



## LEGISLATION IN BRIEF

### *The Companies Act 2006 Directors Duties and the New Derivative Action*

One of the most publicised changes under the Companies Act 2006 is the codification of directors' duties. This note provides an overview of these key provisions. In addition, the Act contains new statutory provisions for derivative actions, another important change for companies and their directors. The new derivative action provisions are also outlined briefly in this note.

#### **The general duties of directors**

These are set out in sections 170 to 177 of the Act. One fundamental aspect has not changed; a director's duties are explicitly owed to the company of which he is a director. Section 170 states that its provisions are merely a codification of the existing law: *"the general duties are based on certain common law rules and equitable principles... and have effect in place of those rules..."* and *"the general duties shall be interpreted and applied in the same way as common law rules or equitable principles and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties"*.

#### **Significant changes under the new Act**

- The duty to promote the success of the company and the list of factors to which directors must have regard
- The statutory provisions for derivative actions

#### **Specified duties**

There is further familiar territory in the duties:

- to exercise independent judgment (s.173);
- to exercise reasonable care, skill and diligence (s.174). This uses the definition from the Insolvency Act, which is regarded as reflecting the position at common law: "(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has";

- to avoid conflicts of interest (section 175); a conflict for a private company may be authorised by the directors, public company boards may do this as well as long as the company's articles give them authority to do so;
- not to accept benefits from third parties (section 176); and
- to declare an interest in a proposed transaction or arrangement (section 177).

While the duty to exercise reasonable care, skill and diligence is a general principle to be applied to specific directors and specific circumstances, section 172 of the Act contains a specific new duty; the duty to promote the success of the company. The duty to promote the success of the company.

This much debated section is intended to reflect what are termed "enlightened shareholder values".

Under Section 172 of the Act a director's duty to promote the company's success will involve considering, amongst other factors:

- the likely long term consequences of a decision;
- the interests of the company's employees;
- relationships with the company's trading partners;
- the effect of the company's operations on the community and the environment;
- the desirability of maintaining the company's reputation for high standards of business conduct; and
- the need to act fairly as between members.

Inevitably there will be conflicts, for example:

- a commercial decision to close an unprofitable operation may result in redundancies and have an adverse effect on the local community;
- a profitable opportunity may have adverse environmental consequences.

While success may not be reflected in profit alone, the only claim which may be made for breach of duty under the legal principles which the Act says shall continue to apply, is for loss and loss is a purely financial concept. Conversely the duty to promote the success of the company may free directors to make decisions which are not purely based on immediate profit. If the board decides to invest in a more expensive process which has environmental or social benefits, then they can point to those provisions in defence of their not having pursued pure financial success.

## **Derivative Actions**

A derivative claim is defined as a claim by a shareholder:

- in respect of a cause of action vested in the company; and
- seeking relief on behalf of the company.

Derivative actions have previously been, in practice, infrequent and the law relating to them was complex and, in some important areas, uncertain.

When a Derivative Claim may be brought

Section 260(3) provides that a derivative claim:

*"may be brought only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company."*

Despite the use of the word "only", this is a significant widening of the circumstances in which a derivative claim can be brought compared with those at common law, as it potentially extends to a breach by a director of any of the duties set out in Sections 171-178 of the Act. In addition, the reference to "proposed" actions envisages the possibility of seeking an injunction to prevent a proposed action of the directors.

Section 260(4) of the Act provides that a derivative claim can be brought by someone who is not a shareholder at the time of the action complained of. This gives rise to the possibility that someone may acquire shares in a company which is in difficulties and then seek to bring a derivative claim against the directors who were said to be the cause of them. It should, however, be emphasised that any recovery from a derivative claim represents the loss to the company and goes to the company, not the shareholder which brings the claim.

A derivative claim can also be brought against a former director or a shadow director.

### **Likely effect**

The new rules relating to derivative claims will potentially expose directors to a wider range of possible claims, but the real issue will be where a claimant can demonstrate a credible case that a director's actions or lack of them have caused, or will cause, loss to the company. This possibility of a derivative claim may become another factor which will influence discussion between major investors and management; the threat of the cost and disruption caused by a potential derivative claim will be something which cannot be ignored.

#### **Control by the Court**

While a shareholder can commence a derivative action, there are two levels of control, exercisable by the court.

- The shareholder bringing the claim must get permission from the court to continue it and the Court must refuse permission if it considers that a prima facie case (undefined) for giving it has not been made. If permission is granted, it may give directions to provide evidence.
- If the shareholder passes the first test, the court may, in considering the evidence, give or refuse permission for the claim to be continued. A number of criteria are laid down in the Act.

**For further information on The Companies Act 2006, Directors Duties and the New Derivative Action please contact Robert Haldane, Corporate, Stephenson Harwood on +44 (0)20 7809 2176 or email: [robert.haldane@shlegal.com](mailto:robert.haldane@shlegal.com)**