

CLIENT MEMORANDUM

COMPANY DIRECTORS AND THEIR RESPONSIBILITIES

The purpose of this Memorandum is to describe the principal responsibilities of a company director, as laid down by law and case law decisions.

It is not possible in the space available to cover all these wide-ranging responsibilities. In addition, it must be borne in mind that directors' responsibilities are constantly being expanded by new legislation. Recent examples relate to money laundering, health and safety at work and data protection.

Penalties for infraction vary, but in some cases these can be severe. A director who is in doubt as to his (or her) responsibilities in relation to a specific situation should take legal advice on the particular facts of the case.

WHO IS A DIRECTOR?

This may seem to be an easy question to answer, but it is not always so in practice.

The definition extends much wider than simply covering everyone who is formally appointed a director of a company. It also covers the chairman and non-executive directors.

“Shadow directors” are also included. This refers to a person who is not described as a director, but who gives directions or instructions which are commonly acted upon by the formally-appointed directors. In order to decide whether a person is deemed to be a director, it is necessary to consider the nature of the duties performed and the authority exercised by the individual within the company.

MEMORANDUM AND ARTICLES OF ASSOCIATION

The Memorandum of Association is, in effect, the published set of rules setting out how the company relates to the outside world, including details of its trading (or other) objects.

The Articles of Association are also a publicly available document. They set out the internal rules for operating the company.

Every director should be aware of the main provisions of their company's Memorandum and Articles. In particular, the Articles contain details of directors' powers, the rules for appointing and removing directors, and the procedures for holding directors' meetings and shareholders' meetings, and each director needs to be familiar with these.

LIABILITY TO THIRD PARTIES

There are numerous circumstances in which a director may be personally liable for having committed a statutory offence or a breach of duty.

We give below some examples.

- Failure to show the company's name clearly on cheques, bills of exchange etc
- Offences under the Health and Safety at Work legislation
- Authorising payment of an illegal dividend (for example, where insufficient profits are available)
- Failure to register the Company for VAT purposes
- Fraudulent evasion of VAT
- Fraudulent trading (for example, with intent to defraud creditors)
- Acting as a director while disqualified
- Irregularities in allotments of shares
- Avoiding National Insurance debts by liquidating the company
- Knowingly giving preference to a creditor on a winding-up
- Employing illegal immigrants

There are over 250 offences listed in the Companies Act 1985 alone. In some cases, the liability rests with the company, in other cases it rests with the directors. There is a wide range of penalties, varying from small fines for minor offences to imprisonment for criminal offences.

PENSION LIABILITIES

An important recent development has been the appointment of the Pensions Regulator. This office opened for business on 6 April 2005, and it is aimed at preventing employees from ‘avoiding their pension liabilities’.

The relevant legislation requires directors of a company to give the same consideration to a company’s pension scheme as to other creditors. This may be particularly relevant if

- (a) the company is insolvent, or
- (b) the pension scheme is underfunded, or
- (c) the company is planning a merger or is about to be taken over.

In appropriate circumstances, the Regulator can investigate the position and take action to ensure that the pension scheme will be adequately resourced.

This has become a very important issue in takeover situations, and demergers, and must always be taken into consideration.

Fortunately, there is a procedure for obtaining an advance clearance from the Pensions Regulator.

DUTY OF SKILL AND CARE

In addition to the above, a director has a fiduciary duty towards the company, as well as a duty of skill and care to the company. If the director fails in this duty, the company may take action against him (or her) for any loss suffered or undisclosed profits made. In certain circumstances the company is permitted to ratify the position retrospectively. Alternatively, it can take legal action for damages or restitution, or it can dismiss the director.

The director must exercise skill and care in the course of his (or her) duties. This is particularly relevant when raising money, for example, from a bank or from the public. He (or she) may be liable for a breach of duty under the Financial Services and Markets Act 2000 if making a misleading, false or inaccurate statement. If there is evidence of intentional fraud or recklessness, there may be criminal penalties. If there has been neglect or careless omissions there may be a claim for negligence against the director.

There has been a considerable amount of litigation over the years as to the level of skill which is to be expected from a director. A director must use such skill as can be expected having regard to his (or her) personal qualifications. Thus, a higher standard will normally be expected from an experienced businessperson than from a person with little business experience.

It has also been held in the courts that a director must exercise such “diligence” in the performance of the duties as an ordinary person would be expected to take on his (or her) own behalf.

The director may also be liable for the acts or failures of co-directors or company officers. Three examples from case law illustrate this point:

- A director was held liable for breach of duty for unquestioningly signing a cheque which subsequently proved to be for an unauthorised purpose
- It was held that a director cannot necessarily escape liability merely because he (or she) missed the relevant board meeting
- Ignorance of wrongful actions by another officer was held not to be a defence if the director should have supervised the other officer or should have known that the action was wrong

FIDUCIARY DUTY

A director occupies a position of trust towards the company and its assets, and he (or she) must act honestly and reasonably. It would be improper for a director to appropriate the company’s assets for his (or her) own use. However, in certain circumstances this may be authorised by the other directors, for example the use of a company car as a “perk”. In other circumstances, dealings between the company and the director should normally be on an “arm’s length basis” unless specific authorisation for an alternative course of action is given by the board and the members. Any “secret profits” must be accounted for to the company. The director also has a duty to avoid conflicts of interest, or to disclose these to co-directors.

These matters are particularly difficult in relation to small companies, especially (for instance) where the only directors are a husband and wife. In practice, there may be few problems if the husband and wife are also the sole shareholders. However, major problems can arise in the event of a divorce, or if a family trust holds shares in the company, or if there are outside shareholders.

LOANS TO DIRECTORS

There are very restrictive rules about the making of loans from a company to a director.

In principle, a company must not make a loan to a director (or the spouse or minor children of a director). In addition, the company must not facilitate a loan by another person to a director, for example by entering into a guarantee or by providing security.

There are some exceptions to this strict rule. These relate to small loans (not exceeding £5,000) and to loans covering expenditure incurred in the performance of the director’s duties.

PERSONAL LIABILITIES

A common myth when setting up a company is that the directors will benefit from “limited liability”, in other words if things go wrong there will be no recourse by lenders and customers against the directors.

Although it is true that companies carry “limited liability”, the position is not as straight-forward as some people imagine.

For instance, a director may be required to give a personal guarantee to the bank to support loans from the bank to the company. Hence, if the company fails, the bank will require the director to pay up under the terms of the guarantee.

A similar situation can arise in relation to property leases. A director will often be required to guarantee rental payments due by the company. This liability may well continue after the company is wound up, for example if the lease continues and cannot be assigned or if the property can be re-let only on less advantageous terms from the landlord’s point of view.

A company provides its directors with some protection against negligence claims. For example, if a professional person is in business on his (or her) own account or as a partner, he (or she) could be bankrupted by a large negligence claim. If the business was conducted through a company, the claim would lie against the company, not the individuals. However, it is possible that the claimant could pursue the individual for damages, depending on the precise contractual position and the nature of the negligence.

FOR GENERAL INFORMATION ONLY

Please note that this Memorandum is not intended to give specific technical advice and should not be construed as doing so. It is designed to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topics.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.