

COMPANIES ACT 2006

EXPLANATORY NOTES

COMMENTARY ON INDIVIDUAL DUTIES

Section 171: Duty to act within powers

323. This duty codifies the current principle of law under which a director should exercise his powers in accordance with the terms on which they were granted, and do so for a proper purpose. What constitutes a proper purpose must be ascertained in the context of the specific situation under consideration.
324. This duty codifies the director's duty to comply with the company's constitution. The constitution is defined for the purpose of the general duties in section 257. As well as the company's articles of association it includes:
- decisions taken in accordance with the company's articles; and
 - other decisions taken by the members (or a class of them) if they are to be treated by virtue of any enactment or rule of law as decisions of the company, for example a decision taken by informal unanimous consent of all the members.

Section 172: Duty to promote the success of the company

325. This duty codifies the current law and enshrines in statute what is commonly referred to as the principle of "enlightened shareholder value". The duty requires a director to act in the way he or she 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 to the factors listed.
326. This list is not exhaustive, but highlights areas of particular importance which reflect wider expectations of responsible business behaviour, such as the interests of the company's employees and the impact of the company's operations on the community and the environment.
327. The decision as to what will promote the success of the company, and what constitutes such success, is one for the director's good faith judgment. This ensures that business decisions on, for example, strategy and tactics are for the directors, and not subject to decision by the courts, subject to good faith.
328. In having regard to the factors listed, the duty to exercise reasonable care, skill and diligence (section 174) will apply. It will not be sufficient to pay lip service to the factors, and, in many cases the directors will need to take action to comply with this aspect of the duty. At the same time, the duty does not require a director to do more than good faith and the duty to exercise reasonable care, skill and diligence would require, nor would it be possible for a director acting in good faith to be held liable for a process failure which would not have affected his decision as to which course of action would best promote the success of the company.
329. In requiring directors to have regard to the interests of employees, this provision replaces section 309(1) of the 1985 Act.

330. *Subsection (2)* addresses the question of altruistic, or partly altruistic, companies. Examples of such companies include charitable companies and community interest companies, but it is possible for any company to have “unselfish” objectives which prevail over the “selfish” interests of members. Where the purpose of the company is something other than the benefit of its members, the directors must act in the way they consider, in good faith, would be most likely to achieve that purpose. It is a matter for the good faith judgment of the director as to what those purposes are, and, where the company is partially for the benefit of its members and partly for other purposes, the extent to which those other purposes apply in place of the benefit of the members.
331. *Subsection (3)* recognises that the duty to promote the success of the company is displaced when the company is insolvent. Section 214 of the Insolvency Act 1986 provides a mechanism under which the liquidator can require the directors to contribute towards the funds available to creditors in an insolvent winding up, where they ought to have recognised that the company had no reasonable prospect of avoiding insolvent liquidation and then failed to take all reasonable steps to minimise the loss to creditors.
332. It has been suggested that the duty to promote the success of the company may also be modified by an obligation to have regard to the interests of creditors as the company nears insolvency. *Subsection (3)* will leave the law to develop in this area.

Section 173: Duty to exercise independent judgment

333. This duty codifies the current principle of law under which directors must exercise their powers independently, without subordinating their powers to the will of others, whether by delegation or otherwise (unless authorised by or under the constitution to do so).
334. The section provides that directors must not fetter the future exercise of their discretion unless they are acting:
- a) in accordance with an agreement which has been duly entered into by the company; or
 - b) in a way authorised by the company’s constitution.
335. The duty does not confer a power on the directors to delegate, nor does it prevent a director from exercising a power to delegate conferred by the company’s constitution provided that its exercise is in accordance with the company’s constitution. Under the draft model articles of association for private companies limited by shares, the directors may delegate their functions in accordance with the articles.

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

336. This duty codifies the director’s duty to exercise reasonable care, skill and diligence. Traditionally, the courts did not require directors to exhibit a greater degree of skill than may reasonably be expected from a person with their knowledge and experience (a subjective test). More recently, the courts have said that the common law standard now mirrors the tests laid down in section 214 of the Insolvency Act 1986, which includes an objective assessment of a director’s conduct. This section is modelled on that section.
337. The section provides that a director owes a duty to his 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 same functions as the director in relation to that company (an objective test); and
 - b) the general knowledge, skill and experience that the director actually has (a subjective test).

Section 175: Duty to avoid conflicts of interest

338. This duty replaces the no-conflict rule applying to directors. Under the current no-conflict rule, certain consequences flow if directors place themselves in a position where their personal interests or duties to other persons are liable to conflict with their duties to the company, unless the company gives its consent. A conflict of interest may, in particular, arise when a director makes personal use of information, property or opportunities belonging to the company or when a director enters into a contract with his company. Conflicts of interest may also arise whenever a director makes a profit in the course of being a director, in the matter of his directorship, without the knowledge and consent of his company.
339. This duty covers all conflicts, actual and potential, between the interests of the director and the interests of the company. This includes conflicts relating to the exploitation of the company's property, information or opportunity for personal purposes. The only conflicts not covered by this duty, are those relating to transactions or arrangements with the company (interests in transactions or arrangements with the company must be declared under section 177 in the case of proposed transactions or under section 182 in the case of existing transactions unless an exception applies under those sections).
340. **Section 180(4)** preserves any current ability of the members of a company to authorise conflicts that would otherwise be a breach of this duty.
341. Under *subsections (4) to (6)* the duty is also not infringed if:
- the situation cannot reasonably be regarded as likely to give rise to a conflict of interest;
 - in the case of a private company, unless its constitution prevents this, authorisation has been given by directors who are genuinely independent (in the sense that they have no direct or indirect interest in the transaction);
 - similarly, in the case of a public company, but only if its constitution expressly permits this, authorisation has been given by the independent directors.
342. The present law is that in all cases, conflicts of interest must be authorised by the members of the company, unless some alternative procedure is properly provided. The CLR were concerned that this strict requirement might stifle entrepreneurial activity; and therefore recommended that, in the case of a private company, it should be possible for conflicts to be authorised by independent directors unless the company's constitution prevents this.
343. Under *subsection (6)*, board authorisation is effective only if the conflicted directors have not participated in the taking of the decision or if the decision would have been valid even without the participation of the conflicted directors: the votes of the conflicted directors in favour of the decision are ignored and the conflicted directors are not counted in the quorum.

Section 176: Duty not to accept benefits from third parties

344. This section codifies the rule prohibiting the exploitation of the position of director for personal benefit. This duty prohibits the acceptance of benefits (including bribes). The acceptance of a benefit giving rise to an actual or potential conflict of interest will fall within the duty to avoid conflicts of interest (section 175) as well as this duty. This specific duty dealing with benefits from third parties is not subject to any provision for board authorisation.
345. Any current ability of the members of a company to authorise the acceptance of benefits which would otherwise be a breach of this duty is preserved by section 180(4).

346. The duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. Benefits conferred by the company (and its holding company or subsidiaries) do not fall within this duty.

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

347. The equitable rule that directors may not have interests in transactions with the company unless the interest has been authorised by the members is replaced by this duty. This section requires a director to disclose any interest, direct or indirect, that he has in relation to a proposed transaction or arrangement with the company. The director does not need to be a party to the transaction for the duty to apply. An interest of another person in a contract with the company may require the director to make a disclosure under this duty, if that other person's interest amounts to a direct or indirect interest on the part of the director.
348. Under the current equitable rule, shareholder approval is required for transactions between a company and a director. Company articles often modify the equitable rule, requiring disclosure of the conflict instead. As proposed by the CLR, shareholder approval for the transaction is not a requirement of the statutory duty. The members of the company may however still impose requirements for shareholder approval in the articles.
349. The duty requires directors to disclose their interest in any transaction before the company enters into the transaction (*subsection (4)*). The duty does not impose any rules on how the disclosure of interest must be made, but *subsection (2)* allows the disclosure to be made by written notice, general notice or disclosure at a meeting of the directors.
350. Disclosure to the members is not sufficient. The director must declare the nature and extent of his interest to the other directors. It is not enough for the director to merely state that he has an interest.
351. If after he has disclosed his interest, he becomes aware that the facts have changed, or for some other reason the earlier disclosure is no longer accurate or complete, the director must make a further declaration, correcting the earlier one (*subsection (3)*). However, this is only necessary if the company has not yet entered into the transaction or arrangement at the time the director becomes aware of the inaccuracy or incompleteness of the earlier declaration (or ought reasonably to have become so aware).
352. As the duty requires disclosure to be made to the other directors, no disclosure is required where the company has only one director. There is no need to disclose anything the other directors already know about or ought reasonably to have known (*subsection (6)(b)*). A director will breach the duty if he fails to declare something he ought reasonably to have known, but the duty does not otherwise require a director to declare anything he does not know. *Subsection (6)(c)* makes special provision for service contracts that are considered by a meeting of the directors or a committee appointed for the purpose (such as a remuneration committee).
353. No declaration of interest is required if the director's interest in the transaction cannot reasonably be regarded as likely to give rise to a conflict of interest (*subsection (6)(a)*). Currently regulation 85 of Table A imposes a materiality test.
354. Conflicted directors may, subject to the company's articles of association, participate in decision-taking relating to such transactions with the company.

Section 181: Modification of provisions in relation to charitable companies

355. This section reverses certain relaxations made to the no-conflict rule as it applies to the directors of charitable companies in England and Wales and Northern Ireland.
356. *Subsection (2)(a)* replaces section 175(3) which excludes conflicts of interest arising out of transactions or arrangements with the company. The replacement excludes such

conflicts of interest from the duty only if or to the extent that the charitable company's articles so allow. The articles must describe the transactions or arrangements which are to be so excluded from the duty.

357. *Subsection (2)(b)* replaces section 175(5) which allows authorisation for conflicts of interest to be given by the directors. The replacement only allows authorisation to be given by the directors where the charitable company's constitution expressly allows them to do so.
358. *Subsection (3)* restricts the application of section 180(2)(b) which disapplies sections 175 and 176 in relation to those matters excepted from the requirements for member approval under Chapter 4. Section 180(2)(b) is restricted so that it only applies if or to the extent that the charitable company's articles allow the duties in sections 175 and 176 to be disapplied. The articles must describe the transactions or arrangements which are to be so excluded from those duties.
359. *Subsection (4)* amends the Charities Act 1993 to give the Charity Commission the power to authorise acts that would otherwise be in breach of the general duties. This is necessary to preserve the current power of the Charity Commissioners to do so, in the light of the statutory statement of the general duties.

Chapter 3: Declaration of Interest in Existing Transaction Or Arrangement

Section 182: Declaration of interest in existing transaction or arrangement

360. This section requires a director to declare the nature and extent of any direct or indirect interest that he has in any transaction or arrangement entered into by the company. It replaces the provision made by section 317 of the 1985 Act.
361. This chapter differs from the provisions of that section in a number of important respects. The main points are summarised below.

What should be declared?

362. Directors are required to declare any interest, direct or indirect, that they have in an existing transaction or arrangement entered into by the company. This section only applies to transactions or arrangements already entered into by the company. Section 177 (duty to declare interests) applies in the case of proposed transactions or arrangements with the company.
363. The director does not need to be a party to the transaction with the company in order for a declaration to be required under this section. For example, where the director's spouse enters into a transaction with the company that may (but need not necessarily) give rise to an indirect interest on the part of the director in that transaction.
364. The declaration must be of the nature and extent of the director's direct or indirect interest.
365. If the director has declared his interest in accordance with section 177 at the time the transaction was proposed, and before it was entered into by the company, the director does not need to repeat that declaration once the transaction becomes an existing transaction to which this section applies (*subsection (1)*).
366. Furthermore, a director need not declare any interest:
- that cannot reasonably be regarded as likely to give rise to a conflict of interest;
 - that the other directors already know about, or ought reasonably to know about; or
 - that concerns the terms of his service contract, considered (or to be considered) by a meeting of directors or by the relevant committee of directors.

367. A director is regarded as failing to make the declarations required by this section if he fails to declare something that he ought reasonably to have known. But the director is not otherwise expected by this section to declare things he does not know (*subsection (5)*).

When should the declaration be made?

368. The declaration should be made as soon as is reasonably practicable. But even if the declaration is not made as soon as it should have been, it must still be made (*subsection (4)*). If after a declaration has been made the director's interest in the transaction or arrangement changes, or the director realises that his interests were not as originally declared, the director must make another declaration of interest, correcting or updating the earlier one (*subsection (3)*).

How should the declaration be made?

369. The declaration of interest must be made to the other directors using one of the following three methods:-
- at a meeting of the directors; or
 - by notice in writing (in accordance with the requirements of section 184); or
 - by general notice (in accordance with the requirements of section 185).

Section 183: Offence of failure to declare interest

370. This section restates section 317(7) of the 1985 Act. A director who fails to comply with the requirements of section 182 commits an offence. On conviction on indictment the maximum liability is an unlimited fine. On summary conviction the fine must not exceed the statutory maximum (currently £5,000). This section does not affect the validity of the transaction or impose any other civil consequences for a failure to make the declarations of interest required by section 182.

Section 184: Declaration made by notice in writing

371. This section provides a new written procedure for the declarations of interest required by section 182. A written notice declaring the nature and extent of the director's interest must be sent to all the other directors. It may be sent in hard copy form or, if the recipient agrees, in electronic form. It may be posted, delivered by hand or, if the recipient agrees, by electronic means. When this is done, the notice is treated as forming part of the proceedings of the next meeting of the directors, and so should form part of the minutes of that meeting (*subsection (5)*).

Section 185: General notice treated as sufficient declaration

372. This section replaces section 317(3) and (4) of the 1985 Act. It enables a director to give a general notice of his interests. A general notice is a declaration that the director is interested in another body corporate or firm, or that the director is connected with another person. If the company enters into a contract with the body corporate, firm or other person named in the general notice, the director does not need to declare any direct or indirect interest that he has in that contract arising as a result of his interest in the body corporate or firm named in the general notice or arising as a result of his connection to the person named in the general notice.
373. In order to be effective, the general notice must state the nature and extent of the director's interest in the body corporate or firm (for example, sole shareholder of the company) or the nature of his connection with the person (for example, spouse or other connected person as defined in section 253). The requirement to disclose the extent of the interest implements a recommendation of the Law Commissions.

Section 186: Declaration of interest in case of company with sole director

374. This is a new provision. Where a company has only one director, it is not possible for the director to declare his interests to the other directors, because there are no other directors. Therefore, a sole director does not need to comply with section 182 (declaration of interest in existing transaction or arrangement).
375. The section makes special provision where the company has only one director, when it should in fact have more than one director (for example, because it is a public company). In such a case, the sole director must record in writing the nature and extent of his interest in any transaction or arrangement that has been entered into by the company.

Section 187: Declaration of interest in existing transaction by shadow director

376. This section replaces section 317(8) of the 1985 Act. It extends this Chapter to shadow directors, so that a shadow director must also declare the nature and extent of his interest in any transaction or arrangement that has been entered into by the company, in accordance with section 182. The declaration must be made by notice in writing (section 184) or by general notice (section 185).
377. The declaration is not made at a meeting of the directors, as this is not appropriate in the case of a shadow director. If the shadow director makes the declaration by general notice, that notice must be given in accordance with the notice in writing procedure set out in section 184. This means that a general notice given by a shadow director must comply with both section 184 and the first three subsections of section 185.
378. Otherwise, apart from section 186 (declaration of interest in case of company with sole director), which is not relevant to a shadow director, all the other provisions of this chapter apply to a shadow director, including the exemptions in section 182.