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Business law untangled podcast

Episode 3: Directors' duties: what they are and where it can all go wrong

Stephen Downie	Hello and welcome to another podcast by Francis Wilks & Jones. My name is Stephen Downie and I am here today with Maria Koureas-Jones. We are both partners at FWJ dealing with commercial litigation and contentious corporate and insolvency matters.
Maria Koureas-Jones	And today we are here to talk about directors and their duties. We are not going to go through each and every duty owed by a director to a company but will focus on those that we commonly see in claims against directors.
Stephen Downie	Yes Maria, directors – people who the papers would persuade you are all millionaires with dodgy offshore tax arrangements…
Maria Koureas-Jones	Which some are…
Stephen Downie	But most of which I would urge you are hardworking individuals genuinely trying to do well in business.
Maria Koureas-Jones	And today we will break down the barriers in seeking to clarify what duties a director has and what can go wrong for them personally (and their business and family) when they do not properly adhere to their duties owed to a company or, worse still, where they do not keep decent records to show how they were complying with their duties to a company.
Stephen Downie	So, what are a director's duties? I think the first ones are the most important – what are a director's fiduciary duties? Now I need to probably for the audience explain what fiduciary duty means. It refers to a duty of trust and confidence an individual or entity would have with regard to assets or responsibilities managed or organised on their behalf. So, a director's fiduciary duty essentially refers to a director's duties in respect of the company, its shareholders and associated parties which can include employees and creditors.
Maria Koureas-Jones	And of course, these are the duties owed to a company where, if a director breaches them and a company suffers a loss as a result, this can lead to a director being personally liable as a result. So, it is very important for a director to understand what their obligations are. Over the last 100 years the specific duties were developed via cases in the courts called the common law and there was no easy list of what a director should or shouldn't do as a director and, most importantly, what was likely to get a director in trouble.
Stephen Downie	Luckily for us lawyers, the fiduciary duties were eventually set out and codified

	under the Companies Act 2006, which is the legal principal which has supported what we have been working with for the last 15 years. So, what are the main fiduciary duties Maria?
Maria Koureas-Jones	So, as you said they are set out in the Companies Act 2006 and you will find them between sections 171 and 177 of the Companies Act 2006. They comprise the following: • Section 171 - acting within your powers • Section 172 - promoting the success of your company • Section 173 - exercising independent judgment • Section 174 - exercising reasonable skill, care and diligence • Section 175 - avoiding conflicts of interest • Section 176 - not accepting benefits from third parties, and finally: • Section 177 - declaring interests in proposed transactions or arrangements These are all an accumulation of many years' worth of case law and common law decisions and as these duties are personal to the director, they personally are liable where they breach those duties owed to the company.
Stephen Downie	So, despite owning and running a company and having the limited liability status which most people think prevents a director from being personally liable, by not acting in accordance with these fiduciary duties the director will actually be personally liable?
Maria Koureas-Jones	Correct.
Stephen Downie	And I am right in saying that a breach of some of these duties is more likely to land you in hot water than others Maria?
Maria Koureas-Jones	Absolutely. Amongst the seven duties that are owed there is one that's extremely important and that is Section 172 and the duty to promote a company's success and we can encompass within that a duty to act in good faith or with good faith.
Stephen Downie	And so, where the company is operating normally and is solvent, the duty is owed to the company and the shareholders. Where a director is acting to the prejudice of any of its shareholders, even if they include co-directors or minority shareholders, this breach can make them personally liable for any losses. One example is where the director starts up a competing business – they may be a 50% shareholder, one of two directors of the original business (or even the only director) but they may have decided (as we see with a lot of corporate disputes) that they want the whole business. They might just set up a new company, start redirecting business to the new company but ultimately the original company is a distinct and separate legal entity, partially owned by another. By acting in this way and against the originating company as a whole (regardless of how much that director owns – even if he/she owns 95%) they are going to be acting in breach of their fiduciary duties to that originating company and therefore liable for the losses of that originating company irrespective of their own personal interest.

Maria Koureas-Jones	And the problem with this situation is of course a practical one – the wrongdoing director is usually the one of two directors (or they may even be the sole director) and the wronged minority shareholder can often do little. A breach of a fiduciary duty is a breach of a duty owed to the company so it is only therefore the company who has the right to sue that director (and whilst they are in office or after they have exited) for the losses suffered.
Stephen Downie	Yes, that's not a very practical solution where a SME company is trading and the person in control of the finances or operations is the wrongdoer.
Maria Koureas-Jones	No, not at all. There are options in such situations though. Shareholders can seek to issue derivative claims under the Companies Act 2006 where they apply to the court (as shareholders) to sue the wrongdoing director on behalf of the company. Where the court permit this then that shareholder's legal fees are paid by the company and the company become the claimant.
Stephen Downie	Yes, but this is a solution that is not always the best one to be opted for is it?
Maria Koureas-Jones	No, that's right. Ultimately if a company gets to this position where the owner-managers are in dispute, where they are complaining about each other or where actions are being taken such as the threat of legal proceedings, then the company may not of course be facing that positive a future.
Stephen Downie	Yes, and so the circumstances - maybe negotiate an exit of one or the other is likely the best option, subject to what each of them want and whether one wants to buy another out and can do so.
Maria Koureas-Jones	That's right, and of course whether that is going to be possible will very much depend on the nature of the business and the personalities of the directors and shareholders involved. But Stephen we can always rely on your accountancy expertise…
Stephen Downie	Yes, well that was a long time ago and it is mainly the darts I have to blame for my numerical abilities, but the listeners don't want to hear about that….
Maria Koureas-Jones	There are other circumstances where the duty of good faith to the company does not refer directly to its shareholders
Stephen Downie	Yes, that's right Maria. Where a company is insolvent – be that on the basis of its balance sheet or on the basis of the lack of cash flow/inability to pay creditors – then a director owes such fiduciary duties to creditors (in priority to shareholders, despite them being one of them). Now, when I say insolvent, insolvent doesn't mean they are placed in an insolvency process it could just be on the basis of their management accounts or internal records that the company is insolvent. This is all something that may be analysed in the future in retrospect looking back. So, when dealing with insolvency claims we see this a lot when we are acting for liquidators or we are defending claims against

	liquidators or administrators. Where those claims are brought, this is often referred to as misfeasance. What is misfeasance Maria?
Maria Koureas-Jones	So, this is something that directors - post an insolvency process - often face a claim for. So, it would be a claim by a liquidator or administrator for misfeasance and misfeasance is a breach of the duty that the directors owe to the company which gives rise to a loss. Misfeasance is found in the Insolvency Act 1986 and gives the liquidators the same remedy that the company had for pursuing the director's breach. So, in other words, a claim against the director personally. It is perhaps one of the most common methods a liquidator can employ to pursue a director personally and can result in a court making an order against a director personally for equitable compensation. Now this equitable compensation will usually reflect the loss suffered by the company. However, the amount the director has to pay will be substantially increased by the court because the court will apply interest from the date of the breach (and bearing in mind that a claim may be issued some 5 or 6 years after the breach occurs) the interest applied can be material. In addition, there are substantial liquidator's time costs and legal costs which will also be added to the claim amount.
Stephen Downie	So Maria, whilst I know for live companies, the usual claims of this kind may include where a wrongdoing director (and it may not have gone to insolvency yet but for a live company the wrongdoing director) may have set up competing companies, they may be making changes to the Companies House records, and may even be removing shareholders from the Companies House records to indicate that they hold more shares, they might draw unauthorised income and generally they may exploit the company and its resources to the loss of other directors or shareholders and, in potentially the meantime, setting up another company to take away the business. But what sort of breaches commonly fall into such a bracket when a liquidator starts investigating rather than for a live, ongoing, trading company?
Maria Koureas-Jones	Well Stephen, that is an interesting question. Decisions by directors are analysed far more closely post-liquidation even though the conduct concerned may have happened a number of years before the liquidation process itself.
Stephen Downie	Yes, so, directors have to be wary, even where the company is currently solvent that, notwithstanding tax aspects, if they act in any way which could cause the company loss (and may even ultimately cause it to fail) they may later be pursued personally for those losses, even where they have resigned some time before the liquidation.
Maria Koureas-Jones	That's absolutely right. One thing we find is that the directors enjoy the fruits of success for a few years and then where in the later years, or after the company is placed into liquidation, the directors are then faced with a much more forensic examination regarding their conduct and what they were doing.

	One of the most common causes of such difficulties are director's loan accounts. Directors use director loan accounts as a means for payment that is not taxable, but which is a loan and due to be paid by them personally. We have a separate podcast on director's loan accounts which is a very large subject on its own so it is something that we consider separately but certainly something that directors should make sure they understand fully.
Stephen Downie	Yes, and similar to that, lots of breaches of directors' duties can of course be quite innocent at the time. Often directors don't maintain accounting records, many of them don't have any experience of bookkeeping or preparing accounts and then they use cash to pay for company expenditure i.e. company expenditure which is legitimate company expenditure (sometimes it is not of course) but the failure to keep any records means that any sums drawn in cash could well have to be paid back and they may be subject to court proceedings to require that they pay such monies back. A further example is the use of tax avoidance schemes. Lots of directors have used these schemes in the past to avoid paying tax on their remuneration but it leads to non-payment of HMRC, it's the disposal of a company asset and, whilst it appears quite innocent at the time, it can be subject to recovery proceedings by the liquidator. The principal issue for directors is that they must be aware of a later analysis.
Maria Koureas-Jones	This is exactly why bookkeeping is so important and why all the accountants out there should be aware of the importance to their clients of ensuring the bookkeeping arrangements are as thorough as they can be. The lack of records is one of the most common reasons for a director to be culpable to a claim, even where the claim is for sums that a director did not personally or directly benefit from. From the liquidator's point of view, they see money exiting the business without explanation and in circumstances where there are no books and records to support the director's account of where the money went there is good reason why the director is able to pursue the claim and why the courts will generally err on the liquidator's side in the absence of books and records which support the director's position.
Stephen Downie	That's right. You can't really blame them. Ultimately, the liquidators see money exit without explanation in the books and records and they go after the money because there is no answer. Case law is pretty solidly set down that, without accounting records, a director cannot rely on his own failures to defend himself against such a claim and this is something that accountants should be very wary of. It's not the financial accounts that the accountants prepare that are the company's books and records, it's the original ledger entries that record what all the transactions in an out be that purchase, sales etc. etc. what they actually are. But moving on, we have mainly discussed here breaches of the duties to the company's shareholders or its creditors where the company is solvent. There are other fiduciary duties which Maria mentioned earlier but are there any others which you think are worth a mention in more detail Maria?
Maria Koureas-Jones	Yes, absolutely. Although it all depends of course on the circumstances of any claim brought.

Stephen Downie	And from my experience I find that quite a lot of claims brought for such breaches of duty are not very well drafted even where it is on behalf of a liquidator.
Maria Koureas-Jones	That's right. It's probably best if we give a few scenarios of other duties that we regularly see as the basis for claims by either administrators or liquidators.
Stephen Downie	Go for it.
Maria Koureas-Jones	Well, for example with a director's duty to act within their powers, if a director say disposes of a substantial asset of the company then they may be acting outside their powers as, conventionally, the company's Articles of Association require shareholders to pass a resolution in respect of any substantial property transaction. In relation to a duty to exercise independent judgment, a director may receive advice from a professional or otherwise which they knew, or ought to have known, was not correct and of course where there is that doubt they should really have sought other independent advice regarding the advice obtained. This is arguably regularly seen in relation to tax avoidance schemes which directors have entered into over the last 20 years or so. Duties to avoid conflicts of interest arise commonly in businesses, and this is where a director makes decisions on matters which personally benefit them, but conflict with the interests of the company. So, for example, where company A is tendering for a supplier and the director of company A prefers supplier B over supplier C because supplier B is a company in which they have a financial interest even though supplier C is much more competitively priced. So that would expose the director to a claim for breaching their duty to avoid conflicts of interest.
Stephen Downie	So, a lot to think about when you are a director, although for me I find a lot of it is reasonably straightforward common sense wouldn't you agree?
Maria Koureas-Jones	Absolutely, and directors have for many years used SME companies as their own piggy bank and this is unlikely to change to any significant degree.
Stephen Downie	Unless the company goes bust or one of their partners have a disagreement or are not well treated then complaints are raised and by then you have got to pay back from money spent?
Maria Koureas-Jones	Absolutely.
Stephen Downie	Further, there are also the non-fiduciary duties. So, we have gone past the fiduciary duties, the duties of trust and confidence, but there are other non-fiduciary duties which can be added to the director's burden of responsibilities.
Maria Koureas-Jones	Yes, so these encompass everything outside the duties a director owes to a company, its shareholders and potentially also its creditors.
Stephen Downie	This can include circumstances where companies could be wound up in the public interest, for example those companies set up to perpetuate frauds and miss-selling, and any companies set up for which the substantial part of it comprised general misconduct by directors where their decisions are investigated by the Secretary of State which may ultimately lead to director disqualification proceedings. The sort of scams that you see that often are wound up in the public interest - the

	companies that is - can include miss-selling over the telephone. People have great hoards or warehouses of individuals calling individuals with money to invest and seek to sell property investments, wine investments and all sorts of things which are regularly subject to Secretary of State public interest winding up proceedings. I mean eventually directors who act contrary to the public interest - or to the prejudice of any other party - whether that's the public generally, HMRC or even employees - they can be disqualified from acting as a director, whether they were fraudulent or not. The non-fiduciary duties can extend to them being liable for company wrongs and therefore this is commonly referred to as "piercing the corporate veil". One example could be the Information Commissioner's Office and breaches of GDPR. We are seeing a lot of director disqualifications and even more severe remedies being taken against directors for substantial or serious breaches of GDPR.
Maria Koureas-Jones	And piercing the corporate veil is of course where the company's limited liability status is set aside and a director becomes personally liable for a claim against the company. All of the categories for misconduct can be cited, as Stephen mentions, where a director faces disqualification – a claim which can be brought where a company is placed into administration or into liquidation.
Stephen Downie	And further, directors can also be subject to director disqualification proceedings as a result of new legislation currently going through parliament - I think it is on its way to its third reading at the moment. It is going to enable the Secretary of State to disqualify a director of a dissolved company as well as a director of an insolvent company. But this is something we will discuss in a later podcast, which will also address director disqualification generally and how to deal with such threats.
Maria Koureas-Jones	So, we have discussed directors and their duties to the company, and potential risks they face personally as a result of their decision making. But it is worth mentioning that these risks don't just extend to those directors who are registered at Companies House as being a company director. It also extends to other individuals who hold themselves out as being a director or who instruct directors to do their bidding for them. So, these are often referred to as *Shadow Directors*.
Stephen Downie	Those directors who stay in the shadows, secretly conducting the company's affairs whilst trying to avoid any publicity?
Maria Koureas-Jones	Yes, but this can also apply to those who simply remain an employee of a company but whose authority or decision making make them a director regardless of the title they hold.
Stephen Downie	Ultimately Maria, what does a director do when facing such a claim?
Maria Koureas-Jones	Ideally, not put themselves in a position of risk in the first place, that would be a good start. Obviously directors are regularly faced with risk and I think there are a number of

	things that directors can do. So, they should document all transactions within the company, ensure that any remuneration that they receive is based on contractual or other entitlements. An example of this might be a contract of employment. They should ensure that all monies drawn are on the correct legal basis, ensure that there are full management accounts and other accounting records are maintained for the company - so an example of this would be a cash ledger where there are large sums of cash being withdrawn from a company. It is important that a director in 4-5 years' time can justify where that money went. The final thing is to make sure that they are recording why they are making decisions, when they are making decisions and the rationale behind those decisions so that if it is subject to later scrutiny they can point to those minutes or documents in the future.
Stephen Downie	And lastly, if they find themselves facing a claim, either many years later or within the company then really they need to get advice early and don't try and fire fight it themselves because therein lays the danger of making the whole situation worse. Anyway, that really concludes our podcast on directors' duties and thank you for listening to this podcast. You have been listening to Maria Koureas-Jones and Stephen Downie discussing directors' duties and I hope you have enjoyed it. If you have any queries relating to these matters, please do not hesitate to contact us. More podcasts will follow. And it's goodbye from me.
Maria Koureas-Jones	And goodbye from him.
Stephen Downie	Goodbye.