

# Duties of directors of spin-out companies

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**The most common corporate vehicle used for a spin-out company is a private limited company. All companies require to have at least one director and one shareholder. Directors are responsible for the day to day running of the company and making strategic decisions. The shareholders are the owners of the company and have the right to receive payment of the profits of the company in the form of dividends, should the directors decide that the company pay such dividends. Depending on the rights given to the shareholders of a company under its constitutional documents, certain key decisions may require the agreement of the shareholders.**

A director of a spin-out company owes certain duties to the company and to its shareholders. These are contained in the Companies Act 2006 (the "2006 Act") which recently codified and replaced the existing combination of statutory and common law duties of directors.

The 2006 Act contains a statement of seven general directors' duties:-

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

Directors have an obligation to act within their powers as set out in the constitution of the company, and only to exercise these powers for the purposes for which they were conferred.

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

Directors must act in a way that they consider, in good faith, would most likely promote the success of the company and be for the benefit of its shareholders as a whole. Ministerial statements have indicated that success of a commercial company will usually mean long term increase in value.

The directors must exercise this duty whilst having regard to the following non-exhaustive list of factors:-

- 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 environment
- the desirability of the company maintaining a reputation for high standards of business conduct
- the need to act fairly as between shareholders of the company

In practice, directors should be presented with papers at board meetings that make reference to and consider the above, and any other relevant, factors.

Extensive board minutes are not necessarily required to ensure compliance with the new duties, and the factors listed above should not be included as a checklist. However, where a decision is made which involves the board considering particular factors, or competing factors, there may be some circumstances where the consideration of those factors should be minuted and the conclusions recorded.

## **3 Duty to exercise independent judgement**

Directors have a duty not to act in accordance with the will of others, whether that be through delegation or by simply acting in accordance with the wishes of others; rather they must exercise independent judgement on matters affecting the company.

This does not prevent directors from properly delegating matters to committees or appropriate individuals. Directors are also able to seek independent expert advice, provided that they still take their own independent decisions.

The duty does not however affect any actions taken by the directors in accordance with the constitution of the company, or through any agreement entered into by the company that may restrict the future exercise of discretion by its directors.

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

The duty to exercise reasonable care, skill and diligence is considered to be that which would be exercised by a reasonably diligent person with the general knowledge, skill and experience that may be expected of a person in that role, in addition to any general knowledge and skills that that director has.

#### 5 Duty to avoid conflicts of interests

A duty is imposed on a director to avoid any situation that would give rise to a direct or indirect conflict of interest with the interests of the company. This applies particularly to the exploitation of any property, information or opportunity, regardless of whether or not the company could take advantage of the same. Conflicts may also arise when a director takes on other directorships or makes a profit in the course of being a director, without the knowledge and consent of the company. Conflicts of interest arising in relation to a transaction or arrangement with the company are not covered by this duty.

There are two safe harbours where: (1) the situation cannot reasonably be regarded as likely to give rise to a conflict; and (2) the matter has been authorised by the shareholders of the company or by the non-conflicted directors, with such directors taking account of their other duties in deciding whether to grant such authorisation. Board authorisation may be given only if:-

- in the case of a private company incorporated prior to 1 October 2008, the shareholders have passed an ordinary resolution giving the directors the express power to grant such board authorisation and there is nothing in the company's articles of association that would invalidate the grant of such board authorisation
- in the case of a private company incorporated on or after 1 October 2008, there is nothing in the company's articles of association that would invalidate the grant of such board authorisation
- any quorum requirement is met without counting the conflicted director(s)
- authorisation is given excluding any vote(s) cast by the conflicted director(s)

It is possible that difficulties could arise in relation to directors who sit on more than one board and who are subject to a duty of confidentiality to one or more of the companies. Directors should be encouraged to seek

independent legal advice if in any doubt as to whether a conflict of interest may exist.

It should be noted that, if shareholder or board approval for a director's conflicts has not been properly given:-

- the director with the conflict is in breach of his duty
- if the company's articles of association state that a director can only vote on a matter in which he has a conflict if the conflict has been pre-approved, as may be the case, and this hasn't been properly done, the meeting may not have the requisite quorum for a valid board decision to be made. If such an inquorate board meeting approved the execution of an agreement, that agreement may be unenforceable against the company

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

Directors must not accept any benefits from third parties that arise by virtue of their office as a director, or equally through their doing, or not doing, anything in their capacity as a director. This does not apply to any transaction approved by the shareholders or one for which it is provided that approval is not needed.

#### 7 Duty to declare interests in proposed transactions and arrangements

If a director is, directly or indirectly, interested in a proposed transaction or arrangement with the company, he or she must declare the nature and extent of that interest to the other directors before the company enters into the transaction or arrangement.

There are four safe harbours: (1) where the director is not aware or ought not reasonably to be aware of the interest; (2) where the matter cannot reasonably be regarded as giving rise to a conflict of interest; (3) if and to the extent the other directors are aware or ought reasonably to be aware of the interest; and (4) if it concerns the relevant director's service contract which has been considered at a board (or committee) meeting.

Directors should also be aware of an additional obligation under section 182 of the 2006 Act (which does not form part of the codified duties). This section requires directors to declare an interest in any existing transaction or arrangement with the company (whether legally binding or not). Failure to make such a declaration is a criminal offence.

## **Particular considerations for spin-out companies**

Conflicts of interest can arise in the context of a spin-out company where, for example, a director of the company retains an interest in the intellectual property rights made available to the company and an issue arises in relation to the intellectual property which is to be determined by the company's directors. If a conflict does arise, a director's overriding duty is 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 the shareholders as a whole; a director cannot safeguard his or her own interests to the detriment of the company's interests.

In some cases, an employee of a competitor of the company may be permitted to sit on the board of the spin-out company. This tends to occur in spin-outs where individuals with the necessary management or sales experience required to develop an early stage business are in short supply. Accordingly, non-executive directors appointed by spin-out companies, largely for the specialist industry or technology expertise and contacts that they bring, may also be serving directors of the competing companies thereby creating a conflict of interest. The presence on the board of such a competitor's representative may inhibit the willingness of other directors to make full disclosure to the board. In certain circumstances, mere notification that a subject is to be discussed may be potentially damaging if that fact is made known to a competitor. As a result, where matters of confidentiality or a potential conflict are under discussion, it may be prudent for the directors to exclude the participation of any so conflicted director, in circumstances where there are good grounds to believe that he may divulge the confidential information, or will be placed in a position of conflict.

## **Additional duties and responsibilities of directors**

Directors have a personal responsibility to ensure that accounting records are maintained so that at any time they

are able to demonstrate and explain the financial position of the company. Failure to do this may cause every defaulting director of the company to be liable to a fine, imprisonment or both.

Companies must deliver annual accounts and reports to Companies House. The company's accountants will prepare these accounts using the information supplied to them by the company. However, the duty to ensure that the accounts are submitted on time lies with the directors of the company. Failure to submit in the required period carries an automatic civil penalty payable by the company in default, which increases according to how late the accounts have been filed.

## **Breaches of directors' duties**

In addition to the consequences of breach of directors' duties discussed above, a director in breach of his duties may be liable to the company for such breach. Any such action may be raised by the company, or the shareholders in certain circumstances, which if successful may result in the director paying damages to the company in respect of the breach.

## **Conclusions and actions**

Directors of all companies incorporated in Scotland, England and Wales should be fully aware of their new duties and responsibilities.

Directors should identify their own actual and potential conflicts of interest with a view to disclosing them for board or shareholder approval.

Burness is able to advise on all issues relating to the directors' duties and, in particular, ensuring that the constitutional documents of the company allow the company to authorise director conflicts of interest and that procedures are put in place to minimise the risk of directors falling foul of the law.

## **CONTACT US**

This briefing note sets out a summary of the law at the time of writing and is for information purposes only. It should not be regarded as legal advice but if you would like further information please contact:

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