

**LEGAL ROLE & RESPONSIBILITIES OF DIRECTORS**

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## **LEGAL ROLE & RESPONSIBILITIES OF DIRECTORS**

### **Introduction**

Company law and charity law impose significant legal obligations on directors of charitable companies; and breach of those obligations could, in principle, involve personal liability for directors and/or consequences (eg a company director disqualification order) which could have a significant impact on a director personally.

This note on Legal Role & Responsibilities of Directors is intended to raise awareness of the key principles. Clearly, the material in this note can represent only a summary of the main points – but it is hoped that the note can serve as a useful point of future reference for individual directors in the course of carrying out their work. The material is arranged under the following headings:

- Role of directors
- Key legal responsibilities of directors under company law
- Additional duties imposed by Scottish charities legislation
- Key legal hazards for directors

## **Role of directors**

- The role of the board of directors of a company is to set overall strategy; and to exercise overall supervision and control in relation to the company's activities.
- Each of the directors should take whatever steps may be necessary to ensure that he/she has sufficient knowledge and familiarity with the affairs of the company to discharge the duties which his/her position entails.
- Directors are legally responsible for ensuring that accounting records are maintained, and that annual accounts are prepared in accordance with the statutory requirements; at a practical level, directors must ensure that there are adequate systems of internal control and that members of staff (or external service providers) involved in accounting/accounts preparation are competent and reliable
- Directors must monitor financial performance, and take steps to address any issues of concern; at a practical level, setting of annual budget, regular review of outturn against budget etc
- Delegation to senior management is expected, but
  - directors must keep under review the competence and reliability of management staff
  - directors should retain decision-making/control in relation to overall strategy and key policies
  - directors should set overall framework of delegation (delegation to committees, delegation to chief executive, levels of delegated authority in relation to expenditure etc) and ensure that it is observed
- Directors must regularly review key risks associated with the company and its activities – and ensure that measures are in place to address the risks so identified

## **Key legal responsibilities of directors under company law**

- As noted above, the directors are required to exercise overall control and supervision over the company's activities; and the directors are legally responsible for ensuring that accounting records are maintained, and that annual accounts are prepared in accordance with the statutory requirements
- The Companies Act 2006 has introduced a statutory statement of directors' duties (which came into effect as of 1 October 2007 – with the exception of duties relating to conflict of interest) and which complements the common law principles. The statutory statement of duties contains 7 general duties, as outlined below.

### *Statement of directors' duties under the Companies Act 2006*

#### 1 *Duty to act within powers*

A director of a company must: –

- (a) act in accordance with the company's constitution, and
- (b) only exercise powers for the purposes for which they are conferred (i.e. for their proper purpose).

#### 2 *Duty to promote the success of the company*

A director of a company with charitable status must act in the way he/she considers, in good faith, would be most likely to promote the success of the company in achieving its purposes, and in doing so have regard (amongst other matters) to: –

- (a) the likely consequences of any decision in the long term;
- (b) the interests of the company's employees;
- (c) the need to foster the company's business relationships with suppliers, customers and others;
- (d) the impact of the company's operations on the community and the environment;
- (e) the desirability of the company maintaining a reputation for high standards of business conduct; and
- (f) the need to act fairly as between members of the company.

It should be noted that the list of factors to which the directors of the company must have regard in exercising this duty, is non-exhaustive; for example, a director can owe a duty to the interests of the creditors when the company is on the verge of insolvency.

The duty to promote the success of the company broadly replaces the common law duty of directors to act in the best interests of the company. The meaning of “success” is as yet untested; but the government has stated that the decision as to what will promote the success of the company and what constitutes that success is one for the directors’ judgment, providing that is made in good faith

The duty to promote the success of the company can be of particular relevance in a situation where directors have “divided loyalties” due to their association with another organisation. Each director must always ensure that when he/she is taking a decision in his/her capacity as a director of a particular company, he/she is voting in such a way as he/she considers, in good faith, is most likely to promote the achievement of the company’s purposes (and not necessarily in the manner which best serves the interests of the body with which he/she is connected).

### 3 *Duty to exercise independent judgment*

A director of a company must exercise independent judgment. This duty is not infringed by his/her acting: -

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

This duty does not prevent directors from relying on the judgement of others in areas on which they are not expert; in certain circumstances, it would be irresponsible (and a breach of directors' duties) for the directors to proceed without first obtaining outside professional advice. It is important, however, that the directors should not blindly follow the advice of third parties; they should exercise their own independent judgement in deciding whether to follow the advice which has been given, as responsibility for decisions ultimately rests with the board.

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

A director of a company must exercise reasonable care, skill and diligence. This means the care, skill and diligence that would be exercised by a reasonably diligent person with: -

- (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
- (b) the general knowledge, skill and experience that the director has.

The duty of care is of particular relevance in relation to the directors’ role in monitoring the activities of the company, and especially the company’s financial position.

5 *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 might conflict, with the interests of the company. This applies in particular to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity).

This duty could have an impact in relation to particular pieces of information (eg a forthcoming development opportunity) that might be exploited by a director for personal financial gain.

This duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company (that type of conflict is covered by other principles). Further, this duty is not infringed: -

- (a) if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest; or
- (b) if the matter has been authorised by the directors.

Authorisation by the directors may be given - where nothing in the company's constitution invalidates such authorisation - by the matter being proposed to and authorised by the directors. Further, the authorisation will only be effective if

- (a) any requirement as to the quorum at the meeting at which the matter is considered is met without counting the director in question or any other director with an interest in the matter in question; and
- (b) the matter was agreed to without their voting or would have been agreed to if their votes had not been counted.

It should be noted that this new duty - unlike the other general duties - does not come into effect until 1 October 2008.

Reference should be made to the further material on conflicts of interest set out below under the heading "Dealing with potential conflicts of interest".

6 *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/her being a director, or
- (b) his/her doing (or not doing) anything as a director.

In this context, a “third party” means a person other than the company, an associated body corporate, or a person acting on behalf of the company or an associated body corporate.

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

This duty has been separated from the duty to avoid conflicts of interest - such that a director obtaining a benefit from a third party can only be authorised by the members of the company rather than by his/her fellow directors.

7 *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 (but he/she does not have any duty to avoid such an interest, as he/she has in relation to transactions or arrangements with third parties).

The declaration may (but need not) be made: -

- (a) at a meeting of the directors, or
- (b) by way of a notice to the directors (either in relation to a specific matter or by way of a general notice)

Any declaration in pursuance of this duty must be made before the company enters into the transaction or arrangement. Further, if a declaration of interest in accordance with this duty proves to be, or becomes, inaccurate or incomplete, a further declaration must be made (but only if the company has not yet entered into the transaction or arrangement at the time that the director becomes aware, or ought reasonably to have become aware, of the inaccuracy or incompleteness of the statement).

This duty does not require a declaration of an interest of which the director is not aware, or where the director is not aware of the transaction or arrangement in question. For this purpose a director is treated as being aware of matters of which he ought reasonably to be aware. In addition, a director need not declare an interest: -

- (a) if it cannot reasonably be regarded as likely to give rise to a conflict of interest; or
- (b) if, or to the extent that, the other directors are already aware of it (and for this purpose the other directors are treated as aware of anything of which they ought reasonably to be aware).

## **Additional duties imposed by Scottish charities legislation**

### *Background*

- The Charities and Trustee Investment (Scotland) Act 2005 imposes additional duties on directors of companies which have charitable status
- A director of a company with charitable status falls within the category of a “charity trustee” for the purposes of the Scottish charities legislation

### *Duties of charity trustees*

- Charity trustees must act in the interests of the charity; and must in particular
  - seek in good faith to ensure that the charity exercises its functions in a manner which is consistent with its purposes
  - act with the care and diligence that it is reasonable to expect of a person who is managing the affairs of another person
  - in circumstances where a conflict of interest may arise, put the interests of the charity first (or, where some other duty prevents that, disclose the conflict and take no part in the deliberations/decision)
- In addition, the charity trustees must ensure that the charity complies with any direction, requirement, notice or duty imposed on it by virtue of the 2005 Act.
- Breach of trustees’ duties specified above is to be treated as misconduct in the administration of the charity.

### *Contracts between a charitable company and a director (or a party connected with a director)*

- The 2005 Act provides that where a charity trustee provides services to a charity or might benefit from any remuneration paid to a connected party for such services, then
  - the maximum amount of the remuneration must be specified in a written agreement and must be reasonable
  - the charity trustees must be satisfied that it would be in the interests of the charity to enter into the arrangement (taking account of that maximum amount)
  - less than half of the charity trustees must be receiving remuneration or benefit from remuneration
  - the remuneration must not be expressly prohibited by the constitution
  - remuneration contrary to the above will be recoverable.
- It should be noted that remuneration of directors in the context of a company with charitable status represents the exception rather than the rule.

## **Key legal hazards for directors**

### *Breach of statutory duties (see above)*

- Remedies for breach of a director's general duties have not been codified - according to the Companies Act 2006, the consequences for breach of these duties are the same as would apply if the corresponding common law principle applied.

### *Scope of authority*

- Where the board cause the company to act outwith the terms of the objects clause they could be personally liable for any losses thereby incurred by the company. If the directors are proposing to move into a new area of activity, therefore, the terms of the objects clause should be carefully considered.
- An individual director who acts on behalf of the company should ensure that he/she acts only within the scope of the authority delegated to him/her by the board; again, if he/she oversteps that authority, he/she might be personally liable to the company.

### *Statutory offences*

- The Companies Acts impose detailed requirements in relation to the keeping of statutory registers, maintaining proper accounting records and filing annual accounts, the annual return and various other statutory forms with Companies House; although in practice the responsibility for keeping statutory books and filing returns is normally assigned by the board to the company secretary<sup>1</sup>, the directors of the company remain liable along with the company secretary in relation to the various fines prescribed by the Companies Acts for failing to comply with these requirements.
- Various other items of legislation (eg. in relation to health and safety) could potentially involve directors being liable to criminal penalties, in extreme cases.

### *Liability to third parties for negligence and defamation*

- While the primary target in the context of a claim by a third party against the organisation on the grounds of negligence would be the company as a corporate body, there remains the possibility that a claim could lie against the directors, if it could be demonstrated that they had a duty to third parties to ensure that the appropriate systems to reduce the risk of injury etc. were in place and/or were being properly implemented.
- Similarly, a director could be personally liable where defamatory material was issued by the company, if he/she had been personally involved in issuing it.

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<sup>1</sup> Note: the Companies Act 2006 would allow private companies to dispense with a company secretary; but a number of voluntary sector companies may choose to retain the requirement for a secretary under the terms of their articles of association

### *Wrongful trading*

- The “bottom line” in relation to these provisions is that a director could have to pay out of his/her own personal funds and assets towards a company’s debts if it has gone into liquidation; fortunately, there are a number of hurdles which have to be gone over before the court could order this to be done. The following circumstances would have had to apply:-
  - at some point before liquidation commenced, the director knew - or ought to have concluded - that there was no reasonable prospect that the company would avoid going into insolvent liquidation.
  - as from the point when the director knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation, he/she failed to take all necessary steps to minimise further loss to creditors.

### *Company director disqualification orders*

- A disqualification order can be made
  - where a person has been convicted of an offence in relation to the promotion, formation or management of a company
  - where he/she has been persistently in default in relation to filing returns or accounts with Companies House
  - where he/she has been guilty of fraudulent trading or breach of duty
  - where (in the context of a company which has become insolvent or is the subject of a special investigation) his/her conduct as a director makes him/her unfit to be concerned in the management of a company
  - where he/she has been ordered to make a contribution to a company’s assets under the wrongful trading provisions

### *Directors and officers’ liability insurance*

- While directors and officers’ liability insurance should provide an element of protection for directors, it is important to be aware that the detailed terms of such policies are such that the insurance does not provide blanket cover; the protection in relation to liability under the wrongful trading provisions, for example, is weakened by the need to renew the insurance on an annual basis, coupled with the requirement to disclose any circumstances (e.g. financial difficulties) which could be relevant to the insurance company in continuing the cover

NOTE: The material in this paper is provided for the purposes of general guidance only. It does not represent an authoritative statement of the law, and specific legal advice should be sought if there is any doubt as to the impact of the legal principles or legislation in any given case.

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