that involves disclosing his own wrongdoing too."

The ruling of Item Software was criticised for failing to consider whether an employee who was not a director would have an obligation to disclose his own misconduct. In *Tesco Stores Limited v Pook and others*[32], the Court suggests that a senior employee is probably under the same duty as a director.[33] The only addition to the common law rules is contained in section 172 (1) which provides that, in exercising those duties, directors must have regard to (amongst other matters) the following six factors:

(a) The likely consequences of the decision in the long term;
(b) The interests of the company's employees;
(c) The need to foster the company's business relationships with suppliers, customers and others;
(d) The impact of the company's operations on the community and the environment;
(e) The desirability of the company maintaining a reputation for high standards of business conduct; and
(f) The need to act fairly as between members of the company.

[29] [1983] 2 All ER 707
[30] Adapted from online article at: http://www.personneltoday.com/articles/2005/02/03/28418/disclosing-misconduct.html
[31] Adapted from ICLR
[32] [2004] IRLR 618
[33] The comments of the High Court in *Tesco v Pook* is mere *obiter* and did not form part of the decision and so are not legally binding. However, they do indicate the direction in which the law on this subject is evolving.

However, it must be noted that these factors are ancillary to the provisions of section 172, and that the duty is owed only to the company, not to individual shareholders or to third parties.

It is also arguable that the duty to exercise independent judgement contained in Section 173 is derived from the common law principles and pre-existing rules. Section 173 of the Act imposes a positive duty on a director of a company to exercise independent judgment. The section has two elements inter alia:

(a) A director must first exercise a judgment; and,
(b) He must exercise the judgement independently.

Observers have noted that, this rule would impinge on so-called ‘sleeping directors’ who play no active role in the management and leave decisions to others. By analogy, this would impact on ‘shadow directors’. Because, if a director is to exercise independent judgment, then there will be no scope for shadow directors.

However, the government has confirmed in debate at the parliament that a director will not be in breach of this duty if he exercises his own judgment in deciding whether to follow someone's else’s judgment on a matter. In addition, this duty is not infringed upon if a director acts in accordance with an agreement that was duly entered into by the company. It remains to be seen how in practice this rule will impact on a director.[34]

Similarly, section 174 (1) codifies the common law rule of duty of care and skill. Section 174 (2) mirrors s. 214 of the Insolvency Act 1986 by prescribing that the degree of ‘care, skill and diligence’ expected from a director is akin to the care, skill, diligence that would be exercised by a reasonably diligence person.

Section 250 defines ‘director’ as including ‘any person occupying the position of director, by whatever name called’ this means that the general duties apply equally to *de facto* directors. However, the position with shadow directors is unclear. In section 170 (5) shadow directors are subject to the duties to the extent that, before the Act, they were subject to the corresponding common law rules and equitable principles. It has been a ‘grey’ area of the rules in that, the mere fact that a person is a shadow director, and exercises indirect influence, is not enough to impose fiduciary duties as in *Ultraframe (UK) Ltd v. Fielding.*[35]

It is important to note that the duties may continue after a person has ceased to be a director. In *Shepherds Investments Ltd v Walters* [2006] EWHC 836 (Ch); it was held that the former directors of the claimant investment companies were in breach of their fiduciary duties and in breach of their obligation of loyalty by virtue of the steps they had taken prior to their resignation to promote the establishment of a competing business. In this case, the court held that the duty of the former directors arose both from their position as a fiduciary, and by reason of the implied term of fidelity.

The judgement in *Shepherds* partly stems from the *rule of equity* also described as *‘proper purpose doctrine’* being an independent common law basis on which the courts may review the purported exercise of power by a board of directors or by a director. In reviewing the said powers, the court considers the nature of the

[34] Bytestart Companies Act 2006 Articles , Online document of Sykes Anderson LLP Solicitors, “Companies Act 2006 and Directors Duties” adapted online from:
http://www.bytestart.co.uk/content/legal/35_2/companies-act-directors-duties.shtml

[35] [2005] EWHC 1638. Also discussed in Sealy, L, and Worthington,S (2007) Cases and Materials in Company Law, 8th Edition, Oxford: University Press

power in question and determines the mechanisms by which remedies for impropriety may be sought.

Sections 175 and 176 of the 2006 Act affirm the continuity of duties even when the person(s) ceases to be a director. These sections apply to the extent stated in section 710 (2), and subject to 'any necessary adaptation, indicating that the courts may be flexible as in *Industrial Development Consultants Ltd v Cooley*[36] and in *CMS Dolphin Ltd v Simonet.*[37]

Section 170 (3) explicitly explains that the general statutory duties replaces the common law rules and equitable principles from which they are derived hence, actions against directors will have to be based on breach of some of the statutory provisions, and not breach of related common law rules and equitable principles. To assist the courts to make sound judgements, Section 170 (4) requires the new law to be interpreted by reference to pre-existing common law and equitable principles (that is, in continuance of the development of the common law rules and equitable principles upon which the new statute is based).[38]

CONCLUSION

Despite the argument that the Companies Act 2006 is superficial, and that it does not make any real change to directors' duties; Arguable, it has provides for the "transition of directors' general duties from common law rules and equitable principles to statutory duties"[39] and the codified directors duties to encourage the success of the companies in England[40] though for the companies to benefit fully from the 2006 Act, it will require some amendment to certain aspects of articles of association for example express provisions are needed where the existing provisions in the articles fails to reflect the new statutory regime, such amendment will be at the expense of the companies.

Companies Act 2006 provides a "safe mechanism" to the effect that where a company articles contain provisions dealing with conflicts of interest, the general duties will not be breached by anything done, or omitted, by the directors in accordance with any such provision. A company could, for example, provide that a director will not be in breach of his duty if he does not disclose to the company confidential information of a third party which he obtains as a result of an authorised conflict situation.[41]

The 2006 Act is widely criticised for;

> "Lacking guidance to the weight to be given to each factor and how conflicts between the factors should be resolved. It will be up to the directors to exercise their good faith judgment to resolve any conflicts that may arise between the different factors. Directors will clearly have difficulties over such conflicts, such as decisions relating to short-

[36] [1972] 1 WLR 443
[37] [2001] 2 BCLC 704
[38] ibid
[39] Davidson, R (2007) The Companies Act 2006: Directors' duties and promoting the company's success, Journal of International Banking and Financial Law, Issue 11, December 1.
[40] ibid
[41] Caveat adapted from Salans Legal Briefings 2008, found at www.salans.com

term benefits, employees, community and environmental matters."[42]

Despite the codification of directors' fiduciary duties in sections 171 to 177 (the codified duties) of the 2006 Act, the new legislation fails to clearly identify all the duties that a director may owe to a company. The implication of this 'loop-hole' is that, some duties will still remain at common law (such as the duty to take into account creditors if an insolvency situation may be likely) and other duties are to be found elsewhere in the Act (such as the duty to file annual accounts or hold an annual general meeting).

It is unlikely that the outcome of the cases decided prior to the enactment of the 2006 Act (for example: *Item Software* and *Ultraframe (UK) Ltd*)) would have been different under the new legislation in the sense that the Companies Act 2006 is largely a piece of legislation which amalgamated pre-existing common law and statutes. As such, the interpretation of much of the act depends on an understanding of the original common law and equitable principles as stipulated in Section 170 (4) of the Act.

In my opinion, the amalgamation of various pre-existing laws and codification of the common law rule of duty of care and skill does not constitute significant changes to the law. However, the new law is a positive milestone in legal development of that company directors are now under statutory obligations where they were once under the common rules. In s. 170 (3) the general statutory duties replaces the common law rules and equitable principles from which they are derived. This will probably deter company directors from reckless negligence and wilful omissions and likely compel them to be more compliant with the statutory provisions.

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