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Directors general duties under the Companies Act 2006

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1. Introduction and background

This guidance has been produced primarily for quoted public companies that are looking to provide directors with practical guidance on their general duties under the Companies Act 2006 (the Act). However much of the note can also be applied to private companies. It is important to note that directors will have obligations and responsibilities beyond the general statutory duties covered in this guidance.

Directors' general statutory duties are set out under sections 171–177 of the Act, with supplementary provisions set out under sections 178–182. The individual duties are not to be looked at in isolation because, as section 179 states, more than one of the general duties may apply in any given case. Directors must act in accordance with their company's constitution and companies may, through their Articles of Association (Articles), go further than the general duties by placing more onerous requirements on their directors. However, the Articles may not dilute the duties set out in the Act except to the extent that this is permitted by sections 173, 175, 180(4) (a) and (b) and 232[1] .

These general duties are owed to the company, for the benefit of members as a whole; not directly to its shareholders. If a director breaches their duties, they could face civil action and, in some cases, criminal sanction. For example, section 183 makes it a criminal offence for a director to fail to comply with the requirements of section 182 (declarations of interest) and, under Part 11 of the Act, members can, in certain circumstances, bring a derivative claim against an individual director on behalf of the company. The general duties are owed by a de facto director or shadow director in the same way and to the same extent that they are owed by a properly appointed director.

Although, in general, a director will not continue to owe the general duties to the company once they cease to hold office, certain aspects of the duty to avoid conflicts of interest and the duty not to accept benefits from third parties continue to apply even when a person is no longer a director.

[1] These sections permit directors to act in accordance with:

a) an agreement duly entered into by the company that restricts the future exercise of discretion by its directors, or in a way authorised by the company's constitution; or
b) the company's articles or any rule of law; and allows conflicts of interest that have been authorised by the directors, or where the situation cannot reasonably be regarded as likely to give rise to a conflict of interest.

2. The key elements of the provisions under the Companies Act 2006 and practical guidance for directors

2.1 Section 171: Duty to act within powers

2.1.1 This section sets out a director’s duty to comply with the company’s constitution and only exercise powers for the purposes for which they are conferred.

2.1.2 A director should exercise their powers only in accordance with the terms for which they were granted and for a proper purpose. What constitutes a proper purpose must be ascertained in the context of the specific situation under consideration.

2.1.3 **Practical guidance**: It is important for directors to appreciate that the liability for not complying with the company’s constitution is strict. Here are some examples to think about:

- Formal procedures should always be followed when a meeting of the board is held, with a distinction always being made between a meeting of the board or a formally constituted committee of the board and other meetings involving directors, such as a chief executive’s senior management committee which assists them in the exercise of their personal delegated financial and/or other authority from the board. Having a clear and comprehensive schedule of matters reserved for the exclusive decision of the board of the company and of subsidiaries may help to provide clarity on what may and may not be decided outside board meetings.

- Directors should be conscious of their company’s Articles and the powers in the constitution. For example, this is relevant when considering the issuing of shares, the situations where the directors should be referring to shareholders, and the rules for establishing a quorum.

- If in doubt, directors should always seek the advice and guidance of the company secretary.

2.2 Section 172: Duty to promote the success of the company

2.2.1 The overriding duty, as set out in section 172, is that a director must act in the way he considers, in good faith, will be most likely to promote the success of the company for the benefit of its members as a whole. In doing so, he must have regard (amongst other matters) to the six factors below. Examples of decisions where a factor may be relevant are given in each case.

a. The likely consequences of any decision in the long term. Examples may include a pharmaceutical company cutting its research and development budget.

b. The interests of the company’s employees. Examples may include closing down a plant, leading to redundancies among the existing staff; fair remuneration practices such as the ratio of employee pay to executive pay; the management of any deficit in the company's defined benefit pension fund; the level of any dividend payments to shareholders and investment in the business.

c. The need to foster the company’s business relationships with suppliers, customers and others. Examples may include the finance department proposing a tightening of supplier terms of trade in order to improve cash flow.

d. The impact of the company’s operations on the community and the environment. For this it is first necessary to identify the community or communities of which the company is a part. Examples may include the board of a bank needing to consider the impact on the community in certain localities of a proposed programme of branch closures, or the impact of the company's operations on the environment.

e. The desirability of the company maintaining a reputation for high standards of business conduct, such as the need for directors to consider the reputational risks involved in the company's activities.

f. The need to act fairly as between members of the company, for example when considering the structure of corporate transactions, share issues, takeover offers, or equality of access to information. The website is possibly a useful way to address the latter potential inequality. If the directors are also shareholders, or represent one or more major shareholders, they should recognise their duties as directors are owed to the company and should be exercised for the benefit of its members as a whole.

2.2.2 The list of factors is not exhaustive and directors should consider 'other matters' which would include any other stakeholders or factors relevant to the company's circumstances and which could impact the success of the company.

2.2.3 At times these six factors, and any other matters or other stakeholders that are being considered, may be in conflict but the key issue for the setting of strategy, decision-making, or approving policies is that the directors should choose the action that they believe will promote the overall success of the company for the benefit of members as a whole, even if that may sometimes have a negative impact on one or more of the six factors.

2.2.4 **Practical guidance**: Some key practical points to note are:

- Directors should not attempt to balance the interests of the company and those of other stakeholders. The six factors and any 'other matters' discussed above are matters to which directors must ‘have regard’ but, ultimately, directors should comply with the overriding duty to 'promote the success of the company for the benefit of the members as a whole'. For most commercial companies, success will often mean a long-term, sustainable increase in value but traditional considerations such as profitability, viability and the financial effects on the company and its shareholders, remain of critical importance. Of course, where the purpose of the company is not explicitly commercial, success may be otherwise defined.

- To fulfil its duty to have regard to the six factors, the board must take into account the workforce, customers, suppliers, government and regulators, and wider stakeholders in each case where relevant.

For additional guidance on how boards should approach meaningful stakeholder engagement please see the Institute's guidance note *The stakeholder voice in board decision making* at https://www.cgi.org.uk/knowledge/resources/stakeholdervoice

- In the decision-making process there is generally no absolute wrong or right approach; the directors must make a judgement in good faith for the success of the company having regard to all the information and having taken advice when appropriate. It is important that consideration of the factors set out in section 172 are embedded within the culture and policies of the organisation, and taken into account in decision-making at all levels.

- Papers written for the board, which are not merely information papers, need to include relevant details and refer to the six factors, and any other factors or stakeholders where they are applicable to the decision being made, but not in circumstances where any of those factors does not arise. In order to ensure that this happens, it is recommended that each person below board level responsible for writing board papers should understand the implications of section 172 for board decision-making and the circumstances in which reference should be made to the six factors, or any other factors or stakeholders.

- The minutes should record decisions taken but do not necessarily need to give detail on how each factor was considered, particularly where the company provides the relevant information in the board papers.

- A system of reviewing board papers before they are included in the board pack is good practice, and this should cover a check that the factors regarding a decision that are relevant to directors’ duties have been adequately considered and, where relevant, covered in the paper. This review process would normally be coordinated by the company secretary. Ensuring that all the factors relevant to directors' duties are covered in board papers will assist companies in complying with reporting requirements (see part 4 below).

- The directors’ obligations in relation to their duties in sections 171–177 and, in particular, to the six factors described under section 172, and their non-exhaustive nature, should be brought to the attention of all directors on appointment.

- The directors of quoted companies are required to report in the strategic report on how they have discharged their duty under section 172, including how they have taken the six factors into account and, in particular, how they have engaged with employees. See part 4 below for further detail on reporting requirements.

- The application of section 172 will depend upon the purposes of the company. Where a company's purposes are other than promoting the interests of the members, for example a community interest company or a charity, section 172(2) allows for directors to act so as to achieve these purposes in the discharge of their duty under section 172.

2.3 Section 173: Duty to exercise independent judgment

2.3.1 This section reflects the principle that a director must exercise their judgment independently of the influences of others.

2.3.2 The provision explains that this duty would not be infringed by a director if they are acting:

a. in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by its directors; or

b. in a way authorised by the company’s constitution.

The circumstances under (a) above include a previous collective board decision.

2.3.3 Practical guidance:

- A director should ensure that they do not allow personal interests, for example in a particular contract, to affect the exercise of their independent judgment in the interest of the company. A director should ideally excuse themselves from any meeting at which a decision is to be taken in respect of their own property or interest. This is also relevant when the director is considering conflict of interest duties under sections 175–177.

- Importantly, where someone is an executive director, they must not, without due consideration, promote a collective executive line, but should give the board the benefit of their own independent judgment, including their appreciation of the risks involved in a particular course of action.

- This duty does not prevent a director from exercising their power to delegate but they must do so appropriately and still exercise their own judgment in deciding whether to follow the action suggested. They should not abrogate all responsibility.

- Similarly, a director would not be prevented by this duty from seeking legal or other professional advice (and, indeed, where needed should do so) but, ultimately, the director’s final judgment would need to be independent. The extent to which they rely on any external advice should be reasonable in the circumstances.

- A director associated with a major shareholder should set any ‘representative’ function aside and make decisions on their own merits. This is of particular importance in joint venture situations where there may be constraints imposed by joint venture agreements. However, as set out under 2.3.2 above, this duty is not infringed by a director acting in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by directors.

- Likewise, a director who is a family representative in the business may consult their family but must be clear that they will make the final decision.

- A director of a subsidiary would need to take into account the interests of the parent company and other group companies, where relevant, provided the exercise of their power remains in the interests of the company of which they are a director. This might apply for instance in relation to a transfer of assets within a group. This could, and should, lead to tensions between the subsidiary board members and colleagues where actions are proposed that may be in the interests of the parent but not of the subsidiary company.

2.4 Section 174: Duty to exercise reasonable care, skill and diligence

2.4.1 A director owes a duty to the company to exercise the same standard of care, skill and diligence that would be exercised by a reasonably diligent person with:

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 (an objective test); and

b. the general knowledge, skill and experience that the director has (a subjective test).

2.4.2 **Practical guidance:** The use of both tests means that each director must exercise their duty to a minimum standard, as required by the objective test, with the standard being raised under the subjective test if that director has specific skills or expertise relevant to the particular matter or decision in hand. So if, for example, a non-executive director has an accounting qualification, they would be expected to exercise more active scrutiny of the accounts (such as on the appropriateness of accounting policies) than a director without such a qualification.

2.5 Section 175: Duty to avoid conflicts of interest

2.5.1 This section of the Act provides that a director must avoid a situation in which they have, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. This duty includes both a conflict of interest and a conflict of duties and applies in particular to the exploitation of any property, information or opportunity, whether or not the company is able to take advantage of the property, information or opportunity.

The duty is not infringed if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest or if it has been authorised by the directors.

Section 175(3) states that the duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company. Transactions or arrangements with the company are dealt with under section 177 (in the case of proposed transactions) or under section 182 (in the case of existing transactions). Directors have a duty to declare conflicts of interest relating to transactions unless an exception specified under those sections applies.

2.5.2 **Practical guidance:**

- **Private companies**: Directors who are independent of the conflict may authorise it, unless there is a provision in the company's constitution stating otherwise. In practice it would be rare for there to be a provision requiring authorisation to be given by the members except perhaps in the situation of a management buy-out.

- **Public companies**: In order for directors to be able to authorise a conflict of interest, the company's constitution must include a provision enabling this. Authorisation must be given by directors who are independent of the conflict.

- Directors should remember when authorising a conflict of interest that they must consider whether their action is most likely to promote the success of the company – see section 172. When a director has a potential conflict of interest in a particular activity, authorisation may be given by the non-conflicted directors but, as section 175(6) states, the authorisation is only effective if that director, along with any other "interested director", is ignored for the purposes of the quorum and voting on any board resolution to authorise the matter. It is good practice for a conflicted director to leave the meeting when discussions take place on matters in which they have a conflict.

- Another practical point to consider is whether a director who has the opportunity to take on a new directorship outside the company has a problem in relation to this duty. Multiple directorships would not necessarily need to have formal authorisation from the board – in each case a director should consider whether having multiple directorships is likely to give rise to a conflict of interest or duties, or materially affect the time that a director is able to commit to each company. Where a company is subject to the UK Corporate Governance Code 2018, Provision 15 requires that all other appointments have prior approval of the board.

- Furthermore, it is recommended that each director should consider whether they have a conflict of interest through an interest of a connected person. It is therefore important that the director informs those individuals that would be regarded as connected persons of their appointment and reviews any potential conflicts. A list defining connected persons can be found in section 252. Essentially these are certain family members and certain companies, trustees, partners and firms with legal personality with which the director is connected.

- The board needs to consider how it is approaching conflicts of interest. Many companies have a register documenting all interests for each director, which is reviewed by the board periodically. It is essential that any potential conflicts of interest are presented to the board and authorised before any related activity commences.

- Likewise, any activities of a new director that are potential conflicts of interest should be disclosed to, and approved by, the board before the director's appointment.

2.6 Section 176: Duty not to accept benefits from third parties

2.6.1 A director must not accept a benefit from a third party that is conferred because of their being a director or their doing or not doing anything as a director. However, only those benefits which could reasonably be regarded as likely to give rise to a conflict of interest fall within the scope of this duty.

2.6.2 The Act does not permit the acceptance of benefits which fall within the ambit of this section to be authorised by the board. The acceptance of a benefit can, however, be approved by the company’s members.

2.6.3 **Practical guidance**: This duty opened up some interesting debates on how far these ‘benefits’ may extend, particularly as 'benefit' is not defined in the Act. Some benefits are easily identified, for instance financial rewards or money’s worth such as tickets to prestigious sporting or cultural events. Questions arise as to how far this duty covers the giving or receipt of corporate hospitality. Whether the giving or receipt of corporate hospitality may be considered as creating a conflict of interest should be decided according to the context in which it is given or received, which may include looking at the level of benefit received, the surrounding circumstances and any associated expectations as to the future conduct of the recipient. In practice, most companies take a cautious approach. The following should be considered:

- If a director is currently involved in negotiating a new contract with another person or company and that party offers corporate hospitality it may be considered to infringe this duty.

- Appropriate policies should be developed which outline how to deal with benefits offered by or received from third parties and which state what levels of corporate entertainment are deemed to be significant for this policy or which need prior authorisation. The policies (including any updates) should be approved by the board, perhaps on a recommendation from the audit committee. All relevant employees and contractors should be informed of the policy and any updates and, for the company's protection, procedures should be in place to remind them of their obligations annually.

- It is good practice to set up a register of benefits offered and received above whatever level is decided on by the board. It is suggested that the company secretary should report annually to the audit committee on compliance and any issues arising.

2.7 Section 177: Duty to declare an interest in a proposed transaction or arrangement

2.7.1 This section requires a director to declare to the other directors any interest, whether direct or indirect, in a proposed transaction or arrangement with the company. The extent of the interest must also be declared. However, section 177(6) states that a director does not need to declare an interest if it cannot reasonably be regarded as likely to give rise to a conflict of interest. Section 177(5) makes it clear that there is no breach of duty if the director is not aware of an interest, transaction or arrangement and the matter is not something of which they ought reasonably to have been aware.

2.7.2 Some companies may wish to require shareholder approval for such a procedure and, if so, will need to include appropriate provisions in their Articles.

2.7.3 A director is not required under this duty to disclose facts of which the other directors should already be aware or ought reasonably to be presumed to be aware. If a director becomes aware that some of the information declared is not accurate or complete before the transaction or arrangement has taken place, they must ensure that they correct the initial declaration so that it is accurate.

2.8 Section 182: Declaration of interest in existing transaction or arrangement

2.8.1 A director is required to declare an interest, whether it is direct or indirect, in any existing transaction or arrangement into which the company has entered. If that director has already declared an interest in the transaction or arrangement and that information has not changed, then they will not need to make a further declaration. As with section 177, the director would still need to make a declaration, even if not party to the transaction or arrangement, where they have an indirect interest. However, there is no breach of duty if the director is unaware of an interest in an existing transaction or arrangement.

2.8.2 Practical guidance:

- Section 183 provides that it is a criminal offence if a director fails to comply with the requirements of section 182.

- A director only needs to declare any interest that could reasonably be regarded as likely to give rise to a conflict of interest. The declaration must be made to the directors at a meeting of the directors, or by notice in writing under section 184 or general notice under section 185.

- A director would not need to declare an interest if the directors already knew about, or ought reasonably to have known about, a transaction or arrangement. Furthermore, directors do not need to declare an interest if it is in relation to terms of their service contract or remuneration that have been or are to be considered by the directors in a meeting or by a committee of the directors appointed for that purpose under the company's constitution.

3. Consequences of a breach of duties

Directors who are found to be in breach of their general duties as described above may face a claim brought by the company or, in certain circumstances, a derivative claim brought by a member on behalf of the company. In such cases a director may, amongst other things, be liable to pay damages to the company, account for any profits made by the director and may be removed from office and disqualified from being a director. Directors may also incur liabilities under other statutory and regulatory regimes.

In addition, the reputational risk to both the individual director and all the companies of which they are a director should not be underestimated. A breach of duty by a director can impact both the future career of the director and the success of the companies involved.

4. Section 172 reporting requirements

All large UK companies are required to publish a section 172(1) statement on their website and in the Annual Report[2] . This statement must describe how the directors have had regard to the factors set out in section 172(1)(a) to (f) when performing their duty under section 172. The statement will need to be included within the strategic report but a statement on the factors under section 172(1)(b) relating to employee engagement and section 172(1)(c) regarding business relationships will need to be included in the directors' report, or cross-referenced to the statement in the strategic report. The statement should describe how the board collectively has had regard to these factors, not directors individually.

In addition, the *UK Corporate Governance Code 2018* states that:

"the board should understand the views of the company's other key stakeholders and describe in the annual report how their interests and the matters set out in section 172 of the Companies Act 2006 have been considered in board discussions and decisionmaking."

The Code has a particular focus on workforce engagement and suggests three possible methods of engagement, or alternatively the company may choose another method, or combination of methods, that is effective for their company's engagement with its workforce and explain this in the Annual Report.

The *Wates Corporate Governance Principles for Large Private Companies 2018* also require that large private companies:

"…develop a range of formal and informal channels that enable them to engage in meaningful two-way dialogue, enabling the workforce to share ideas and concerns with senior management. This might include engagement with trade unions, focus or consultative groups."

[2] *The Companies (Miscellaneous Reporting) Regulations 2018*. The requirements apply to financial years beginning on or after 1 January 2019. To qualify as large, a company must meet two out of three of the following criteria:

(i) turner of more than £36 million;
(ii) (ii) balance sheet assets of more than £18 million; and
(iii) (iii) more than 250 employees

The Wates Principles go on to say:

"A board should demonstrate how the company has undertaken effective engagement with material stakeholders and how such dialogue has been considered in its decisionmaking."

Practical Guidance:

Examples of how the factors in section 172(1)(a) to (f) might be considered in decisionmaking are set out in section 2.2.1 above and helpful guidance on the preparation of the section 172(1) statement can be found in the FRC Guidance on the Strategic Report[3] . The FRC Guidance makes clear that the purpose of the section 172(1) statement is to explain how the board has had regard to the factors in their actions, behaviours and decisions. It recognises that companies are run for the benefit of members as a whole, but that the long-term success of a business depends on maintaining relationships with stakeholders and considering the external impact of its activities.

The information contained in the statement should focus on matters that are of strategic importance to the company, and will depend on the circumstances, size and complexity of the business, but is likely to include:

- The issues, factors and stakeholders the directors consider relevant under section 172(1) (a) to (f) and how they have formed that opinion.
- The primary methods used to engage with stakeholders in order to understand the issues they need to consider.
- Information on the effect of having regard to these issues, factors and stakeholders on the company's decisions and strategies.

(a) The longer term

Information on how the longer-term consequences of board decisions have been taken into account, in areas such as strategy and business plan.

(b) The company's employees

This could be a more detailed disclosure. Things to consider include:

- A description of the workforce, with information such as who comprises the workforce, the total number, demographic, diversity etc.
- The method(s) the company uses to engage with its workforce and how views are communicated to the board and taken into account.
- How the workforce contributes to the success of the business model and strategy and creates value.
- How workforce contribution is measured.
- How the company invests in its workforce.

[3] The FRC *Guidance on the Strategic Report* can be found at: https://www.frc.org.uk/getattachment/fb05dd7b-c76c-424e-9daf-4293c9fa2d6a/Guidance-on-the-Strategic-Report-31-7-18.pdf

- Risks associated with its workforce.
- Corporate culture.

Companies may also wish to consider including some examples or case studies reflecting the above.

(c) Relationships with suppliers, customers and others

This section could include information such as:

- Methods used by the company to identify and engage with suppliers, customers and others to obtain their views, and the effect on principal decisions made by the board.
- Customer relations.
- Information on prompt payment to suppliers.
- Supply chain sustainability and resilience, including any risks to the supply chain.
- Responsible sourcing.

(d) The impact on the community and the environment

Again, this is a section that may warrant a more lengthy disclosure, including:

- The environmental impact of the company's operations, how it is assessed, monitored and mitigated - possibly cross-referenced to a separate section on environmental disclosures in the annual report.
- How the company is, and will be, contributing to environmental concerns relating to its operations, including the supply chain.
- Discussion of how the company has engaged with the local community in which it operates and the impact of its operations on that community.

(e) Safeguarding the company's reputation

This section could include:

- Discussion of business conduct, values and culture, including how these are embedded within the organisation.
- The monitoring and mitigating of reputational risks to the company.

(f) Acting fairly between members of the company

This section should discuss how the company has achieved a balance between major investors and minority shareholders such as:

- How a fair balance of access to information is achieved.
- How the company engages with minority shareholders.

The company should also take the opportunity to discuss any other relevant key stakeholders and how it has engaged with these stakeholders and taken their views into account.

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