A QUICK GUIDE TO DIRECTORS' DUTIES AND LIABILITIES

Introduction

The duties and liabilities of Directors are governed by a variety of sources. These include the general law and in particular, the Companies Act 1985 ("the CA 1985") and the Insolvency Act 1986 ("the IA 1986"). Other sources include the Articles of Association which contain detailed instructions as to how the company will work setting out the internal management structure of the company as well as Directors' Service Contracts. Where Directors are to work for a company not just as Directors but in some other full time capacity, they are likely to enter into a contract of employment which details the duties owed by them to the company.

General Duties

Directors' are essentially agents of a company in that a Director acts not on his own behalf but that of the company. A Director's principle duties therefore are owed to the company and not to the shareholders.

Directors' have the duty of managing the whole of the company's business including taking business decisions and entering into contracts on behalf of the Company. Directors' exercise these powers by passing resolutions at Board meetings.

Key Duties

The duties and liabilities of Directors set out here are largely towards the shareholders of a company and towards other third parties.

Directors' duties can be categorised into 3 broad areas namely *duties of skill and care*, *fiduciary duties* and *statutory duties*. Each of these will be considered in turn.

Duty of Skill and Care

A Director owes a duty to the Company to use a reasonable level of skill and care in carrying out his functions.

The IA 1986 sets out the standard of care and skill to be applied to Directors. A Director is expected to have the level of skill and experience which could be reasonable expected from a person carrying out the same functions that are carried out by that Director in relation to the company and the level of skill and experience that that particular Director has. Therefore, a higher standard is imposed on a Director who is professionally qualified such as a Finance Director than on a non-executive Director.

Directors' have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the Company's business to enable them to properly discharge their duties as Directors. The level of duty depends on the role in the management chain of the company assigned to a particular Director and by reference to his duties and responsibilities in that role. As seen above, the level of participation in managing the company's affairs required of executive Directors will generally be greater than that of non-executive Directors.

Whilst Directors' are entitled (subject to the company's Articles of Association) to delegate certain functions to junior members of the management chain and to trust their competent and integrity in carrying out such functions, the exercise of this power of delegation does not release him from the duty to supervise the functions being discharged. The extent of the duty to supervise will again depend on the facts surrounding a certain Director, in particular, his role in the management of the company.

Fiduciary Duties

These fall into 2 broad categories namely a *duty to act in good faith* and a *duty not to make a secret profit.* Both involve high standards of propriety of a Director.

i. Duty to exercise powers of Director in Good Faith

   There are 3 elements to this duty:-

   - A duty to act in good faith

     A Director has a duty to act in good faith in what he considers are the best interests of the company and not for any collateral purpose. His duty also includes making full and honest disclosure to the shareholders of the company before he votes on any resolution. A Director's duty to act in the best interests of the company includes an obligation to have regard to the interest of the company's creditors generally when the company is facing insolvency at which point, the interest of the company's creditors becomes paramount.

   - A duty to exercise powers for their proper purpose

     A Director is a fiduciary agent for the company in that he acts not on his own behalf but that of the company. Therefore, a Director owes a duty to the company to exercise independent judgment accordingly.

     A Director must exercise his powers only for the purposes for which they have been given by the Articles of Association of the Company and should not exceed or abuse these powers. Also, a Director should use the powers he has been given only for the purpose for which they have been given and not for an unauthorised purpose.

   - A duty to avoid conflicts of interest

     A Director as fiduciary is not allowed to enter into any engagements in which he has or can have a personal interest conflicting or potentially conflicting with the company the interest of whom, he is bound to protect.

ii. Duty not to make Secret Profit from office of Director

   In relation to company property, a Director's position is similar to that of a trustee in that a Director controls the company's assets and exercises his power for the company's benefit, not his own. A company's property includes not only money but also tangible assets and confidential information such as trade secrets and details of business opportunities. If any of the company's property is misapplied, a Director is answerable as a trustee.

This duty is a strict one and prevents a Director from using his position for personal gain even if the company itself would not profit from an opportunity, which comes to the Director through his office. For example, if a Director gained information about an attractive business opportunity having gained this information solely because he is a Director of a Company, then he cannot use that information to his own advantage i.e. by entering into the contract in his own name and take profit from it regardless of whether or not the company would have entered into the contract itself.

A Director who makes unauthorised profits in breach of his fiduciaries duties may be liable to pay to the company the amount of the unauthorised profits and where dam age to the company has occurred as a result of a Director's negligence, he may be liable to pay damages for such additional loss suffered by the company.

Statutory Duties

Various duties are imposed on Directors' by the CA 1985 some of which, are detailed below.

i. Disclosure of personal interests in contracts

If a Director has a personal interest (direct or indirect) in any contract or arrangement which the company is considering entering into, he must formally declare such an interest to his co-directors. Such disclosure should be made at the first Board meeting after which the interest arises or when the Director becomes aware of the proposal. Such personal interest includes those of spouses, minors and other companies in which a Director has a material shareholding.

If a Director fails to disclose an interest, he is liable to a fine. Also, the company may be entitled to refuse to honour the contract or arrangement and if any money has been received by the Director, the company may be able to demand repayment.

ii. Service Contracts

Shareholders have the right to inspect the terms of Directors' service contracts at the registered office of the company.

iii. Annual Accounts

Directors' are responsible for ensuring that full accounts are produced each year and that they are sent to all shareholders within 10 months of the company's accounting reference date. The accounts must also be sent to Companies House each year and therefore become a public document open to public inspection.

iv. Annual Return

Directors' are also responsible for submitting an annual return to Companies House within 28 days after its "return date" (the date to which the annual return is made up). The purpose of the annual return is to ensure that information kept at Companies House is kept up to date

Directors' Liability

This varies depending on whether the liability is to the company or to outsiders.

Liability to the Company

Such liability can take many forms:-

i. Liability for ultra vires acts

   If the Directors' make the company party to an ultra vires transaction (a transaction that is not within the scope of the company's permitted activities as stated in the Objects clause of the company's Memorandum of Association), they are acting in breach of duty and are therefore liable to indemnify the company for any loss it has suffered because of the ultra vires act and to account to the company for any profit they have made as a result.

   The Directors' can be excused from such liability if the shareholders are prepared to pass 2 special resolutions ratifying the ultra vires act and indemnifying the Directors' against any liability.

ii. Liability for exceeding actual authority

   Where a Director binds the company by acting within his apparent authority, but exceeds his actual authority, that Director is acting in breach of duty. Such a Director is liable to indemnify the company for any loss it has suffered and to account to the company for any profit he has made.

   Again, the Director's action resulting in the breach of duty can be sanctioned by the company if the shareholders agree to ratify the breach of duty by passing an ordinary resolution to that effect.

iii. Declaration of dividends

   Directors' can be liable to the company for a dividend which was wrongly declared even though they did not benefit from it personally.

Liability to Outsiders

Generally, Directors' have no liability for any debts they incur on the company's behalf except in the case of misconduct on the part of the Director. However, there are situations where a Director can incur personal liability such as those set out below:-

i. Breach of warranty of authority

   Where a Director acts on behalf of the company but is acting outside his actual or apparent authority, his actions will not bind the company. The third party however will have the right to pursue the Director for any loss suffered as a result of this lack of authority.

ii. Wrongful Trading

   If a company is facing insolvent liquidation and a Director fails to take all steps to minimise loss to creditors of the company at a time when he knew or ought to have known that there was not reasonable prospect of the company avoiding insolvent liquidation, then the IA 1986 provides that such a Director is liable for wrongful trading if the company goes into liquidation. The result of this is that the Director can he required to contribute to the assets of the company to increase the amount available to pay creditors.

iii. Fraudulent Trading

This involves continuing to incur debts with the intention of defrauding creditors i.e. with the intention that creditors will not be paid. If a Director is knowingly party to fraudulent trading, he can under the IA 1986 also be expected to contribute to the assets of the company as above.

iv. Personal Guarantees

Where a Director has personally guaranteed a loan to the company and the company breaches the terms of the loan agreement, the lender has the option of enforcing the guarantee against the personal assets of the Director.

v. Failure to maintain Company Records

Directors' must maintain proper and up-to-date records at Companies House and within the company itself in terms of the company's statutory books. Failure to do so renders Directors' liable to a fine.

This note is intended to provide a brief summary of the principal duties of Directors' in England and Wales and the situations which may give rise to them incurring personal liability. The list however is not intended to be comprehensive nor intended to provide any specific legal advice and therefore, should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

If you would like any further information or specific advice please contact Rajwant Kaul or Raymond Taylor.

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