SMES, DIRECTORS & SHAREHOLDERS

Breaches of a director's fiduciary duties

10 frequently asked questions

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INTRODUCTION

Directors of limited companies have the benefit under company law to trade a business as a separate legal entity whilst simultaneously being at arm's length from any consequences of the company falling into insolvency (or any other risks which the business may be presented with).

However, in exchange for the benefit of this protection, the common law and (more recently) company law (via the Companies Act 2006 and other connected company legislation) have imposed certain obligations which directors must adhere to whilst performing this role.

These obligations are referred to as directors' duties and primarily focus on a director's fiduciary duties but can also include certain non-fiduciary duties.

Whilst every company is very different from another (and therefore the application of a single rule of company law to directors' duties is difficult to make) directors are expected to act in all circumstances with honesty and integrity and in the interests of the company or its stakeholders rather than their own personal interests.

1 What are directors' fiduciary duties?

The word "fiduciary" is defined by common law as an individual or entity that acts for another in a particular matter in circumstances which give rise to a relationship of trust and confidence.

A fiduciary should act exclusively in the interests of the other party to the exclusion of their own personal interests. Fiduciaries include trustees, partners, liquidators, agents, mortgagees and company directors.

2 What are non-fiduciary duties?

Company directors have certain non-fiduciary duties where no relationship of trust and confidence exists. A breach of these duties can also have consequences in certain circumstances.

Such non-fiduciary duties support the idea that directors should always act with honesty and integrity in their dealings and examples of non-fiduciary duties include general public interest duties, where a director is required not to act in such a way so as to provide a risk to the general public interest (for example in circumstances where there was no direct person or organisation with whom a relationship exists).

A breach of non-fiduciary duties may also include incompetence. Incompetence may not be a breach of a director's fiduciary duties but it may certainly refer to a breach of a non-fiduciary duty.

A breach of a non-fiduciary duty does not always lead to a legal consequence, whereas a breach of a director's fiduciary duties can carry very serious personal risks for directors.

3 Who does a director owe such fiduciary duties to?

A director's fiduciary duties are primarily owed to the shareholders of the company, which essentially comprises the company itself.

Such fiduciary duties do not apply to specific shareholders or specific groups of shareholders, as they can quite often be divided, but must be addressed in respect of shareholders as a whole and thus the reference to shareholders is generally construed to mean the company.

For example, some shareholders may also be employees of the company and seek to increase their personal remuneration out of limited company's funds to the detriment of any dividend or profits that may be available to shareholders as a whole.

In many small owner managed companies this may be preferable, or alternatively it may not be preferable for obvious tax reasons.

However, when deciding to increase any such remuneration, benefits or other payments to employee shareholders, the directors are under a duty to consider the reason for such increases and whether it is truly in the company's interest as a whole, rather than just those specific shareholders who may have requested it.

4 What are the exceptions to such duties?

There are of course circumstances where a director's fiduciary duties are different, perhaps by reason of the company objectives.

Some companies are not incorporated or set up to provide profits and dividends to shareholders. The most common example are companies limited by guarantee. However, other non-limited by guarantee companies which (for example) may be registered as charities may have completely different objectives (and therefore it may never be a breach of a director's fiduciary duties not to pursue profit).

This will largely be determined by the company's constitution and its articles of association. There may also be shareholder agreements which dictate the strategic direction and corporate governance of the company and these documents are critical when determining whether a director has breached his/ her fiduciary duties.

Other circumstances may also exist where a director does not have to prioritise shareholder interests.

For example, if the company is insolvent (either its assets are less than its liabilities or it is unable to pay debts as and when they become due) then a director's fiduciary duties lay more with the interest of creditors rather than shareholders.

A director should not seek to direct assets to shareholders where the company is struggling to trade and creditors may be at risk should the company be placed into insolvency. In such circumstances a director would be in breach of his/her fiduciary duties and may be liable for misfeasance (please see our booklet entitled "misfeasance" which provides more detail on this area).

Directors should also be aware of their non-fiduciary duties in respect of, for example, the proceeds of crime legislation and anti-money laundering matters (amongst many other non-fiduciary risks).

5 Why can't I do what I want with my business?

It is an issue often raised, particularly where sole trader or partnership businesses have decided to incorporate yet still consider all assets, money and income the possession of the director/shareholders of the company.

In many owner-managed companies it is not uncommon for directors to draw income from it as a means of supporting their lifestyle without considering other interested parties. These drawings may often be reflected in the directors' loan accounts and can frequently lead to an overdrawn director's loan account which may be repayable if the company is placed into insolvency.

Please see our booklet entitled "Director's loan accounts" which deals with this subject.

There are obvious problems withdrawing money from a company, particularly where tax obligations may appear at a much later date when that money is no longer available.

A director's personal interests must never be allowed to conflict with the interests of the company and so at all times the directors should make provision for future liabilities (i.e. taxes) or events which may mean that the money drawn may be subsequently declared invalid.

Most importantly, it is vital that a director ensures that proper records and accounts are always available to the Board of directors and management generally, so that such situations can be easily managed, monitored and foreseen.

If a director just takes money from the company on the presumption that future trading will cover any current liabilities or that he can just place the company into insolvency, this decision will have substantial impact on him personally, as a breach of such fiduciary duties will mean that he can be personally liable for any such losses by the company which have arisen as a result of these decisions.

6 Directors' personal interests and personal risk

It is not unusual for a director to set up the company for personal reasons and thereafter to allow his personal interests to influence the decisions he makes in respect of the company's trading, the distribution of assets or the interests of shareholders. Quite often an unsupervised director will use a company for other purposes which may conflict with the interests of other directors or minority shareholders of the company.

Minority shareholders have a statutory protection which enables them to take action if any such conflicts of interest occur but additional to this the director's fiduciary duties should constrain him/her from making decisions based on his/her personal interests but which may not be otherwise in the company's interest.

If a director breaches any such duties, s/he could be dismissed as a director by a majority of shareholders, pursued personally by the company for such a breach of his fiduciary duties, co-shareholders could sue him/her for unfairly prejudicing their shareholding interest (under the Companies Act 2006) and the company itself could commence proceedings (issued by the directors or shareholders, even minority shareholders) for any such losses arising.

It is dangerous for a director of a limited company to act solely in his/her personal interest without (or with minimal) reference to the co-directors and shareholders generally.

Quite often a director may direct contracts to an associated entity, be that a company or a person, which may not be the best option for the company in terms of price or quality or otherwise. Such a conflict is obviously in his or her associates' personal interests but will undoubtedly not be in the company's interests.

Another example may be where assets are transferred for nil or sold at an undervalue, creditors' interests are ignored in insolvency scenarios or cash drawings are taken and not accounted for within the company (which would prejudice HMRC).

If a director has any doubt as to whether it could later be perceived that s/he is acting in conflict with their fiduciary duties, it is recommended that all decisions are agreed by co-directors and a detailed minute drawn up to explain the purpose of the transaction.

7 Standards expected of directors

In a similar manner to professionals, directors are expected to act to a certain standard.

That standard exceeds the standards expected of any conventional individual and is more similar to the professional standards expected of surveyors, architects, solicitors and accountants.

Being a director is considered by legislators to be a privilege, and with such privileges come the burden and expectations that directors act with honesty and integrity and in accordance with a specific standard as described above and below.

A director should have a standard of knowledge, skill and experience which is higher than that of a conventional unqualified non-professional individual. This is because of the public accountability and the fiduciary duties of trust and confidence they bear.

However, if the director is professionally qualified, then the expected standard of behaviour will be lifted even further as a result of these additional skills and their assumed knowledge that any misbehaviour (if established) was incorrect.

The standard expected of all directors is usually referred to as a standard of reasonable care, skill and diligence and comprises the following two aspects:-

1. **the general knowledge, skill and experience that may be reasonably expected of a person carrying out the functions of a director in relation to that company; and**
2. **the general knowledge, skill and experience that specific director has.**

The second scenario provides for a higher bar where a director is qualified by experience or otherwise, as s/he is expected to have understood the consequences of any decisions they make.

However, even if a director has no such formal qualifications or experience, the standard generally expected of directors is high. It is for this reason that directors often employ professional advisors to guide them through compliance with their fiduciary duties.

8 Reliance on professional advisors

As described in the previous section, it is often the case (particularly in businesses occupied historically by non-professionally qualified directors) that external professional advisors are employed to assist and guide directors through their various regulatory and legal fiduciary duties.

This is very important as it is no defence for a director to defend himself through a lack of knowledge, as he is expected to be of a certain standard as set out under the last section.

However, it is also the case that directors often seek to excuse any decisions they have made on the basis that the responsibility for adhering to such statutory obligations (or otherwise) was delegated to another, be that a bookkeeper, an accountant or an external entity which provides services to the company's business.

This explanation is not generally available, particularly where any claim for a breach of fiduciary duties exists.

A director must be independent of any decisions made and accordingly even where s/he seeks professional advice they have a duty to independently consider such advice in light of the company's business, the proportionality of the transaction and the appropriateness as regards the company's trading and the interests of all stakeholders.

If a director delegates a role to third parties (for example a bookkeeper or the accountant) without, as a minimum, supervising their function (or otherwise ensure that there is an appropriate reporting line) then by default s/he is liable for any loss or damage arising from decisions made by those parties (regardless as to whether s/he was personally involved in making such decisions).

Whilst external professionals are essential in any trading company, it must always be remembered that the responsibility for any such decisions made on the basis of such advice lies with the directors (who must at all times act independently).

Of course the company also retains the right to sue any such professional advisors for misadvising on such matters, but in any event the responsibility for decisions made as a result of such advice lies with the directors themselves.

9 How do I avoid being personally liable for a breach of my fiduciary duties?

The first answer to this is obviously always going to be, don't breach such fiduciary duties.

Directors are expected to achieve a certain standard of behaviour in decision-making, and whether there is any doubt as to the validity of a decision made then the reasoning behind such decisions should be properly documented and dealt with by all directors at a board meeting.

The importance of documentation in such circumstances cannot be over emphasised.

However, there may be circumstances where a conflict of interest exists or where a director has a personal interest in a transaction, yet the transaction or conflict does not undermine the benefit to the company.

Alternatively, in many small owner managed companies, this conflict may be positively encouraged as ultimately these are individuals in business together for the common purpose of the company being successful, which may include connected companies.

There is nothing wrong with individuals setting up a business as a limited company and making decisions in which they have a personal interest provided it does not cause loss or damage to third parties and the directors/shareholders are in agreement.

This is also legitimate for conflicts of interest where the directors as a board all agree that the transaction should proceed despite the conflict.

Where a director has an interest in a proposed transaction on behalf of the company, then s/he must declare this at a meeting of directors and, once declared, if the transaction is authorised to proceed then it is implied that the transaction was agreed by all directors and therefore the company.

Some transactions specifically require the approval of shareholders at a shareholders meeting, or by written resolution, depending upon the company's articles of association.

These transactions include directors' service contracts, substantial property transactions with associated parties and loans or benefits provided to directors in the course of the business. Directors' loans are not available where the company lends money to a director and it is not authorised by shareholders unless certain exceptions are complied with. See our booklet entitled "Directors' loan accounts" for more information on this subject.

10 Consequences of a breach of a director's fiduciary duties

The consequences of a breach of a director's fiduciary duties can be quite severe. A shareholder, creditor or the company can bring proceedings against a director personally for a breach of such duties, provided loss or damage was caused as a result of such a breach.

The common law duty of reasonable care, skill and diligence pervades throughout all of the directors' decisions within the company and if any breach of such duties or standards occurs then proceedings for a breach of his/her fiduciary duties may be bought by the person with whom the relationship of trust and confidence existed (usually the company).

Generally, proceedings for a breach of directors' fiduciary duties are bought by the company, usually on the instigation of the remaining directors in that company. In such circumstances a director may be removed from his position (either temporarily or permanently, dependent upon shareholder approval) and then pursued by the company for recovery of such monies.

Becoming declared bankrupt directly as a result of these circumstances.

However there are other options available, should it appear that a director is in breach of his/her fiduciary duties.

For example, shareholders can bring proceedings under the Companies Act 2006 which derive their rights to sue that director in his personal capacity on behalf of the company.

This can be a complex litigation procedure but enables shareholders (including minority shareholders) to take action that would otherwise only be available to the company care of its directors (who may be colluding with the wrong doing director).

The consequences of the penalty imposed upon directors for a breach of their fiduciary duties is usually in damages representative of the loss.

This can be very severe and, in addition to any sum awarded for the loss and damage that the company (or innocent parties) have suffered, can also include interest on any such sums retained and the claimant's legal fees.

It is not uncommon for a director to be pursued personally, be dismissed from a company and that such proceedings lead to a loss of his residential home and ultimately, in the worst case scenario, becoming declared bankrupt directly as a result of these circumstances.

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