The Companies Act 2006: Directors' Duties Guidance

By David Chivers QC

CORPORATE RESPONSIBILITY
the corporate responsibility coalition

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About the Author

David Chivers QC specialises in company law, which he practices from Erskine Chambers. David's practice encompasses both litigation and advisory work in the fields of company law and corporate insolvency. He advises on all aspects of the Companies Acts including issues of directors' duties. David has extensive experience of acting both for the Department for Business, Enterprise and Regulatory Reform (DBERR, formerly the Department of Trade and Industry) seeking disqualification orders against directors, and for directors defending such proceedings.

David provided advice to The Corporate Responsibility (CORE) Coalition during its campaign around the Companies Act 2006 and negotiated proposed amendments to this Act with the DTI and government ministers on questions of directors' duties.

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The Corporate Responsibility (CORE) Coalition represents over 130 civil society organisations, including development, environment and human rights groups, trade unions and progressive businesses campaigning for a stronger rules-based approach to tackling irresponsible corporate behaviour. During the passage of the Companies Bill through Parliament in 2006, The Corporate Responsibility (CORE) Coalition lead a campaign for the strengthening of non-financial reporting requirements and the revision of directors' duties.

Important Disclaimer

(1) This guide provides advice on the actions required by directors in order to ensure compliance with the directors' duties as codified in the Companies Act 2006. The Corporate Responsibility (CORE) Coalition welcomes these new provisions as a step towards ensuring full transparency, accountability and responsibility in relation to the environmental and social impacts of UK companies wherever in the world they operate. The coalition will continue its campaigning over the coming years in order to ensure more stringent regulation in this area so as to create a level playing field for responsible businesses.

(2) The law on directors' duties is complex. Much of it is new. This guide is intended as a general introduction to the subject and is no substitute for proper professional advice in any particular case. Neither The Corporate Responsibility (CORE) Coalition nor David Chivers QC accept legal responsibility to any person in respect of the material in this guide or any omission from it.

Contents

Introduction

Purpose of this document

This guide is intended to assist directors of private and public limited companies incorporated or operating in the United Kingdom in understanding their statutory duties under the Companies Act 2006. It pays particular attention to the new codification of the 'Duty to promote the success of the company'.

The new legislation has not yet been the subject of any legal guidance from the courts.

However, by following the guidance set out below, directors can expect to protect themselves from claims for breach of duty and from actions to disqualify them from office.

The guidance sets out the responsibilities of directors, under this Act, in respect of their management of the company. It covers all decisions of directors, whether made:

- at a formal board meeting
- informally between directors
- in committee or
- as a sole director.

The guide focuses on the material that directors require properly and lawfully to make decisions. It is important that directors ensure that managers and support staff are aware of their obligations to provide such material to the directors.

The guidance introduces the duties of company directors as set out in the Act and then details Action Points intended to provide a clear platform upon which directors can build their own procedures to ensure compliance with their duties under the Act.

This guide is not intended to be a complete statement of the law on directors' duties. It does not deal with the more routine administrative obligations of directors. Nor does it address in any detail the obligations of directors when a company is or may become insolvent. These are matters upon which directors should take immediate advice from a suitably qualified person.

Background

On 8 November the Companies Act 2006, the biggest reform of UK company law for 150 years, received Royal Assent and became law. The Act contains revised measures on a wide range of issues, including: financial and non-financial reporting, company communications with shareholders, and the duties of company directors. In relation to the latter, the Act maintains a primary duty on directors to act in the interests of shareholders. However, it also requires that in fulfilling this duty directors specifically have regard to a number of other matters, including: the likely consequences of any decision in the long term; the interests of the company's employees; the need to foster the company's business relationships with suppliers, customers and others; and the impact of the company's operations on the community and the environment.

All provisions under “Part 10 A company’s directors” of the Companies Act, other than provisions relating to directors’ conflicts of interest, directors’ residential addresses and underage and natural directors, come into force on 1 October 2007. The remaining provisions of Part 10 come into force on 1 October 2008.

- The Companies Act 2006 is the largest UK Act ever, with 1,300 sections.
- Approximately one third of the provisions are simply a restatement of the previous company law in a way that is intended to be clearer and easier to understand.
- The Act replaces the company law provisions in the following pieces of legislation:
  - 1985 Companies Act
  - 1989 Companies Act
  - 2004 Companies (Audit, Investigations and Community Enterprise) Act

(except for provisions on community interest companies and provisions on investigations which are either self standing or apply more widely than merely to companies).

- Further information about the Act, including the full text and timetables for implementation are available on the website of the Department for Business, Enterprise and Regulatory Reform (DBERR) at: http://www.berr.gov.uk/bbf/co-act-2006/index.html

During the passage of the Companies Bill through Parliament, the Government committed to provide non-statutory guidance on the statutory statement of directors’ general duties in the Bill. The Government has yet to issue this guidance, but in the meantime it has made available a compilation of Ministerial statements on the purpose and meaning of the new directors’ duties provisions made during the passage of the Bill through Parliament. This document is available on the DBERR website at the following website link Companies Act 2006 – Duties of Company Directors: Ministerial Statements
http://www.berr.gov.uk/files/file40139.pdf

Readership

This guide is intended to be read by all directors of companies. It is important both that directors working in the business and non-executive directors are fully aware of their responsibilities under the Act. This guide should also be read by managers or support staff who are not themselves directors, but who prepare board packs, briefing materials, and other information for directors.

Provisions

Directors' Duties

The Companies Act 2006 includes the first ever statement in statute of directors' duties in respect of the environmental and social impacts of their companies' business. The new law explicitly enables directors to take into regard these issues, highlighting the important link between responsible business behaviour and business success.

What does the Act say?

In terms of the directors' duty to promote the success of the company, the Companies Act 2006 states the following:

172 Duty to promote the success of the company

(1) 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.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3) The duty imposed by this section has effect 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.

What has changed?

The language previously used (by the courts) to describe the obligations of a director were that the director had to act "bona fide in the best interests of the company". In essence, this obligation is repeated in the Act, the obligation of good faith remains and it is the company's interests, defined as the benefit of its members as a whole, that must be advanced.

What has changed is that the Act now prescribes not only the basic duty of the director, but how the director must go about discharging that duty. The director must now have regard to the specific matters set out in section 172(1)(a)-(f). While competent directors have previously had regard to these matters, that process is now part of the directors' statutory obligation.

What does this mean in practice?

Before the Act was passed, concern was expressed that setting out a list of matters to which directors were to have regard would lead to all decisions of directors being made only after a formal “box ticking” exercise had been conducted. It was feared that this would lead to an increased administration burden but no substantive change in directors’ behaviour.

The Government responded as follows: DTI (June 2007) Companies Act 2006: Duties of Company Directors: Ministerial Statements

“The words ‘have regard to’ mean ‘think about’; they are absolutely not about just ticking boxes. If ‘thinking about’ leads to the conclusion, as we believe it will in many cases, that the proper course is to act positively to achieve the objectives in the clause, that will be what the director’s duty is. In other words ‘have regard to’ means ‘give proper consideration to’”.

A director who gives proper consideration to the statutory matters will not be in breach of the duty to have regard to them. A director who pays lip service to the list of matters, but gives no proper consideration to them will be in breach of duty.

For the competent director, this imposes no additional burden. Indeed, the new Act will assist in:

(a) justifying (as well as requiring) the proper consideration of these matters;

(b) ensuring that all directors are, prior to making any decision, provided with adequate information about the consequences of that decision; and

(c) protecting directors from shareholder pressure to achieve short term gain at the expense of long term progress.

The Act does not require a director to compromise the interests of the company to achieve any particular social and environmental object. However, the Act recognizes that companies whose directors have regard to the relevant social and environmental objects are likely, in the long term, to perform better than those whose directors do not.

The extent to which a director will be able to have regard to the consequences of any action will of course depend upon adequate management information systems and the resources available to the company. A large and well resourced company can be expected to provide directors with very full information. Such a company might engage outside specialists to provide the relevant reports where the company itself did not have the relevant expertise.

A smaller company might be expected to prepare its own reports, in proportion to its impact. Importantly, the duty to have regard to the relevant matters remains the same, however small the company and regardless of its resources.

A single director/shareholder of a small company (or directors of an insolvent company) will not be excused the obligation to have regard to the likely consequences of a decision simply because the company cannot afford to investigate those consequences in any depth. The director must make the best assessment of the consequences as is possible in the circumstances. Indeed, the fact that the consequences may to that extent be “unforeseeable” would itself be a matter to which the director would have to have regard.

Example

A large company manufactures goods in the UK. The finance director and managing director together draw up a plan to move production to a lower wage cost country abroad. This will save the company a substantial sum, even after taking into account redundancy payments to the UK factory workers. The manufacturing plant is in an area of high unemployment and its closure is likely to have a significant impact upon the local community.

Analysis

The financial case for closure seems compelling. If regard were had only to this then the directors would close down production at the plant. However, the directors must have regard to the interest of employees. Will the retention of a loyal and skilled workforce, even at a higher cost, be of future benefit to the company? Will the company be able to attract, in other divisions of the group, higher quality employees if it is seen to be loyal to its existing workforce?

Looking at the proposed employment of workers in the low-wage country; would those employees have low wages because of poor human or union rights, or sub-standard working conditions? How would this impact on quality and timely provision of products to customers?

The directors must also have regard to their business relationships with suppliers and customers. What will be the impact upon sales of the company's products if they are no longer "made in the UK"? What about the company's relations with the community? Will closure and the redundancy programme have an adverse impact upon the company's reputation and ability to do business?

What about the impact upon the environment? This may be two-fold. Will production in the new location have a positive or detrimental effect upon the environment there? What will happen to the UK plant that has been closed? How will different energy, transport, waste and material consumption issues affect the company in these two options?

Conclusion

If the directors do close the plant, they may be subject to criticism by factory employees, unions, politicians, environmental and human rights groups. If they do not close down the plant, they may be subject to criticism by shareholders and other groups. The Act does not inform directors as to the decision they should reach – that is a matter for their own judgment. It does, however, ensure that any decision is made having full regard for all the consequences. The decision may be as difficult, but the quality of the decision making will be better.

Note on Creditor protection

Section 172(3) makes it clear that the statutory duties set out above are subject to certain obligations of directors to act in the interests of creditors; and for many companies, this is a regular issue. The Act does not, however, set out when such circumstances arise. Weighing up the risk to creditors of any course of action is a necessary part of any director's duty. In a wholly solvent company this may be a matter easily dealt with, but for many companies the task of balancing risk to creditors against profit to shareholders is a constant function of the board.

Where the company becomes, or may become insolvent, the risk to creditors becomes acute. At this point it is essential that directors take proper professional advice.

Effective assessment and improvement of a company's environmental and social performance also demands good corporate governance. Good corporate governance assists company directors to act with independence; and fosters the culture of enquiry.

Exercise of Powers

171 Duty to act within powers

A director of a company must —

(a) act in accordance with the company's constitution, and

(b) only exercise powers for the purposes for which they are conferred.

What has changed?

This duty is now set out in the Act, and does not represent a significant change in the law.

What does this mean in practice?

The constitution of the company (usually the memorandum and articles of association, but under the Act now simply the "constitution") is one or more documents setting out the rules by which the company is to be operated. While the constitution is subject to the Act, it sets out what powers directors have and how they are to exercise them. Directors must abide by these rules.

Directors must also exercise their powers for proper purposes. If a power is given for one purpose, they cannot exercise it for a different purpose, even if they think that to do so would be in the best interests of the company.

Example

The directors of a company are concerned that they are vulnerable to a takeover. They genuinely believe that it would not be in the interests of the company if the takeover were to proceed. They have the power under the constitution to allot sufficient new shares to the employees share scheme (which they control) to block the takeover.

It would be a breach of duty to allot the shares in these circumstances. The power to allot shares might properly be exercised to raise capital, or to provide a benefit to employees, but it is not a legitimate use of that power to use it for the purpose of blocking a takeover.

Independence

173 Duty to exercise independent judgment

(1) A director of a company must exercise independent judgment.

(2) This duty is not infringed by his 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.

What has changed?

This duty is now set out in the Act, and does not represent a significant change in the law.

What does this mean in practice?

A director must act in the interests of the company. It will usually be a breach of duty for a director to act in accordance with the instructions of some other person.

Example

A company has two shareholders, each of which appoints a director. One shareholder instructs "its" director to vote against the company entering into a particular contract. The director, however, thinks that it would be in the best interests of the company to do so.

The director must in these circumstances ignore the instruction from the shareholder and vote in favour of the contract.

The position may be different if all shareholders give an instruction to the director, but if the interests of creditors are involved the duty in section 173 would override this instruction.

Conclusion

It can be difficult to serve on a board as the nominee of some other person. A person who is appointed on that basis must accept that their obligation to the company cannot be discharged, and may be breached, by accepting instructions from the appointer. A director is allowed to look after the interests of their appointer, but only in so far as that is compatible with the interests of the company.

Standard of Skill and Care Required

The Act also sets out, for the first time, the standard of skill and care required of directors in exercising their duties.

> 174 Duty to exercise reasonable care, skill and diligence
>
> (1) A director of a company must exercise reasonable care, skill and diligence.
>
> (2) This means the 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, and
>
> (b) the general knowledge, skill and experience that the director has.

What has changed?

This duty is now set out in the Act, and does not represent a significant change in the law.

What does this mean in practice?

Directors must continue to act with reasonable skill and care. If they have special skills or knowledge then they will be expected to exercise them. Otherwise they will be measured against the standard of a reasonable person occupying their position.

Example

A private company appoints a qualified accountant as its marketing director and an unqualified person as its finance director. The marketing director will be expected to exercise the skill of a qualified accountant in all aspects of decision making. The finance director will be expected to exercise the skill of a reasonable finance director and will not be excused any lack of skill because they are, in fact, unqualified.

Conclusion

Individuals should think carefully before accepting directorships. Do they have the necessary skills to perform the task? Even non-executive directors are expected to have a reasonable degree of knowledge and competence. All directors should give the company the full benefit of their actual experience and knowledge.

Conflicts of Interest

The Act sets out rules as to what may happen where a director has a conflict of interest.

175 Duty to avoid conflicts of interest

(1) A director of a company must 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.

(2) This applies in particular to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity).

(3) This duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company.

(4) This duty is not infringed—

(a) if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest; or

(b) if the matter has been authorised by the directors

(5) Authorisation may be given by the directors—

(a) where the company is a private company and nothing in the company's constitution invalidates such authorisation, by the matter being proposed to and authorised by the directors; or

(b) where the company is a public company and its constitution includes provision enabling the directors to authorise the matter, by the matter being proposed to and authorised by them in accordance with the constitution.

(6) The authorisation is effective only if—

(a) any requirement as to the quorum at the meeting at which the matter is considered is met without counting the director in question or any other interested director, and

(b) the matter was agreed to without their voting or would have been agreed to if their votes had not been counted.

(7) Any reference in this section to a conflict of interest includes a conflict of interest and duty and a conflict of duties.

What has changed?

The Act creates a new, positive duty to avoid unauthorised conflicts of interest. The Act also allows conflicts of interest to be authorised by directors instead of by shareholders.

What does this mean in practice?

Until 1 October 2008 it will continue to be possible for directors to place themselves in a position where they may face a conflict of interest. After that date, directors must be specifically authorised by the board to allow them to continue to act in such a case. The scope of the section is very wide, covering not only actual conflicts of interest, but possible conflicts of interest as well. After 1 October 2008, therefore, all directors who face actual or possible conflicts of interest by virtue of their position must either obtain authority to act, or remove the possibility of the conflict, or resign as directors.

Example

Company A buys goods from Company B. Every year there is a negotiation between them on price. At present, a person could lawfully be a director of both Company A and Company B, although that person would no doubt have to take care (and comply with the constitutions of both companies). On a practical level, the situation would usually be dealt with by the director "sitting out" on all deliberations of both Company A and Company B as to dealings between them.

Under the new law, "sitting out" will not be sufficient. It will not be possible to remain as a director of both companies without obtaining proper authorisation from the boards of both companies.

Conclusion

The law relating to conflicts of interest is particularly complicated and directors should take legal advice where necessary. It is important to ensure that the constitution of any company permits a director to be authorised in an appropriate case, and that the necessary authorisation is given.

Note that section 175 does not deal with cases where a director proposes to enter into some transaction with the company itself. A director is allowed to do this if permitted under the constitution of the company and also subject to making proper disclosure to the board under section 177 (which forms one of the general duties, but which is not set out in this document). In addition, specific rules apply where directors propose to enter into "substantial" property transactions with a company, or to receive a loan, or credit from a company. Specialist legal advice should be taken in such a situation.

The "No Bribe" Rule

176 Duty not to accept benefits from third parties

(1) A director of a company must not accept a benefit from a third party conferred by reason of—

(a) his being a director, or

(b) his doing (or not doing) anything as director.

(2) A "third party" means a person other than the company, an associated body corporate or a person acting on behalf of a company or an associated body corporate.

(3) Benefits received by a director from a person by whom his services (as a director or otherwise) are provided to the company are not regarded as conferred by a third party.

(4) This duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.

(5) Any reference in this section to a conflict of interest includes a conflict of interest and duty and a conflict of duties.

What is new?

The Act sets out for the first time a statutory rule against directors accepting benefits from third parties. However, directors have (subject to the constitution of the company) always been required to account for benefits received by them so this rule makes little difference to the law.

What does this mean in practice?

Directors should ensure that they do not receive any benefits not provided for, or allowed, under the constitution of the company. The only exceptions will be benefits that are so minor that they could not be thought to influence the director in any way.

Examples

The procurement director is taken by a prospective supplier on an all expenses paid holiday. This would be a breach of duty (and the director would have to pay to the company the value of the holiday).

Once a year the sales director receives a food hamper valued at £50 from a major customer. This gift could not reasonably be thought to influence the director and there would be no breach of the section.

Conclusion

There is a grey area between those gifts or benefits that will be acceptable, and those which will not. A hamper once a year may be innocuous, a hamper once a week will not. But what about once a quarter? Difficulties are also likely to arise where instead of an expenses paid holiday, the director is invited to a "procurement conference" in an exotic location, all paid for by the supplier, or where a long-standing business relationship gives rise to the receipt of "personal" gifts between individuals. Corporate hospitality should be viewed critically in the light of section 176.

While there is no easy answer to such problems, it is vital that directors are completely transparent with their boards and with their shareholders as to the benefits that are received.

Action Points

Detailed below are action points to help directors fulfil their duties set out in the previous section

1. Take responsibility for better environmental and social performance

Directors have a legal responsibility to have regard to the company's wider impacts. The company must foster a working environment in which the wider responsibilities of the company are both accepted and fulfilled.

Further advice

It may assist directors to have regard to their statutory responsibilities if specific individuals with relevant expertise are designated as having primary responsibility for

- monitoring corporate responsibility issues on a continuing basis
- assisting all the directors to comply with their corporate responsibility obligations
- in particular, taking responsibility for the provision of relevant corporate responsibility material to the board – or to individual directors – prior to decision making.

2. Provide full and proper social and environmental reporting

The Act contains detailed provisions as to which companies must report on social, environmental, employee, community, contractual relationships with suppliers and others and as to the information required to be given. See the Annex for the text of section 419 of the Act.

All companies should acknowledge that shareholders and other stakeholders have a legitimate interest in how the company is meeting its CSR obligations. The company will, for the directors' own purposes, need to know how it is performing in this respect and such information should be shared with stakeholders. The implementation of appropriate reporting systems in respect of social and environmental issues will help with the management of a company's performance in these areas.

Further advice

Directors must as a minimum comply with their statutory obligations. Beyond that, directors are not required to spend a disproportionate amount of time and money on their CSR obligations. Nonetheless, appointing one or more directors with special responsibility both for internal and external CSR reporting will assist the board in ensuring that not only the statutory obligations, but shareholder and other stakeholder expectations are met.

3. Have regard to the interests of creditors

The Act does not expressly require directors to have regard to the interests of creditors. However, the Act does make clear that the statutory duty to promote the success of the company must in certain circumstances give way to creditors' interests.

Under the new Act, directors remain responsible for the company's relationship with its creditors. Directors must always have regard to the interests of creditors. Any risk to creditors must be minimised. Where necessary (and in any case upon the company becoming insolvent) professional advice should be taken.

4. Ensure proper procedures for decision-making

The board must ensure that all of its decisions are taken in accordance with the Act. This will be made easier if proper procedures for decision making are put in place.

It is not enough for directors to proceed on an individual basis in attempting to comply with the Act. The board as a whole must have procedures in place to assist directors to comply with their individual duties – indeed putting the proper procedures in place forms an important part of the duties of all directors, but particularly non-executive directors.

Further advice

It is not necessary to prepare a check list of duties, or matters to which the directors must have regard, prior to each board meeting, or prior to a director making any decision. If directors and those who assist them have been properly educated in their duties, they will already know the matters to which they are to have regard.

Where (as in a public company) there is a company secretary, that person will usually be responsible for the formal aspects of the company's decision making process. The board should ensure that the company secretary (or some other designated person):

- understands their own responsibilities as well as the company's constitution
- is fully aware of the directors' obligations to the company
- puts in place procedures for efficient and proper decision making by the directors
- submits those procedures for review to the board on a regular (at least annual) basis
- immediately reports to the full board any departure from or failure in the agreed procedures.

The Chairperson and/or Chief Executive have a critical role to play in ensuring that the decision making process is carried out properly. The company secretary, or other designated person, should report directly to the Chairperson and/or Chief Executive.

5. Understand obligations under the Companies Act 2006

Directors must make themselves aware of their obligations under the Act and must put in place procedures to ensure that such awareness runs throughout the board.

All directors must educate themselves as to their own responsibilities and duties to their companies. The starting point is to understand their statutory obligations. Directors should be aware that they have (collectively with their fellow directors) many other obligations arising under the Act. These include obligations to keep proper books and records, obligations to prepare and file accounts, and many other administrative requirements.

Beyond their statutory obligations, directors must also be aware that when the company is insolvent or is threatened with insolvency, they must put the interests of the company's creditors before the company's members. It is likely that specialist advice will be required in this event and this guidance does not seek to provide that advice.

Further advice

A formal statement by the board to the effect that all directors are offered suitable information or training as to the performance of their duties, together with regular monitoring of progress both for existing members and new appointees, will ensure that this aspect of the directors' duties are complied with.

6. Develop a proactive approach to corporate governance and understanding the company's affairs

The board should acknowledge that it encourages directors, particularly non-executive directors, to enquire into the conduct of the company's affairs.

Proper corporate governance, even in small companies, requires that all directors are sufficiently aware of the company's affairs as to enable them to bring their minds to bear on any question that may arise in the performance of their duties. Indeed, it would be a dereliction of duty for a director to act, or fail to act, without understanding the consequences of that decision.

The legal obligation to have regard to the matters set out in the Act cannot be complied with if directors have an insufficient understanding of the company's affairs.

Further advice

Non-executive directors play a particularly important role in this regard. Their ability to question management provides an effective safeguard against decisions being made by default and without regard to the statutory factors.

Many cases of corporate mismanagement have arisen because directors have allowed themselves to be sidelined by one or more dominant figures on a board. Such figures can be powerful personalities and may seek to prevent otherwise independent directors from making necessary enquiries into the company's affairs. It is essential to the proper functioning of a board that all directors should be encouraged to make enquiry. In a large company the Chair of the board has a particular role to play in fostering the correct ethos.

Warning!
Directors who participate in decisions without understanding the consequences will be in breach of duty. It is important that the board fosters an ethos of enquiry.

7. Ensure adequate information flows

The board must ensure that directors should have a proper flow of information to enable them to comply with their statutory duties.

The statutory obligation on directors to have regard to particular matters in their decision making cannot be complied with unless directors have before them the relevant material upon which to base their decisions. Furthermore getting useful, complete information from a wide perspective of views is essential to reduce the likelihood of wrong decision.

The board must put in place procedures that enable all directors to have good notice not only of decisions that need to be made by them, but also of the relevant supporting information.

Further advice

Where a structured decision making process is employed – for example a full agenda to accompany notice of a meeting – it is easier to ensure that the proper material is available. However, the late provision of material, particularly dense or complex financial material, can lead to decisions made without any real consideration or understanding of their consequences. Directors who make decisions in this way will not be complying with their statutory duties.

Where decisions are made outside board meetings, it may be more difficult to demonstrate that a director has complied with the relevant statutory duties. Management should therefore ensure that executive directors are kept aware on a continuing basis of the company's financial position and its social and environmental impacts. The board should ensure that the company has a culture of preparing and disseminating such information to all decision makers.

8. Guard against conflicts of interests

The board must put in place procedures to deal with conflicts of interest

The Act contains detailed provisions concerning when directors may take part in decisions in which they may be interested. The new provisions come into force in October 2008 although directors are already subject to common law and statutory obligations in this respect. The board should ensure that all directors are aware of their obligations to disclose relevant interests and that some designated person, usually the company secretary where present, is in a position to give advice as to whether or not such interest prevents the director from acting, or whether the director may be given permission to act.

Directors should take steps, before 1 October 2008, to ensure that the new provisions of the Act will not prevent them from continuing to act as a director. Substantial difficulties will arise if cross directorships between competing (or even co-operating) companies are not given suitable statutory authorisation.

Directors should also understand the extent to which, under the constitution of the company, they are allowed to take part in decisions in which they are interested or to enter into contracts with the company. Directors should, in every case, disclose to their board full details of any interest they have in a proposed transaction by the company. In case of doubt a director should seek specialist advice.

9. Management of subsidiaries

The board must accept that its decisions may impact indirectly upon stakeholders in the company's wider business. In particular, where a company operates through subsidiaries it is not sufficient for directors to turn a blind eye to such operations simply because the directors may not be directly responsible for the management of those subsidiaries.

Directors are responsible for the management of their own company's affairs. However, to the extent that their company has influence over the operation of other concerns the manner in which the directors exercise that influence will be measured by the same criteria as the management of their own company.

Further advice

Directors of holding companies must have regard to the same matters in relation to the exercise of control over a subsidiary (even a foreign incorporated subsidiary) as in relation to any other aspect of the holding company's operations. The fact that the subsidiary may be subject to a different legal regime will not affect the duties owed at holding company level.

Directors cannot avoid their responsibilities under the Act by placing intermediate holding companies between themselves and the operational companies in a group. Where such a structure does exist, directors will have to ensure that the operational companies (even if not subject to English law) provide to the parent company sufficient material to enable the parent directors to exercise their powers (including their powers of control over the subsidiaries) lawfully.

Suitable reporting procedures should therefore pass vertically through corporate structures without regard for separate legal personalities.

10. Acknowledge that statutory duties apply to all areas of decision-making

Directors should acknowledge that they must comply with their statutory duties regardless of whether they are making decisions in a board meeting, in committee, or as individuals.

It is relatively easy for directors to have proper regard to their duties in the formal environment of a board meeting, particularly when supported by competent professionals. However, the provisions of the Act apply to all decisions of directors in the management of a company's affairs.

Accordingly the management structure should support individual directors, particularly where they are given sole responsibility for particular aspects of the company's management. For example, managing and finance directors traditionally have a good deal of autonomy, but their duties remain the same whether in or out of a board meeting.

Further advice

Proper training and a good understanding of their legal obligations will assist directors in this respect, but mentoring, peer review or other informal processes may be useful to ensure that the quality of individual decision making is as good as collective decision making.

11. Responsibility for employees and other staff

Directors should acknowledge that they are, both collectively and where appropriate individually, responsible for the conduct of employees and other staff.

Directors cannot delegate their responsibilities to others. It is important that directors are aware of what is being done in the company's name by employees and other staff, also by any agents authorised to act in the name of the company.

In particular a director cannot avoid liability for breach of duty simply because the relevant conduct was that of an employee, and not the director. If directors take proper responsibility for the actions of staff then they will also ensure that proper systems of reporting and control are in place. The failure to set up such systems could itself demonstrate a breach of duty.

Sanctions & Penalties

A director who is in breach of duty is liable to compensate the company for any loss suffered as a result.

Example

A director considers introducing a new cost-saving production technique to enhance the company's profitability. The director fails to have regard to the environmental consequences of the new technique. The new technique leads to significant environmental damage which the company must pay to clean up; the company is also fined. The director will be liable for any damage that would have been avoided had proper regard been had to the environmental consequences of the new technique.

Disqualification

Directors should also be aware that they may in certain circumstances be liable to disqualification under the Company Directors Disqualification Act 1986. A director may be disqualified if they are shown to be unfit to be a director of a company. In determining this, a court will take into account any past breaches of duty in relation to any company of which the individual is or has been a director.

Going Beyond the Bare Minimum – Further Information on CSR Best Practice

AccountAbility
An international not-for-profit organisation which develops tools and standards for organisational accountability which drive performance and enable people to have a voice in the decisions that affect them.
www.accountability21.net

Business in the Community
A membership organisation for companies which are taking the lead in translating corporate values and commitments into mainstream management practice.
www.bitc.org.uk

CSR.gov.uk
The Government's website on CSR, containing information on relevant legislation and Government projects and programmes, as well as advice on best practice and where to go for further information.
www.csr.gov.uk

Forum for the Future
A sustainable development charity which works in partnership with over 120 leading organisations in business and the public sector, including to inspire and challenge organisations with positive visions of a sustainable future and deliver practical ways to help realise those visions.
www.forumforthefuture.org.uk

Sustainability
A think-tank and consultancy which advises clients on the risks and opportunities associated with corporate responsibility and sustainable development
www.sustainability.com

Annex – The Business Review

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(1) Unless the company is subject to the small companies' regime, the directors' report must contain a business review.

(2) The purpose of the business review is to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company).

(3) The business review must contain—

(a) a fair review of the company's business, and

(b) a description of the principal risks and uncertainties facing the company.

(4) The review required is a balanced and comprehensive analysis of—

(a) the development and performance of the company's business during the financial year, and

(b) the position of the company's business at the end of that year, consistent with the size and complexity of the business.

(5) In the case of a quoted company the business review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include–

(a) the main trends and factors likely to affect the future development, performance and position of the company's business; and

(b) information about-

(i) environmental matters (including the impact of the company's business on the environment),

(ii) the company's employees, and

(iii) social and community issues,

including information about any policies of the company in relation to those matters and the effectiveness of those policies; and

(c) subject to subsection (11), information about persons with whom the company has contractual or other arrangements which are essential to the business of the company.

If the review does not contain information of each kind mentioned in paragraphs (b)(i), (ii) and (iii) and (c), it must state which of those kinds of information it does not contain.

(6) The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—

(a) analysis using financial key performance indicators, and

(b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

"Key performance indicators" means factors by reference to which the development, performance or position of the company's business can be measured effectively.

(7) Where a company qualifies as medium-sized in relation to a financial year (see sections 465 to 467), the directors' report for the year need not

comply with the requirements of subsection (6) so far as they relate to non-financial information.

(8) The review must, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.

(9) In relation to a group directors' report this section has effect as if the references to the company were references to the undertakings included in the consolidation.

(10) Nothing in this section requires the disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.

(11) Nothing in subsection (5)(c) requires the disclosure of information about a person if the disclosure would, in the opinion of the directors, be seriously prejudicial to that person and contrary to the public interest.

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