

# MACFARLANES

## CORPORATE AND M&A

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### BRIEFING

#### THE DUTIES AND LIABILITIES OF DIRECTORS OF ENGLISH COMPANIES

##### INTRODUCTION

This guide states the law as at 1 January 2011.

##### Separate legal personality

Under English law a company (whether public or private, and whether the liability of its members is limited or unlimited) has its own legal personality independent of both those who own it and those who manage it. In the same way as an individual, a company may own property, be party to a contract, sue and be sued and even commit certain crimes.

However, a company is unable to act except through the agency of individuals. For a company to enter into a contract, for example, requires someone with appropriate authority on the company's behalf to acknowledge that the company agrees to be bound by the terms of the contract and, if necessary, to sign or execute the appropriate document.

What determines who has that authority depends in part upon the company's own constitution - its articles of association ('articles') - and in part upon the general law.

##### Articles

The articles establish the basis of the relationship between the shareholders, both in relation to each other and in relation to the company as a whole, and in particular their rights in relation to their ownership of shares in the capital of the company and, through their shares, their control of its activities and indirect ownership of its assets.

Most importantly, in the present context, the articles provide for the establishment of the company's board of directors and vest in the board its power and authority to run the company on behalf of the shareholders. The articles generally provide that, subject to the statutory requirements of the Companies Act 2006 (the '2006 Act'), the particular provisions of the company's own articles and specific directions given from time to time by the shareholders, the business of the company is to be managed by the directors, who are authorised to exercise all the powers of the company. The directors may therefore run the company, within the law, subject only to those residual powers expressly reserved to the shareholders.

The articles also govern the appointment and removal of directors and the manner in which they are to act and reach decisions. Broadly, to make a decision the directors must act collectively as a board at a properly convened meeting, notice of which has been given to all the directors, and must take the decision on the basis of a majority of the votes cast.

However, the particular rules as to voting, delegation of powers to a committee or to a single director, and so forth depend upon each company's own articles.

It is of fundamental importance for anyone appointed as a director of a company to read carefully the articles of the company. It is equally important that directors continue to have regard to and abide by the regulations and restrictions which the articles impose upon them. Failure to do so may result in a director incurring personal liability for his actions. This, together with some of the other principal duties and potential liabilities associated with the holding of office as a director, is considered in this guide.

##### Who is a director?

Many of the duties and liabilities described in this guide do not only apply to directors formally appointed and holding office as such. The definition of a "director" in the 2006 Act states that it includes any person occupying the position of a director, whatever his title. Thus someone who acts as a director notwithstanding that he has never formally been appointed as such may be liable for breach of the provisions of the 2006 Act (at least) and probably for breach of certain common law duties as well.

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UK company law does not recognise two-tier boards where supervisory and management responsibilities are held by different directors. Instead UK companies have unitary boards of directors, on which all directors have the same liabilities and duties to the company. The role of the non-executive director is recognised as part of that unitary board structure.

The 2006 Act also imposes certain of the duties and liabilities imposed on directors on so-called "shadow directors", being persons in accordance with whose instructions the actual directors are accustomed to act. Thus it is not possible for someone to escape many of the statutory requirements by controlling a company from behind the scenes.

#### **DIRECTORS' DUTIES: GENERAL**

##### **Background**

While the articles of a company determine the internal proceedings of directors and the distribution of management power and control within the company, the duties and liabilities of directors towards the shareholders and, particularly, towards third parties are largely governed by the general law. The relevant statutes include the 2006 Act. The 2006 Act contains numerous provisions relating to the duties of directors, including a statutory statement of the general duties of directors, and prescribes penalties for breach of those duties. The duties are further extended by the Insolvency Act 1986 (the 'Insolvency Act'). The legislation makes no distinction between executive and non-executive directors: non-executive directors are directors for all purposes of the legislation. Certain duties (for example in relation to use of confidential information) will continue to apply even after the director has left office.

These duties are designed to protect the company, its members, creditors, employees and members of the general public from incompetence and fraud on the part of the directors and to ensure minimum (and in some cases quite high) levels of care and propriety in the conduct of the company's management.

##### **To whom are the duties owed?**

A director's duties are owed to the company of which he is a director.

Although his duties are owed to the company, a director may also have to consider the interests of persons other than the company. For example:

- ◆ he must not treat minority shareholders unfairly or oppressively, even when to do so might be regarded as being for the benefit of the majority;

- ◆ he must have regard to the interests of employees and to the need to foster business relationships with certain categories of person such as suppliers, customers and others;
- ◆ he must have regard to the impact of the company's operations on the community and the environment.

##### **Sanctions for breach**

The majority of the statutory general duties were, prior to being enshrined in statute, fiduciary duties concerned with the high standards of propriety required of a director. The 2006 Act specifically provides that the statutory duties (other than the duty to exercise reasonable care, skill and diligence) are to be enforceable as fiduciary duties. This has an impact on the remedies available for breach of those duties.

The consequences of breach of any of the statutory general duties (including the duty to exercise reasonable care, skill and diligence) may include damages or compensation where the company has suffered loss. The consequences of breach of any of the duties other than the duty to exercise reasonable care, skill and diligence, may include restoration of the company's property, an account of profits or rescission of a contract where the director failed to disclose his interest.

The shareholders of a company may also, in certain circumstances (considered below), have the right to bring a derivative claim on the company's behalf against a director who is negligent, in default, in breach of duty or in breach of trust.

The sanction for breach of a director's duty is also, in many cases, to impose on him personally financial liability for his actions (or failure to act). The consequences of breach may thus be serious and the office of a director is not one to be taken lightly. Having said that, provided a director is aware of the duties expected of him, acts with reasonable diligence, adopts a high standard of propriety in his conduct and, when appropriate, seeks and acts upon competent professional advice, he is most unlikely to incur personal liability as a result of his actions.

##### **Corporate Governance**

The UK Corporate Governance Code published by the Financial Reporting Council and corporate governance more generally are beyond the scope of this guide. We can provide further information on corporate governance on request.

It is worth noting in respect of listed companies, however, that the UK Corporate Governance Code specifically emphasises the role of the chairman in the induction of new directors. The chairman should ensure that all new directors receive induction on joining the board and also that they regularly update and refresh their skills and knowledge. Chairmen will have to make sure that all directors are aware of and understand their duties under the 2006 Act.

#### **A DIRECTOR'S STATUTORY GENERAL DUTIES AND OTHER KEY DUTIES**

The 2006 Act sets out seven general duties of directors.

The general duties of a director are:

- ◆ to act in accordance with the company's constitution and only exercise his powers for the purposes for which they are conferred;
- ◆ to 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;
- ◆ to exercise independent judgement;
- ◆ to exercise reasonable care, skill and diligence;
- ◆ to avoid conflicts of interest;
- ◆ not to accept benefits from third parties; and
- ◆ to declare interests in proposed transactions or arrangements with the company.

The duties are cumulative in that they must all be complied with in any given set of circumstances. In practice they are likely to overlap in many circumstances. They are described as "general duties", which distinguishes them from other duties, for example, statutory duties under insolvency and health and safety legislation, which may apply in any given situation. The general duties are not exhaustive - compliance with them will not excuse any breach of any other duty imposed on directors by law or statute.

It is not possible to contract out of the general duties, although the 2006 Act provides exemptions in connection with certain of the duties whereby the duty in question will not be infringed if certain circumstances apply. The specific exemptions are identified in connection with the relevant duties below.

The general duties apply to all directors, by whatever name they are called. As such they apply to both executive and non-executive directors alike, and also to de facto directors to the same extent as they would to a formally-appointed director. The duties are also owed, in some cases, by shadow directors and former directors.

**Duty to act within powers and to use powers for proper purpose**  
***A director of a company must act in accordance with the company's constitution and only exercise powers for the purposes for which they are conferred.***

A director must only exercise his powers for the purpose or purposes for which they are given, even if he believes that to do otherwise would be in the interests of the company.

An example of breach of this duty would be the improper allotment of shares to ward off an unwelcome takeover bid, even if the directors genuinely believe that defeating the takeover would promote the success of the company for the benefit of its members as a whole.

A company's constitution for the purpose of this duty includes the company's articles, any decisions taken in accordance with the articles and any other decisions taken by the members (or a class of members) if they can be regarded as decisions of the company.

Breach of this duty renders the director liable to be sued by the company for any loss suffered as a result of the wrongful exercise of power.

**Duty to promote the success of the company**  
***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.***

'Success' in this context will, for commercial companies, usually mean 'long-term increase in value'. "Members as a whole" is likely to continue to be construed by the courts as meaning both current and future members. This statutory duty thus requires that directors should take a medium to long term view of the effect of their actions on the company and its business.

The decision as to what will promote the success of the company, and what constitutes such success, is one for the directors' good faith judgement. The intention behind this formulation of the duty is to ensure that business decisions on, for example, strategy and tactics, will be for the directors and will not be subject to review by the courts so long as those decisions were, and can be shown to have been, made in good faith.

Directors of subsidiaries must remember that they should act in a way which is most likely to promote the success of the subsidiary as an individual entity, not the success of the parent company or the group as a whole.

In fulfilling the duty to promote the success of the company, a director must have regard (amongst other matters) to:

- ◆ 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;
- ◆ the impact of the company's operations on the community and the environment;
- ◆ the desirability of the company maintaining a reputation for high standards of business conduct; and
- ◆ the need to act fairly as between the members of the company.

The list of factors to which directors are required to have regard is not exhaustive. Other relevant factors must also be considered.

There is clearly the possibility for conflicts between various factors. For example an action may benefit the company's employees, at the expense of one or more of its suppliers, if the directors decide that more of a product should be developed in-house rather than being purchased from a third party supplier. However, directors have always had to juggle a number of factors in reaching decisions and directors are only required to "have regard" to (i.e. think about, or take into consideration) external factors. As stated above, each director must use his good faith judgement to determine the relevance of the individual factors to any given business decision and the extent to which relevant factors should influence the decision. The overall duty of a director is to promote the success of the company, not the interests of the various other stakeholders referred to in the list of factors.

There is no specific reference to creditors in the list of factors to which the directors must have regard. However, the 2006 Act provides that the duty to promote the success of the company is subject to any rule of law requiring directors in certain circumstances to take into account the interests of creditors. If the company is facing financial difficulty, the interests of the company's creditors become paramount and the directors will have an overriding duty to consider the interests of creditors.

There has been some debate about the extent to which the new duties and the six factors should be documented in a company's board minutes. The GC100 group, which represents the general counsel and company secretaries of the FTSE 100 companies, has issued guidance setting out what it considers to be best practice for public companies in this area.

The GC100's suggested approach is that companies need only specifically record consideration of the directors' duties under the 2006 Act where the particular circumstances make it particularly necessary or relevant. The default position should be not to include such references. Where background papers are being prepared for the board by the management team, the relevant factors, including those referred to in the 2006 Act, should be considered during the preparation of the papers. The directors can then review the papers, consider the proposal and the related recommendations using their own business judgement and then, following discussion, make a decision. Directors will, however, have to be satisfied that the people to whom the task of compiling the briefing is delegated are appropriate people. If one or more factors are clearly irrelevant, the GC 100 believes that best practice does not require a negative statement. The approach of the GC100 is consistent with the Government's statement (during the passage of the 2006 Act through Parliament) that there is nothing in the 2006 Act which requires a paper trail to demonstrate that the directors have considered every element.

It is important to remember that more than one of the statutory general duties may apply at any one time. If, for example, the directors take action which does not lead to the success of the company and the decision to take that action was lacking reasonable care and skill, the directors will be in breach of the duty to exercise reasonable care, skill and diligence (see below).

**Duty to exercise independent judgement**  
***A director of a company must exercise independent judgement.***

This duty effectively codifies the principle that directors must exercise their powers independently, without subordinating their powers to the will of others, whether by delegation or otherwise, unless they are authorised by the company's constitution to do so.

A director does not infringe the duty if he acts:

- ◆ in accordance with an agreement entered into by the company that restricts the future exercise of its directors' discretion; or
- ◆ in a way authorised by the constitution.

A director appointed by a substantial shareholder must be particularly careful not to breach this duty. The shareholder in such circumstances will often be keen to convey their opinions to the director in question. The director can listen to those opinions but must ensure that the decision on the way in which he exercises his powers is his own and is taken on the basis of his duties to the company, not the shareholder (see below).

The statutory duty does not specifically permit a director to delegate his powers. However, provided that the articles permit delegation and any delegation is carried out in accordance with the articles, a director may delegate the exercise of his powers. Articles in the form of or incorporating the Model Articles or Table A contain the power to delegate.

#### **Duty to exercise reasonable care, skill and diligence**

##### ***A director of a company must exercise reasonable care, skill and diligence.***

When carrying out his functions, a director must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with:

- ◆ the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the relevant director (i.e. an objective test); and
- ◆ the general knowledge, skill and experience which that director actually has (i.e. a subjective test).

In other words, a director is expected to exercise the greater of the level of skill and experience he possesses, and the level of skill and experience which might reasonably be expected of someone carrying out his function within the company.

Thus, a higher standard may be expected from an experienced managing director than from a non-executive director. It may be unreasonable in practice to expect a non-executive director to have the detailed and up-to-date knowledge that the executive directors have, and it is also not practicable for the non-executives to exercise close supervision of those employees to whom day to day management is delegated. A non-executive director must, however, bear in mind that whatever skills and knowledge he has acquired in his profession must be brought to bear on his actions as a director.

A director must attend diligently to the affairs of the company. Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors. The content and extent of this duty of participation will depend upon the circumstances.

In relation to attendance at board meetings, while a director is not obliged to attend all meetings of the board, he will be expected to attend whenever he reasonably can.

While directors may be permitted by the articles to delegate particular functions to those below them in the management chain, if they choose to exercise the power of delegation they will have a duty to supervise the discharge of those delegated functions. The directors will be able to trust the competence and integrity of any persons to whom functions are delegated to a reasonable extent, but must still supervise the execution of the functions. The question of whether a director's supervisory obligations have been discharged will depend on the facts of each particular case, including the director's role in the management of the company.

In addition to potentially incurring liability to the company itself for loss caused by his negligence in carrying out his functions, in exceptional circumstances a director may incur liability jointly with the company towards a third party. This might include where his particular lack of care has resulted in the company or its employees causing loss or damage to the third party.

#### **Conflicts of interest**

Under the 2006 Act regime conflicts fall into three distinct categories:

- ◆ conflicts of interest where the company is not party to the transaction or matter in question;
- ◆ conflicts of interest in connection with a proposed transaction or arrangement with the company;
- ◆ conflicts of interest in connection with an existing transaction or arrangement with the company.

Each category involves different duties and obligations.

### **Duty to avoid conflicts of interest**

***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.***

This duty is expressly stated to apply in particular to the exploitation of any property, information or opportunity, regardless of whether or not the company could take advantage of that property, information or opportunity.

Although not specifically mentioned in the formulation of the duty under the 2006 Act, the old equitable rule that directors owe a duty to the company not to make a secret profit is generally understood to be included within the duty to avoid conflicts – the interests of a director who is making a profit for himself will generally conflict with the company's interests. A different aspect of the no-profit rule is reflected in the new duty not to accept benefits from third parties (see below).

Under the 2006 Act the disinterested directors are able to authorise a conflict (rather than a conflict having to be sanctioned by the shareholders). The directors may authorise the matter:

- ♦ in the case of a private company, where nothing in the company's constitution invalidates such authorisation, by the matter being proposed to and authorised by the directors; or
- ♦ in the case of a public company, where its constitution specifically permits such authorisation, by the matter being proposed to and authorised by the directors in accordance with the constitution.

In addition, private companies in existence before 1 October 2008 are required to pass a shareholders' resolution in order for the directors to be permitted to make use of the power to authorise a conflict. It is likely to be beneficial to directors of both private and public companies to put in place procedures to deal with conflicts of interest under the 2006 Act regime.

A director who takes on multiple directorships will have to pay particular attention to this duty. Taking on any other directorship may give rise to a situation "which possibly may conflict" with the interests of the company. The Government's position during the passage of the 2006 Act through Parliament was that the conflict or potential conflict arising will not be prohibited as long as it is authorised by the directors in accordance with the 2006 Act.

In practice, any existing director taking on another directorship should seek board authorisation before doing so and any director joining the board should seek authorisation for all his current directorships and other interests. Any such authorisation should be framed in wide enough terms to cover not just taking on the directorship but any foreseeable conflicts that may arise in connection with that directorship in the future e.g. the negotiation of contracts in the same business sector as the company. If the authorisation is not framed sufficiently widely, or if an unforeseen conflict arises, the interested director will have to disclose the conflict at that point, in sufficient detail that the disinterested directors can consider on an informed basis whether to give authorisation. If the interested director's duty of confidentiality to the other company prevent disclosure of the relevant details, the practical solution will be for the director to absent himself from the board discussions on the subject in question. The 2006 Act does not contemplate directors taking this approach but it was common practice under the former regime.

The duty is not infringed if the situation "cannot reasonably be regarded" as likely to give rise to a conflict of interest. If the disinterested directors decide that this exemption applies in a particular case, they should document their reasons for making that decision. It will also be in the interested director's interests to ensure that the decision is documented.

This duty also applies to a person who ceases to be a director. Such a person will remain subject to the duty as regards the exploitation of any property, information or opportunity of which he became aware at a time when he was a director.

The duty does not apply to a conflict of interest in relation to a proposed or existing transaction or arrangement with the company, both of which are dealt with below.

### **Declarations of interest**

***Under the 2006 Act, the regime for the declaration of interests in connection with transactions or arrangements with the company falls into two different categories:***

- ♦ a director has a duty to declare an interest in a proposed transaction or arrangement with the company; but
- ♦ a director has an obligation to declare an interest in an existing transaction or arrangement with the company.

It is important to distinguish between the two categories because the sanctions for breach are different, as are (in minor respects) the procedures for ensuring compliance. Both aspects are covered below.

**Duty to declare interest in proposed transaction or arrangement**  
*If a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, he must declare the nature and extent of that interest to the other directors.*

Any declaration required under this duty has to be made before the company enters into the transaction or arrangement in question.

A sole director need not declare interests and directors need not declare an interest in three other situations.

First, no declaration is required if the interest "cannot reasonably be regarded" as likely to give rise to a conflict of interest. As with the similar exemption in respect of the duty to avoid conflicts of interest, if the board decides that this exemption applies in a particular case, they should document the reasons for making that decision.

Secondly, if, or to the extent that, the other directors are already, or ought reasonably to be, aware of the interest, no declaration is required. If this exemption is being relied on, the interested director should ensure that there is documentary evidence of the fact.

Thirdly, if, or to the extent that, the interest concerns the terms of a director's service contract that have been or are to be considered by the directors, no declaration is required.

The 2006 Act does not require the declaration to be made in a particular way but sets out a non-exhaustive list of the ways in which it may be made:

- ◆ at a meeting of the directors; or
- ◆ by notice:
- ◆ in writing; or
- ◆ in accordance with the 2006 Act's requirements for general notice (see below).

A director must also make a further declaration if his previous declaration proves to be or becomes inaccurate or incomplete.

The remedies available for failure to comply with the above duty are the same as for breach of any of the other statutory general duties. These include the interested director being required to account for any profits and, potentially, rescission of a contract where the director failed to disclose his interest.

**Obligation to declare interest in existing transaction or arrangement**

*Where a director of a company is in any way, directly or indirectly, interested in a transaction or arrangement that has been entered into by the company, he must declare the nature and extent of the interest to the other directors in accordance with section 182 of the 2006 Act.*

A declaration under this obligation must be made as soon as reasonably practicable. The obligation does not apply where a director has already declared his interest in respect of the proposed transaction or arrangement (see above).

A director need not declare an interest in the same three situations as are set out in respect of proposed transactions.

First, no declaration is required if the interest "cannot reasonably be regarded" as likely to give rise to a conflict of interest. As above, if the board decides that this exemption applies in a particular case, they should document the reasons for making that decision.

Secondly, if, or to the extent that, the other directors are already, or ought reasonably to be, aware of the interest, no declaration is required. If this exemption is being relied on, the interested director should ensure that there is documentary evidence of the fact.

Thirdly, if, or to the extent that, the interest concerns the terms of a director's service contract that have been or are to be considered by the directors, no declaration is required.

Unlike the declaration in respect of a proposed transaction or arrangement, the declaration of an interest in an existing transaction must be made:

- ◆ at a meeting of the directors; or
- ◆ by notice in writing (sent in accordance with the 2006 Act); or
- ◆ by general notice (as set out in the 2006 Act).

General notice is a notice that the director:

- ◆ has an interest (as a member, officer, employee or otherwise) in a specified body corporate or firm and is to be regarded as interested in any transaction or arrangement that may, after the date of the notice, be made with that body corporate or firm; or

- ♦ is connected (as defined in the 2006 Act) with a specified person (other than a body corporate or firm) and is to be regarded as interested in any transaction or arrangement that may, after the date of the notice, be made with that person.

A general notice must state the nature and extent of the director's interest in the body corporate or firm or, as the case may be, the nature of his connection with the person. The general notice must be given at a meeting of the directors or, if it is not, the interested director must take reasonable steps to ensure that it is brought up and read at the next meeting of the directors after it is given.

A director must also make a further declaration if his previous declaration proves to be or becomes inaccurate or incomplete.

The above requirement is an obligation, not one of the general duties. As such, the sanctions for failure to comply are different from the remedies for breach of one of the duties. Failure to comply is a criminal offence, punishable by a fine.

#### **Duty not to accept benefits from third parties**

***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.***

Although this duty is formulated separately from the general duty to avoid conflicts of interest (and not to make a secret profit) and the duty to exercise independent judgement, there is clearly some overlap with those duties.

Under this duty, there is no scope for authorisation by the directors. The only situation in which the duty will not be infringed is if the situation 'cannot reasonably be regarded' as likely to give rise to a conflict of interest or the position is regulated by provisions contained in the company's articles. Directors should consider the company's existing code of ethics (if any) in the light of the new duty and should consider putting one in place if none exists. As third party benefits cannot be authorised, any such code should be drafted in terms that specified benefits or forms of hospitality can be accepted as they cannot reasonably be regarded as giving rise to a conflict of interest.

The duty does not apply to benefits received by a director from a person by whom his services (as a director or otherwise) are provided to the company. These are not regarded as being conferred by a third party.

#### **OTHER STATUTORY OBLIGATIONS AND DUTIES**

Directors are subject to a number of specific duties imposed by statute, which will affect them in different areas of the company's business. It is not possible, within the scope of this guide, to outline these. The following are, however, some of the key company law duties arising under the 2006 Act.

#### **Restrictions on entering into certain contracts**

Although not strictly duties, the 2006 Act contains provisions prohibiting certain contracts or arrangements between a company and its directors. Generally, if such a contract or arrangement is entered into it will be unenforceable. In addition, the director and/or any connected person concerned (and any other directors who authorised the arrangement) may be jointly and severally liable, subject to certain limitations, to account for any gain which they receive from the arrangement and to indemnify the company from any losses which it incurs. The prohibited contracts and arrangements include the following:

- ♦ payment of compensation for loss of office as a director unless first approved by the shareholders or due under a contract (subject to a very low threshold of £200 below which no approval is required);
- ♦ contracts of employment with the director for more than two years and incapable of termination by the company before the end of such term, unless first approved by the shareholders;
- ♦ transactions between the company and a director (or certain connected persons, e.g. the director's spouse, civil partner or children) involving the transfer of assets worth over £100,000 (or 10% of the net assets of the company, if less, subject to a minimum of £5,000), unless first approved by the shareholders or conditional on shareholder approval; and
- ♦ loans over £10,000 to directors or connected persons, or guarantees of loans made by a third party; unless first approved by the shareholders. More rigorous rules apply to public companies and their subsidiaries although, again, are permissible if first approved by the shareholders.

#### **Disclosure of dealings in shares of the company**

Directors and certain senior executives of a listed company, as well as their connected persons, must notify the company of transactions in its shares or other financial instruments under the Financial Services Authority's Disclosure and Transparency Rules.

### **Allotment of new shares**

A company is prohibited from allotting shares for cash unless it also makes an offer to all existing shareholders on the same or more favourable terms. Breach of this provision renders the company, and every officer who knowingly authorised or permitted the breach, jointly and severally liable to compensate any person to whom the offer should have been made for losses suffered as a result.

Unlike a private company, a public company cannot exclude these statutory pre-emption provisions through a provision in its articles. Both public and private companies may, however, disapply them by special resolution. The Listing Rules also require companies to make pre-emptive offers of new securities to existing holders in proportion to their existing holdings, except to the extent pre-emption rights are disapplied by shareholder resolution.

The Pre-emption Group, which comprises representatives of listed companies, investors and intermediaries, publishes a statement of principles that provides guidance to companies and investors on the disapplication of pre-emption rights by listed companies. The guidelines are not rules, but are intended to represent the likely position taken by institutional shareholders on any disapplication resolution. The guidelines recommend that any general disapplication of the statutory pre-emption provisions should be limited to 5 per cent. of the issued ordinary share capital in any one year or 7.5 per cent. in any three-year rolling period. These guidelines are generally regarded as best practice by institutional investors.

The ABI and the NAPF take the view that the statutory section 551 authority required to issue shares should be limited to an amount not exceeding one third of the issued ordinary capital. They will also regard as routine a resolution authorising the allotment of a further one third of the issued share capital provided:

- ◆ the additional authority is only used for fully pre-emptive rights issues; and
- ◆ both authorities expire after one year.

Where a public company receives non-cash consideration for allotting shares, an expert's prior report and valuation will normally be needed. An exception is a where the non-cash consideration comprises all or part of the share capital of another company.

### **Financial assistance for the acquisition of shares**

Public companies are generally prohibited from giving financial assistance for the acquisition of their shares or the shares of their holding company, or for reducing or discharging any liability incurred for the purpose of any such acquisition. There are exceptions to this general prohibition but they are very restricted. The prohibition covers any gifts, guarantees, securities, indemnities or loans. Breach of section 678 or 679 of the 2006 Act is an offence by the company and any officer in default and is punishable by imprisonment or a fine, or both.

### **Purchase of own shares**

Companies are generally prohibited from acquiring their own shares. On and off market purchases are permissible if carried out in accordance with the strict requirements of the 2006 Act and, if the company is listed, the Listing Rules, which include obtaining shareholder consent. Purchases by public companies can only be made out of distributable profits or the proceeds of a fresh issue of shares made for the purpose. Private companies can also purchase shares out of capital, provided a number of 2006 Act requirements are met.

Subject to certain exemptions, every purported act of a company contravening these provisions may render a company liable to a fine. Every director of a company who is in default is also liable to a fine or imprisonment.

Companies with shares listed in the UK or listed or admitted to a regulated market in another EEA state or admitted to trading on AIM, may buy and hold their issued shares in 'treasury'. These treasury shares are then available for resale, transfer to an employees' share scheme or subsequent cancellation. The above requirements for a share repurchase also apply to purchases of shares in treasury.

### **Serious loss of capital**

If the net assets of a public company fall to 50 per cent. or less of its called up share capital, the directors must convene an extraordinary general meeting. Contravention renders each director liable to a fine.

### **Distribution of profits and assets**

The 2006 Act permits companies to make distributions only out of profits available for that purpose. In the case of a public company there is an additional requirement that the net assets of the company must be not less (and would not be less following the distribution) than the aggregate of its called up share capital and undistributable reserves.

### **Making returns to the Registrar of Companies**

There are a considerable number of matters affecting a company in respect of which details must be sent to Companies House within a specified period following the relevant event.

Amongst the most important of these documents and events are:

- ◆ the annual return, which is designed to ensure that information at Companies House is kept reasonably up to date and that changes to the company's directors, shareholders and share capital are noted;
- ◆ changes in the articles;
- ◆ purchases by the company of its own shares;
- ◆ special resolutions of the shareholders, including those in writing;
- ◆ ordinary resolutions, including those in writing, to give authority to allot shares;
- ◆ creation of registrable charges (e.g. mortgages) over the company's property; and
- ◆ the allotment of shares.

### **Preparation of annual accounts**

The directors are responsible for ensuring that proper accounts are prepared and audited by the company's auditors each year.

The accounts must contain the following:

- ◆ a profit and loss account for the past financial year;
- ◆ a balance sheet as at the end of the financial year approved by the board and signed by a director on its behalf;
- ◆ a statement that so far as each of the directors is aware there is no information needed by the company's auditors in connection with preparing their report of which the company's auditors are unaware; and that each director has taken all the steps that he ought to have taken as a director in order to make himself aware of any such information and to establish that the company's auditors are aware of that information;

- ◆ a business review, in the directors' report: (i) containing a balanced and comprehensive analysis of the development and performance of the company's business (and of its subsidiaries) during the financial year and of their position at the end of it; and (ii) using, to the extent necessary for an understanding of the development, performance or position of the company's business, analysis using financial and other key performance indicators including information relating to environmental matters and employee matters;
- ◆ a statement of the amount (if any) which the directors recommend should be paid as dividend; and
- ◆ a report by the auditors stating whether in their opinion the balance sheet and profit and loss account have been properly prepared and give a true and fair view of the financial state of affairs of the company. In the case of a company which is required to report under, or has adopted, International Financial Reporting Standards, the accounts must be "fairly presented".

The 2006 Act expressly states that the purpose of the business review is to help the members assess how the directors have performed their duty to promote the success of the company for the benefit of the members as a whole.

The directors of a quoted company (i.e. one whose equity share capital is officially listed in the UK or another EEA state or is admitted to dealing on either the New York Stock Exchange or Nasdaq) must also:

- ◆ prepare a remuneration report setting out certain information regarding directors' remuneration; and
- ◆ include in the business review, to the extent necessary for an understanding of the development, performance or position of the company's business: (i) the main trends and factors likely to affect the future development, performance and position of the company's business; (ii) information about environmental matters, the company's employees and social and community issues; and (iii) information about persons with whom the company has contractual or other arrangements which are essential to the business of the company.

The directors' report (which contains the business review) and the remuneration report must be approved by the board and signed by a director or the secretary. The profit and loss account and the balance sheet must also be approved by the board of directors, one of whom must sign the balance sheet. The accounts are then sent to the auditors for them to report on. It is this final version which is put before the members in general meeting.

In the case of a public company, copies of the accounts must be sent to the shareholders in advance of the meeting (usually the company's AGM) at which the accounts are to be presented to the shareholders. A copy of the accounts, having been approved by the board, must also be filed with Companies House. All of this must be done within six months following the end of the relevant financial year. Companies also have the option of sending a summary financial statement to those shareholders which want the summary instead of a copy of the full accounts.

A private company must send copies of its accounts to the shareholders and file its accounts with Companies House. It must send out its accounts no later than nine months following the end of the relevant financial year or, if earlier, the date on which it files its accounts with Companies House.

Both the company and the directors (except those who took all reasonable steps to secure compliance) are liable to a fine for failure to comply with these requirements.

#### **Directors' service contracts**

All directors' service contracts must be available for inspection at the company's registered office at all times. Failure to comply may render the company and the directors liable to a fine.

For listed companies, the UK Corporate Governance Code provides that non-executive directors' terms of engagement should be available for inspection at the company's registered office and at the AGM for at least 15 minutes prior to and during the meeting.

#### **CRIMINAL AND RELATED LIABILITIES**

As mentioned above, certain breaches of duty, particularly in relation to statutory duties, are criminal offences for which directors are liable to be fined or even, in extreme cases, imprisoned. The same applies to directors who knowingly or wilfully authorise or permit breach by a company of certain obligations primarily imposed on the company itself (most filing requirements fall into this category).

Fines may accrue daily, so the longer the default the greater the fine. Many of the statutory offences apply to directors of a company as well as to the company itself.

Directors should also be aware of the plethora of additional statutory liabilities which may be visited upon them personally, as well as the company, in areas relating to the environment and under health and safety legislation. It is, accordingly, important that directors assess the exposure of their company to such liabilities and, where appropriate, put in place proper systems and controls and the necessary insurance to minimise the risk of liabilities arising. The Institute of Directors and the Health and Safety Commission have issued joint guidance for directors on their responsibilities for health and safety at work. The guidance can be found on the IoD's website at [www.iod.com](http://www.iod.com).

#### **The Fraud Act 2006**

The Fraud Act comprises three basic fraud offences:

- ◆ fraud by false representation;
- ◆ fraud by failure to disclose information (which there is a legal duty to disclose); and
- ◆ fraud by abuse of position.

Each of these offences can be committed by a company and its officers will also be liable if the act is committed with their consent or connivance. The offences require dishonesty on the part of the perpetrator and an intention to cause gain or loss.

**Fraud by false representation:** this provides that it is an offence for a person dishonestly to make a false representation, by which he intends to make a gain for himself or another or to cause loss to another or expose another to a risk of loss. Significantly, this offence extends to misleading representations which include representations which are misleading by reason of an omission.

**Fraud by failure to disclose information:** this creates an offence where a person fails to disclose to another person information which he has a legal duty to disclose to that person, and in so failing to disclose intends to make a gain for himself or another or to cause loss to another or expose another to a risk of loss.

"Duty" is not defined. The Law Commission has taken a very broad view of a "duty", considering that it covers situations where rights are derived from statute, contracts, customary practice or fiduciary relationships.

**Fraud by abuse of position:** this states that it will be an offence for a person who occupies a position in which he is expected to safeguard, or not to act against, the financial interests of another person, dishonestly to abuse that position (by an act or an omission), and intending thereby to cause loss to another or expose another to a risk of loss.

### **Bribery Act 2010 - director's responsibilities**

#### ***Bribery***

The Bribery Act 2010 is due to come into force in April 2011. In summary, it will:

- ◆ extend the common law offences of bribery to cover all private sector transactions;
- ◆ create a new strict liability offence of failing to prevent bribery – in order to have a defence an organisation must be able to show that it had “adequate procedures” in place to prevent bribery; and
- ◆ impose criminal penalties for both individual directors and their companies.

The scope of the Bribery Act is extensive as the offences under it are very broadly defined and it has significant extra-territorial scope.

#### ***Bribery offences***

There are four main offences under the Bribery Act:

- ◆ a general offence relating to bribing another, i.e. promising, offering or giving a financial or other advantage to another person to induce or reward a person regarding improper performance of a certain function or activity; and offering, promising or giving financial or other advantage to another person, where it is known or believed that the acceptance of the advantage would constitute improper performance;
- ◆ a general offence relating to being bribed; requesting, agreeing to receive or accepting a bribe;
- ◆ an offence of bribing a foreign public official to obtain/retain business; and
- ◆ a strict liability offence for commercial organisations where they fail to prevent bribery by those acting on their behalf.

A director who consents or connives at the commission of the first three offences will also commit the relevant offence.

#### ***Penalties***

An individual director guilty of an offence under the Bribery Act may be liable to imprisonment for up to 10 years and/or to an unlimited fine. Companies guilty of an offence could potentially receive unlimited fine, and such fines are likely to be substantial.

#### ***The strict liability offence***

The new strict liability offence may be of particular concern to directors. A commercial organisation commits an offence if it fails to prevent bribery committed by a ‘person associated’ with the organisation, where it is for the organisation’s benefit.

A ‘person associated’ with the organisation will be interpreted widely and may cover employees, subsidiaries, intermediaries, suppliers, joint venture partners and agents. Accordingly, directors must ensure that appropriate safeguards are in place in order that, if persons associated with the company or the company itself is accused of bribery, they have an adequate defence.

It is a defence for the company to prove that it had in place adequate procedures designed to prevent persons associated with the organisation from undertaking such conduct. Unfortunately the Bribery Act does not define ‘adequate procedures’. However, the Ministry of Justice is to publish guidance on this. Under the draft of this guidance, the government has set out six principles by which commercial organisations should set their procedures:

- ◆ Principle 1: Risk assessment;
- ◆ Principle 2: Top level commitment;
- ◆ Principle 3: Due Diligence;
- ◆ Principle 4: Clear, practical and accessible policies and procedures;
- ◆ Principle 5: Effective implementation and
- ◆ Principle 6: Monitoring and review

Directors should consider what steps they need to take to ensure their procedures are adequate, including conducting a risk assessment for the entire group, updating anti-corruption policies and conducting further due diligence on any third parties, including all contracts with agents and suppliers.

## **Corporate Manslaughter**

### ***The common law***

Under the common law offence of manslaughter by gross negligence, a company may be guilty of manslaughter where its negligent acts cause a person's death. It was notoriously difficult to bring successful prosecutions against large companies for this offence because to do so the prosecution had to show that a senior individual was the "directing mind" within the organisation and was himself responsible for the actions of the company that led to the death. In large companies, it was almost impossible to prove the necessary link between the directing mind of the company and the day to day operations which resulted in the death. The only successful prosecutions have been against small, often owner-managed, companies where the necessary link is easier to establish.

Under the common law offence, the individual "directing mind" (which could, of course, be a director) can himself be liable for gross negligence manslaughter.

### ***The Corporate Manslaughter and Corporate Homicide Act 2007***

The Corporate Manslaughter and Corporate Homicide Act 2007, changes the position at common law (see above). It abolishes the common law offence as it applies to corporations and creates a new offence of corporate manslaughter (or corporate homicide in Scotland).

The key difference in the offence is that a company will be guilty of manslaughter if the way in which its activities are managed or organised by its senior management causes a person's death and amounts to a gross breach of a relevant duty of care owed by the organisation to the deceased.

Senior management in this context means the persons who play significant roles in (i) the making of decisions about how the whole or a substantial part of a company's activities are to be managed or organised or (ii) the actual managing or organising of the whole or a substantial part of those activities.

The duty of care is a broad one. It extends to employees or other persons working for the company or performing services for it. It also encompasses duties owed in connection with the supply by the company of goods and services or the carrying on of construction or maintenance operations or any other commercial activity.

The Act specifically provides that a jury in a prosecution under the Act must consider whether the company failed to comply with any health and safety legislation and may also consider any health and safety guidance relating to the alleged breach. A jury may also consider whether the evidence shows that there were "attitudes, policies, systems or accepted practices within the organisation" that were likely to have led to safety failures. Although the jury can consider any other factors it considers relevant, the Act clearly puts health and safety matters centre-stage.

It is only the company which can be liable under this Act. Individuals cannot be guilty of the main offence and the Act specifically states that individuals cannot be guilty of aiding, abetting, counselling or procuring the commission of corporate manslaughter. Individuals can, however, still be liable under the common law offence of manslaughter by gross negligence and also under health and safety legislation. As such, while directors cannot themselves be personally liable under the Act, in order to protect the company from prosecution under the Act, and themselves from personal liability under the common law and health and safety legislation, they should ensure that health and safety policies are reviewed in the light of the Act and that all senior management are aware of its implications.

Companies found guilty of the corporate manslaughter offence will be subject to an unlimited fine and will be likely to suffer extensive reputational damage as a result of the guilty verdict. The court can order a company to publicise the fact that it has been convicted of corporate manslaughter together with particulars of the offence and the amount of any fine imposed.

### **ASSUMPTION OF PERSONAL LIABILITY**

There are certain other actions on the part of a director which may render him personally liable, either to the company or to third parties, including the following:

#### **Failure to disclose the company's interest or involvement in a contract**

If a director enters into a contract, intending to do so on behalf of the company, but without making it clear to the other party that the contract is with the company, that other party may treat the contract as having been made with the director himself and may hold the director personally liable to perform it, or to pay damages if the company defaults.

### **Failure to disclose full name of company**

Where a director issues certain documents (including cheques and orders for goods) which do not disclose the full name of the company on their face, the party to whom the document is issued may hold the director personally liable if the company defaults. The director may also be fined.

### **Exceeding authority**

If a director purports to enter into a contract on the company's behalf when he is not authorised to do so (for example, by a resolution of the board), he may be personally liable to the other party if, as a result, the company is able to disclaim the contract, or else he may be liable to the company itself where, despite his lack of actual authority, the company is treated as having been contractually bound by his action.

### **DERIVATIVE CLAIMS**

A director's duties are owed to the company and not to any other person, so generally only the company can take action to enforce them. However, in certain circumstances, shareholders may be able to bring a derivative claim under the 2006 Act on the company's behalf for any breach.

The derivative claim procedure applies to any claim arising from negligence, default, breach of duty or breach of trust by a director of the company. The cause of action must be the company's and may be against the director or another person. (If against another person, that person will have had to be involved in the breach, for example by inducing or knowingly assisting the director to act as he did.) The claimant need not have been a shareholder at the time the claim arose but must be a shareholder in order to bring the claim.

There is a two stage procedure which applies to derivative claims. First the claimant must show a prima facie case and then the court must give or refuse permission to continue the claim.

In considering whether to give permission, the court must have regard to various factors including:

- ◆ whether the member is acting in good faith;
- ◆ the importance that a person acting in accordance with the duty to promote the success of the company would attach to continuing the action;
- ◆ the possibility and the likelihood of ratification;
- ◆ whether the member could in fact continue the claim in his own right.

The person bringing a derivative claim could end up bearing the costs if the claim is dismissed and the court determines that it was unmerited.

If a derivative claim is successful, any damages awarded will go to the company, not to the shareholder bringing the claim.

Directors should ensure that the company's directors' and officers' insurance policy includes cover for defending derivative claims.

### **LIABILITY ARISING IN CONNECTION WITH A COMPANY'S INSOLVENCY**

The Insolvency Act imposes upon directors some of the strictest standards which they face in carrying out their duties. In particular, directors risk incurring personal liability to contribute to the assets of the company available to creditors where it is found in the course of winding-up the company that the directors have been guilty of wrongful or fraudulent trading.

### **Wrongful trading**

A director is guilty of wrongful trading where:

- ◆ the company of which he was a director has gone into insolvent liquidation; and
- ◆ at some time before the commencement of the liquidation of the company the director knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

The second test is objective, and the director will be found to fall within it if a reasonably diligent person with his general knowledge, skill and experience (or, if higher, the general knowledge, skill and experience reasonably to be expected of someone carrying out the functions carried out by the director in relation to the company) would have concluded that the company would not avoid insolvent liquidation - even if the director himself, as a result of his own incompetence or failure to acquaint himself with the relevant facts, did not so conclude.

On the application of the liquidator, the court may order a director guilty of wrongful trading to contribute personally to the company's assets.

A director will escape liability if he can show that once he concluded (or, if earlier, ought to have concluded) that the company would not avoid insolvent liquidation, he took every step to minimise the loss to creditors which a reasonably diligent person with his general knowledge, skill and experience (or with that reasonably expected of someone carrying out his functions in relation to the company) would have taken. At the very least, this would suggest seeking competent professional advice at the earliest sign of potential financial difficulties. If necessary, it may require the directors to take steps to cease to trade and to put the company into liquidation, administration or receivership before its trading position deteriorates further.

The wrongful trading legislation imposes a comparatively onerous burden on directors to ensure both that they are aware of the company's financial condition and that they do not permit it to deteriorate so as to pose an undue risk to its existing or potential creditors. The more skilled the director is, the heavier the burden, because the more that is to be expected of him. No element of fraud or dishonesty, or even culpable incompetence, is necessary for the director to be found liable - the provisions affect the unreasonably optimistic director as well as the inept.

Nevertheless, it is unlikely that a director who acts on the basis of a proper consideration of the material facts, but simply makes a bad commercial judgement, will find himself liable for wrongful trading. The courts are unlikely to seek to "second guess" those responsible for running a particular business and to require them to compensate creditors out of their own pockets in the event of losses arising from justifiable commercial risks.

If in any doubt, directors of a company at risk of insolvency are well advised to seek competent independent financial advice and to act upon it.

#### **Fraudulent trading**

Under the Insolvency Act a director is guilty of fraudulent trading where he was knowingly party to the carrying on of the business of the company with intent to defraud creditors or for any other fraudulent purpose. Upon the application of the liquidator in the course of the winding-up the court may order a director found guilty of fraudulent trading to make such a contribution to the company's assets as it thinks proper.

#### **Misfeasance**

The insolvency legislation also makes specific provision for the liquidator, or any creditor of a company, to seek an order from the court in the event of a company being wound-up for a director who has been guilty of any misconduct or breach of duty in relation to the company, or of misapplication of its money or other property, to be made liable to contribute personally to the assets of the company.

In addition to incurring personal financial liability, there are a number of criminal offences of which a director may be convicted in connection with the winding-up of a company. However, these generally involve some clear wrongdoing on the part of the director, such as fraud, tampering with evidence or failure to co-operate with the liquidator.

#### **DISQUALIFICATION**

A person may be disqualified from being a director of any company (for up to 15 years in some cases) for certain breaches of duty or other wrongdoing, including persistent failure to file returns, accounts or other documents with Companies House, fraud, behaviour amounting to wrongful or fraudulent trading or conduct which the court considers demonstrates that the director is unfit to hold such office, such as conviction for an indictable offence.

The Enterprise Act 2002 empowers the Office of Fair Trading to apply to court to make a disqualification order against a director, if his company commits a breach of competition law and the court considers the director's conduct makes him unfit to be involved in the management of a company. Under this Act, a director of a parent company can also be disqualified if it is a subsidiary company which breaches competition law.

#### **AVOIDING LIABILITY**

It will be apparent that, while shareholders of a limited company enjoy a limit on their personal financial liability towards the company's creditors (the limits being the amount unpaid on the shares held by them in the capital of the company), its directors enjoy no such limit on their potential personal liability.

Unfortunately, the means for directors to avoid or mitigate such liability are few, and are limited in their scope and effectiveness. The principal means are as follows.

#### **Ratification by the shareholders**

Under the 2006 Act a company may by ordinary resolution ratify the conduct of a director (including a former director), which amounts to negligence, default, breach of duty or breach of trust in relation to the company. This includes any default by the directors in relation to the statutory general duties.

The effect of ratification is that some acts of directors which would otherwise result in them incurring personal liability may be retrospectively approved by the company's shareholders, thus relieving the directors of liability.

Neither the director, nor any person connected with him, may vote on a resolution to ratify that director's conduct whether at a general meeting or in the form of a written resolution.

It is not possible to ratify acts which are illegal, a misappropriation of the company's assets by the shareholders, a fraud on the company's creditors, a fraud on a minority of shareholders or which are "unfairly prejudicial" to them.

Thus a director who enters into a profitable contract, the opportunity for which arose out of his position as a director, may have the contract ratified by the shareholders (in which case he may retain the profit) provided that he acted in good faith and the contract is not damaging to the company.

#### **Relief by the court**

The court has an overriding power (given by the 2006 Act section 1157) to release from personal liability, in whole or in part, a director who has been sued for breach of duty and held liable, where the court finds that he has (despite being in breach) acted honestly and reasonably and ought in all the circumstances fairly to be excused.

This may occur, for example, where the breach occurred in the course of the director's efforts to support the company, or in certain cases where he acted in reliance in good faith upon faulty legal advice (although ignorance of the law, even when wrongly advised, is generally no defence).

A director may seek pre-emptive protection under these provisions by applying for relief from potential liability even before he is sued.

#### **Indemnification by the company**

Provisions which seek to exempt any director from any liability arising from his negligence, default, breach of duty or breach of trust in relation to the company are void. Any indemnities for directors of the company or any associated company against such liabilities are also void. This is the case whether the provision is contained in the articles, in a separate contract with the company or otherwise.

There are, however, three exceptions to these restrictions:

- ◆ **Insurance:** companies can purchase insurance to cover the restricted liabilities. Directors' and officers' liability insurance policies will, of course, always be subject to certain exclusions and limitations.
- ◆ **"Qualifying third party indemnity provisions":** provisions are permitted which do not provide an indemnity against any liability incurred by the director:
  - to the company or an associated company;
  - to pay a fine imposed in any criminal proceedings or a penalty imposed by a regulatory authority;
  - in defending criminal proceedings in which he is convicted or in defending any civil proceedings brought by the company or an associated company in which judgment is given against him; or
  - in connection with certain applications for relief by the court in which the court refuses to grant relief.
- ◆ **"Qualifying pension scheme indemnity provisions":** provisions are permitted which indemnify a director of a company that is a trustee of an occupational pension scheme against liability incurred in connection with the company's activities as trustee of the scheme. Any such provision must not indemnify the director against any liability incurred by the director:
  - to pay a fine imposed in any criminal proceedings or a penalty imposed by a regulatory authority;
  - in defending criminal proceedings in which he is convicted.

In addition, by way of an exception to the usual restrictions on loans to directors (see above), a company can pay directors' defence costs in civil or criminal (including regulatory) proceedings or in connection with certain applications for relief by the court. Directors must, however, repay any such funding if they are convicted, judgment is given against them or the court refuses to grant relief.

The implications of these rules are that a company may, subject to the company having the requisite capacity and power to do so under its constitution and to it being in the interests of the company as a whole to do so:

- ◆ indemnify its directors in respect of proceedings brought by third parties; and

- ◆ pay a director's defence costs as they are incurred (even where the action is brought by the company itself), provided that the sums are repaid if the director is subsequently found to be in the wrong.

Directors' and officers' liability insurance and the details of any qualifying third party or pension scheme indemnity provisions have to be disclosed in the company's annual report and accounts. In addition, shareholders may inspect the terms of any such indemnities, in the same way as they are entitled to see copies of directors' service agreements.

#### **THE CITY CODE ON TAKEOVERS AND MERGERS**

When a public company (or a certain type of private company) is involved in a takeover or merger each director should be aware of the general principles of conduct and specific rules of The City Code on Takeovers and Mergers ("the Code") promulgated by the Panel on Takeovers and Mergers ("the Panel"), a statutory body.

The Code is mainly concerned with regulating the conduct of the parties to takeovers or mergers to ensure that there is a "level playing field".

#### **The General Principles**

The rules set out in the Code all stem from six General Principles, which include the following:

- ◆ all holders of the same class of securities of an offeree company must be afforded equivalent treatment by an offeror;
- ◆ the board of an offeree company must act in the interests of the company as a whole.

#### **Other restrictions**

Amongst other things, the Code imposes the obligation that before any announcement of a takeover or merger is made, anyone who is privy to confidential information (especially price sensitive information) about an offer must treat that information as secret. The information should only be disclosed on a need-to-know basis and recipients must be told of the information's secrecy.

The Code also imposes restrictions on dealings by persons with unpublished price sensitive information and on frustrating action which might be taken in defending against a hostile takeover.

The rules set out in the Code cover such matters as the making of the first approach; the announcement of the offer; the taking of independent advice; restrictions on dealings in shares during the offer period; the timing and revision of the offer and the contents of offer documents.

Where a public parent company undertakes a transaction which falls within the remit of the Code, the directors of any of its subsidiaries will be subject to the rules of the Code as persons "acting in concert" with the parent company.

#### **Sanctions**

The Panel can:

- ◆ give directions to secure compliance with the Code;
- ◆ make rulings requiring the payment of compensation to holders or former holders of securities (including making such payments subject to interest); and
- ◆ seek enforcement by the courts.

In addition, failing to comply with certain rules constitutes a criminal offence. Proceedings for the offence may only be brought in England and Wales by or with the consent of the Secretary of State or the Director of Public Prosecutions.

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