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Director's Duties

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Abstract

The introduction of the Companies Act 2006 brought significant changes as regards to the duties owed by directors to a company. It can be argued that the restrictions on company's directors under s175 Companies Act 2006 are strict and inflexible. The result of the rule could possibly mean that a director can never make a profit from a transaction outside of their company without it amounting to a conflict of interest and therefore will be liable to account for any profit made. However, certain rules and case law surrounding directors' duties may prove s175 Companies Act 2006 to not be as strict and inflexible as it seems at first glance. If a director was to follow a correct procedure, it is entirely possible they may make profit despite the issues surrounding conflicts of interests. This paper explores these possibilities.

Keywords

Business Law; Conflict of interest; Director's Duties

Prior to the Companies Act 2006 (CA 2006), the majority of directors' duties were founded on common law rules and equitable interests.[1] This foundation still remains in place as explained by CA 2006 they 'have effect in place of those rules and principles as regards the duties owed to a company by a director'.[2] The duties of directors to their companies are set out between ss 170 - 177 of the Act. This is including a 'duty to avoid conflicts of interest' which has been suggested to be strict and inflexible regarding a director being able to make a profitable transaction outside of their company.[3] This is due to the transaction having a 'direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company' which the Act states must be avoided.[4] So, if a director wished to become a director of another company, or enter into an external contract for personal interest, it may prove to be a difficult task. Although on first appearance the Act may seem strict and inflexible, a closer inspection may prove otherwise.

There are subtle but valuable statutory relaxations of the strict equitable requirement to obtain members' approval to authorise what would otherwise be breaches of fiduciary obligations.[5] A fiduciary is someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence.[6] Therefore, unless a private company invalidates it (or a public company permits it) section 175 expresses that through the authorisation of the other directors, a director can act upon what would otherwise be a conflict of interest.[7] This is of course without the inclusion in any vote or quorum from the director it concerns or interests.[8] This can however be stated differently in a company's articles of association, which outline the rules and restrictions relating to the way a company operates and is governed, and therefore is subjective. The rule that the director in question is forbidden to vote may be foreseen as a 'strict' one, but is arguably fair, as he would only vote in favour of himself. Furthermore, it can be argued that the process in which the conflict of interest is decided upon is objectively balanced fairly. This is because it is decided through ordinary resolution at a general meeting.

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[1] J. Scott Slorach and Jason Ellis, *Business Law* (26th edn, OUP 2018) 72.
[2] Companies Act 2006 s 170(3).
[3] Ibid s 175.
[4] Ibid s 175(1).
[5] Stephen Acton, 'A new direction?' (2008) 158 NLJ 606.
[6] *Bristol and West Building Society v Mothew* [1996] 4 All ER 698.
[7] CA 2006 s 175(5) & 175(4)(b).
[8] CA 2006 s 175(6).

An ordinary resolution is one which requires a simple majority of votes in favour if it is to be passed.[9] ‘Simple majority’ means more votes in favour than against and an equality of votes is not sufficient.[10] For example, 51% or above. Therefore, if there were four members (shareholders), presuming they all had equal shares in the company, three out of the four of them would be required to vote in favour of the potential conflict in order to allow it. Depending on the circumstances of the directors’ relationship with the other members, this may be a hard obstacle to overcome in the case of a conflict. Thus, illustrating a subjective process in the case of conflicts of interest. This ultimately conveys that if a director who is in the midst of a conflict of interest with the company, and manages to persuade his fellow directors’ and shareholder’s approval for that conflict to go ahead, the general duty of section 175 is one of flexibility.[11] It is true that if the majority of other members of that company fail to authorise the transaction, that ends the possibility for the director to enter into that transaction. Thus, signifying a strict, but flexible element to the restrictions of the director’s duties under the CA 2006.

Strong evidence from past events illustrate duties from directors can be perceived as strict. A prime example being the case of Regal (Hastings) Ltd v Gulliver.[12] In this case, after the defendants sold their company (3 cinemas) they were found to have made a ‘secret profit’ from shares they sold from subscribing for as previous directors. The House of Lords decided that it was a secret profit since the opportunity to invest in the new company only came to the defendants because they were directors of Regal (Hastings).[13] This rule is further supported by the CA 2006 as it states the Act ‘applies in particular to the exploitation of any property, information or opportunity’.[14] This demonstrates that any potential profit that is to be made from a conflicting transaction is at risk of being in breach of duties as a director. Therefore, supporting the claim that S.175 of the CA 2006 is strict and could perceive to be inflexible.

It’s not section 175 alone that restricts a director from an external contract that may conflict with their companies’ interests. Section 177 of the CA 2006 explains the director’s ‘Duty to

[9] Slorach and Ellis (n 1) 139.
[10] CA 2006 s 282(1).
[11] Ben Griffiths, ‘Dealing with directors' conflicts of interest under the Companies Act 2006’ (2008) 6 JIBFL 292.
[12] (1967) 2 AC 134.
[13] Slorach and Ellis (n 1) 74.
[14] CA 2006 s 175(2).

declare interest in proposed transaction or arrangement'. The director must declare the nature and extent of that interest to the other directors.[15] Cases such as 'Cullen Investments Ltd and others v Brown and others' convey the necessity of disclosing any personal investments made which may conflict with a director's business.[16] In this case, managing the conflict was impossible because it was concealed, so the company could not have consented to it.[17] The defendant was found 'in breach of his director's duties under s.175 of the 2006 Act by reason of the conflict of interest, and was in breach of both s.172 and s.177 by reason of his failure to disclose the interest giving rise to that conflict.'[18] This judgment presents itself with a strict avenue of necessary steps that must be taken in order to enter profitable transactions outside of a directors' company. This includes S.172 CA 2006 which is the duty to promote the success of the company.[19] This implies that when a director is making a transaction, they must always have in mind any consequences that may affect the company. This includes the interests of employees and any other consequences that may impact the company.[20] This can evidently limit a director when entering into a transaction and must therefore always be aware of restrictions. Furthermore, if a director is dishonest and not disclosing profits, he will be found in breach of his directors' duty and liable to account for any profits made.[21] If on the other hand, there was full and frank disclosure to the members of the company and their approval had been obtained by ordinary resolution at a general meeting, an obligation to account for profits made would not arise.[22] As long as the director in question declares their interests before the company enters into the transaction or arrangement and avoids dishonesty among other directors, personal and profitable interests outside their company is achievable.[23]

Consequences due to breach of Section 177 CA 2006 have seen transactions reversed. In the case of Knightsbridge Property Development Corporation (UK) Ltd v South Chelsea Properties Ltd and Others a director of both companies had transferred land from one company to

[15] CA 2006 s 177(1).
[16] [2017] EWHC 1586.
[17] Ali Tabari & Kate Rogers, 'Carrying the can: focus on directors' duties' (2018) 2 CRI 52.
[18] [2017] EWHC 1586 (per Lord Justice Barling) 283(4).
[19] CA 2006 s 172.
[20] CA 2006 s 172(1)(a) and s 172(1)(b).
[21] *Belmont Finance Corporation v. Williams Furniture Ltd (No 2)* [1980] 1 All ER 393.
[22] Tahir Ashraf, *Directors' Duties with a Particular Focus on the Companies Act 2006* (Emerald Group Publishing Limited 2012), 125-140.
[23] CA 2006 s 177(4).

another.[24] The Defendant was acting in the interests of one company over the other and failed to consult any of the other directors before the transactions. This found the transaction of property to not be binding.[25] The ruling here proves to be strict, but the Defendant had a flexible solution he did not pursue. If the director in this case had followed the rules set in S.175 and consulted the other directors of the company, the process of an ordinary resolution by means of a general meeting would have taken place.[26] If then successful, the director in question would have completed his transaction as intended. As stated by Lord Goldsmith to the Lord Grand Committee 'there is no prohibition of a conflict or potential conflict as long as it is has been authorised by the directors in accordance with the requirements set out in (the CA 2006).'[27] This suggests that openness ought to feature when carrying out directorial functions and in particular, where a proposed transaction may cause a conflict of interest between the director and company.[28] This would further comply with the rules set out in Section 175(4) CA 2006 and the ratification process set out in the Act.[29]

More evidence of how a full disclosure can allow a director to make profitable interests can be seen in the case of Kleanthous v Paphitis and others.[30] After the defendants failed to persuade other directors of their company to enter into a contract, they took it upon themselves to do so. They then created a new company to proceed with the purchase of the contract. The claimant's brought the case against the defendants for breaching their duty not to accept benefits from third parties.[31] It was decided there was no conflict of interest due to the full disclosure to the board, and was therefore processed correctly.[32] This amplifies the rules laid out in the CA 2006. Through appropriately following the regulation of section 175(4), the director effectively entered into a contract outside of his company and was found not liable to account for any profit he has made. This successfully eliminates the stereotype directors' duties being inflexible.

[24] [2017] EWHC 2730.
[25] Tabari & Rogers (n 17)
[26] CA 2006 s 175(4).
[27] Lord Goldsmith, Lords Grand Committee, 6 February 2006, (column 288).
[28] Ashraf (n 22).
[29] CA 2006 s 239.
[30] [2011] EWHC 2287.
[31] CA 2006 s 176.
[32] [2011] EWHC 2287.

Although it may be true that S.175 CA provides a stricter approach towards directors being able to make profitable transactions outside their company, it is evidently flexible. There are numerous cases that imply there are strict restrictions on possibly conflicting transactions. However, we can see that if the correct procedure is complied with, in particular a director being open and honest about his possible proceedings, then the possibility of entering into conflicting transactions is achievable. Furthermore, liability to account for any profit made will only be pursued if found in breach of the Act. Section 175 CA 2006 can therefore be a strict rule but can be flexible depending on the circumstances. As long as a director follows the rules set out in the act from S.170 to S.177, namely S.175(4) in particular, then there is a significant opportunity to enter into a profitable transaction outside of their company. Therefore, to conclude, it is evident the statement that 'the restrictions on company directors under S. 175 Companies Act 2006 are strict and inflexible' can be seen as incorrect. For it is possible for a director to enter into a transaction outside of their company without it amounting to a conflict of interest. Therefore, the statement of flexibility is incorrect as it has proven through cases such as Kleanthous v Paphitis and others, and the statute itself to be flexible.[33] On the other hand, there is little evidence that a director can in fact make a profitable transaction without being open and confront with his company's board, as supported by cases such as Cullen Investments Ltd v Brown and Knightsbridge Property Development.[34] This suggests a significant element of 'strictness' is present in the CA 2006 with regards to directors' duties.

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[33] ibid.

[34] [2017] EWHC 1586 and [2017] EWHC 2730.