

# Corporate Governance

ICSA qualifying programme



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# How to use this study text

This study text has been developed to support the Corporate Governance module of the ICSA's qualifying programme and includes a range of navigational, self-testing and illustrative features to help you get the most out of the support materials.

The text is divided into three main sections:

- ◆ introductory material
- ◆ the text itself
- ◆ reference material.

The sections below show you how to find your way around the text and make the most of its features.

## Introductory material

The introductory section includes a full contents list and the aims and learning outcomes of the qualification, as well as a list of acronyms and abbreviations.

## The text itself

Each part opens with a list of the chapters to follow, an overview of what will be covered and learning outcomes for the part.

Every chapter opens with a list of the topics and an introduction specific to that chapter.

Chapters are structured to allow students to break the content down into manageable sections for study. Each chapter ends with a summary of content to reinforce understanding.

## Features

The text is enhanced by a range of illustrative self-testing features to assist understanding and help you prepare for the examination. You will find answers to the 'Test yourself' questions towards the end of this text. Each feature is presented in a standard format, so that you will become familiar with how to use them in your study.

These features are identified by a series of icons. The text also includes tables, figures and illustrations as relevant.

## Reference material

The text contains a range of additional questions and reference material, including a glossary of terms and a comprehensive index.



Stop and think



Test yourself



Making it work



Case study



### Case study 6.2

Polly Peck International, a FTSE 100 company during the 1980s, was effectively run by a single individual, Adil Nadir, who was both chair and CEO. The company collapsed without warning in October 1990. During the administration process, the system of internal controls at the company's London head office was found to be virtually non-existent. As a result, Nadir had been able to transfer large amounts of money from the company's UK bank accounts to personal accounts in Northern Cyprus, without any questions being asked. After the company collapsed, Nadir fled to Northern Cyprus. He returned to London in 2010 (20 years later) to face trial and was found guilty of 10 counts of theft totalling £29 million, for which he was sentenced to 10 years in prison.



### Test yourself 6.2

1. What is the role of the company chair?
2. What are the requirements of the Code with regard to the independence of the company chair?
3. Why should the role of chair and CEO be separate?

### 8. Role of other executive directors

The Code makes provision about the balance of executive and non-executive directors on the board but has nothing else to say about the role of executive directors.

In addition to their responsibilities as directors, executive directors are full-time employees of the company, with executive management responsibilities. As directors they have the same duties as other members of a unitary board. These duties extend to the whole of the business, and not just that part of it covered by their individual executive role.

The only constant on most boards is the presence of a CEO and a finance director. Many companies have deliberately reduced the number of executive directors that serve on the board in order to reduce the number of non-executive directors required and keep the overall size of the board down to manageable proportions.

In practice, there can be tensions for executive directors between:

- ◆ their role as members of the board, 'one step down from the shareholders'; and
- ◆ their role as senior operational directors, 'one step up from management'.

### Stop and think 6.1

In a company that has just enough independent NEDs to comply with Code Provision 11, will those NEDs be in a stronger position if the total number of directors is an odd or even number?

In order to answer this question you may find it helpful to calculate what the minimum number of independent NEDs should be for a board which comprises variously 8, 9, 10 or 11 directors.

### 4.2 Reporting on board composition

The CA2006 requires the names of those who have served as directors during the financial year to be disclosed in the directors' report. In practice this will typically form part of the corporate governance report.

The UK Corporate Governance Code used to require in addition that the annual report identify the chair, the deputy chair (where there is one), the chief executive, the senior independent director and the chair and members of the board committees. Even though this provision has been deleted from the 2018 Code it plainly remains good practice.

In 2016, the King IV Report defined corporate governance leadership by the government as:

- ethical cultures
- good performance
- effective control
- legitimacy

The UK Corporate Governance Code is to facilitate efforts that can deliver the long-term definition of corporate governance. The 2016 Code is still set within governance is therefore almost the values of the company's operational management of the Corporate Governance Code do not exist in isolation: 'to succeed in the long term, business and the companies they lead need to build and maintain successful relationships with a wide range of stakeholders.'

Originally referring to the governance in large listed companies, evidence is growing that corporate governance can deliver benefits to other types of organisations of all sizes across all three sectors, public, private and not for profit. As we will see in Chapter 4, codes of best practice have been developed for the public, voluntary and health sectors, for sports bodies, and for academy schools, among others.

### 4. Theories of corporate governance

There are two main theories that form the basis for corporate governance practices. These are the shareholder primary theory (and related to this, agency theory), which forms the basis of the shareholder value approach to corporate governance, and the stakeholder theory, which forms the basis of the stakeholder approach to corporate governance. These two approaches to corporate governance are discussed later in this chapter.

#### 4.1 Shareholder primary theory

The shareholder primary theory of corporate governance focuses on maximising the value to shareholders before considering other corporate stakeholders, such as employees, customers, suppliers and society as a whole. It was developed in the 1960s by economists, such as Milton Friedman and Henry Manne, out of the legal arguments propounded by Berle and Means in agency theory. The shareholder primary theory is based on the premise that shareholders own companies and that directors, managers and employees are engaged by the company for the purpose of maximising shareholder wealth.

**agency theory**  
A theory based on the separation of ownership from control in a large organisation and the conflict of interests between the individuals who direct the organisation and the people who own it. In a company, the directors act as agents for shareholders, and the conflict of interests between them should be controlled.

**stakeholder theory**  
The view that the purpose of corporate governance should be to satisfy, in far as possible, the interests of all key stakeholders.

## Case studies

Short, illustrative case studies which link theory to real-world examples.

## Test yourself

Short, revision-style questions to help you recap on key information and core concepts. Answers are to be found towards the end of the text.

## Stop and think

'Stop and think' boxes encourage you to reflect on how your own experiences or common business scenarios relate to the topic under discussion.

## Definitions

Key terms are highlighted in bold on first use and defined in the page margins and the end of book glossary.

## About the authors

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Andrew has worked as a Partner of The Mentor Partnership, a consultancy specialising in company secretarial practice, publishing and training. He has lectured widely on company secretarial and legal issues, document retention and document management.

Andrew is the author of two books with ICSA, *The Law and Practice of Company Meetings* and *The ICSA Guide to Document Retention*. He is also the Editor of the ICSA's *Company Secretarial Practice* manual, and its weekly newsletter.

## Acronyms and abbreviations

ABI	Association of British Insurers
ACCA	Association of Chartered Certified Accountants
AGM	Annual General Meeting
AIFS	Alternative Investment Funds
AIM	Alternative investment market
AoA	Articles of Association
BCP	Business Continuity Plan
BEIS	Business Energy and Industrial Strategy
BHS	British Home Stores
BIS	Bank of International Settlement
BITC	Business in the Community
BREXIT	British Exit from the European Union
CA2006	Companies Act 2006
CalPERS	California Public Employees Retirement System
CBI	Confederation of British Industry
CDSB	Climate Disclosure Standards Board
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CIMA	Chartered Institute of Management Accountants
CIPD	Chartered Institute of Personnel and Development
CIPE	Centre for International Private Enterprises
CIPFA	Chartered Institute of Public Finance and Accountancy
CMA	Capital Markets Authority
CNPC	China National Petroleum Corporations

## Chapter four

# Other governance issues

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2. Corporate governance outside the UK
3. The US and Sarbanes-Oxley Act 2002
4. South Africa and the King Codes
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10. Governance in other sectors
11. Governance for family-controlled companies
12. Global principles of corporate governance
13. Key issues in corporate governance
14. Corporate governance issues in developing and emerging markets

### 1. Introduction

This chapter looks at the international aspects of corporate governance. It looks at how governance principles and practices have been adopted outside the corporate sector in the public and not-for-profit sectors. Finally, it covers some of the key issues in corporate governance today around the world.

### 2. Corporate governance outside the UK

Some countries around the world have based their corporate governance frameworks on the UK model of corporate governance. Others have adopted different approaches. The European Corporate Governance Institute (ECGI) makes available on its website the full text of all of the corporate governance

frameworks adopted globally. This chapter cannot go into the details of all of them so the most noteworthy have been selected here.

### 3. The US and Sarbanes-Oxley Act 2002

As mentioned earlier, the US has adopted a rules-based approach to corporate governance in response to the corporate collapses in the US in the early 2000's, among them Enron and WorldCom, and the stock market collapse following the bursting of the dot.com bubble. The Sarbanes-Oxley Act of 2002 (SOX) was enacted, the Securities and Exchange Commission (SEC) adopted many new rules and the New York Stock Exchange and Nasdaq Stock Market changed their standards governing listed companies.

SOX and its related SEC rules resulted in the following with respect to corporate governance:

- ◆ The SEC, as required by Section s. 307 of SOX, adopted a rule that required all stock markets to adopt standards in their listing rules governing the composition and functions of audit committees, and the independence of directors. Both NYSE and NASDAQ adopted listing rules requiring that companies listed on their markets to have:
  - a majority of independent directors on their boards. Controlled companies, that is, where 50% or more of their capital is held by one individual, a group or another company, were exempted;
  - regular executive sessions of the independent directors, that is where the independent directors meet on their own;
  - an audit committee, compensation committee and a nominating committee; and
  - shareholder approval for all equity compensation plans.
- ◆ The SEC under s. 208 of SOX, introduced new rules on auditor independence, restricting the non-audit services an auditor could provide to the company, introducing a 'cooling off' period for auditors, audit partner rotation and expanded disclosure by the company relating to its auditors.
- ◆ Section 101 of SOX introduced an independent, non-governmental board, the Public Company Accounting Oversight Board (PCAOB) to oversee the audits of public companies.
- ◆ The SEC under s. 302 of SOX introduced requirements for the CEO and CFO to certify the quarterly and annual reports including financial statements filed with the SEC. False certifications under Section 302 resulted in SEC penalties and potential civil liability. Section 309 of SOX added a potential criminal liability for false certifications.
- ◆ The SEC under s. 404 of SOX introduced requirements for management to:
  - establish and maintain an adequate system of internal controls and procedures for financial reporting;
  - include in the company's annual report a report on the effectiveness of the company's internal controls over financial reporting.

The original implementation of the Section 404 requirement to review the system of internal controls was seen as very draconian and costly, and was blamed for discouraging foreign companies from listing in the US. In 2006, the provisions were reviewed, and the SEC issued new guidance which allowed management more discretion on how the annual review of internal controls is carried out.

- ◆ The SEC under Section 406 introduced requirements for codes of conduct and ethics governing the CEO, CFO, principal accounting officer or controller, or persons performing similar positions. It did not require a company-wide code of ethics, which has now become common. The New York Stock Exchange and NASDAQ, however, did bring in requirements for a company-wide code of ethics, which included directors, officers and employees for companies listed on their exchanges.
- ◆ Other standards applicable to directors and officers were also brought into SOX/SEC. These included:
  - prohibition of personal loans;
  - reporting of trades in the company's securities;
  - insider trading blackout periods around the release of material information, such as a company's financial reports; and
  - clawback of bonuses and incentive or equity-based compensation where financials have to be restated due to the misconduct of the individual.
- ◆ Section 806 of SOX created a civil action for employees of listed companies who were subject to retaliation by their employers for whistleblowing.

## 4. South Africa and the King Codes

The King Committee on Corporate Governance was established in the early 1990s and has issued four versions of the King Code of Corporate Governance in 1994 (King I), 2002 (King II), 2009 (King III) and the latest version (King IV) in 2016. The King Code is the responsibility of the Institute of Directors in Southern Africa (IoDSA). Compliance with the King Code is a requirement for companies listed on the Johannesburg Stock Exchange.

The King Codes are interesting for the following reasons:

- ◆ They created and still adopt the 'stakeholder inclusive' approach to corporate governance discussed in Chapter 1.
- ◆ Corporate responsibility and ethics form part of the King Code definition of corporate governance.
- ◆ They are well-established, having been first introduced in 1994 – only two years after the Cadbury Code in the UK.
- ◆ They provide for a single corporate governance framework in that they apply to all types of organisation, not just listed companies.

- ◆ King III adopted the 'apply or explain' regime to be followed by the 'apply and explain' regime in King IV, both of which are explained in more detail in Chapter 1.

The South African corporate governance framework is often described as a hybrid corporate governance regime, as some of its provisions follow the principle-based approach, King IV, and others are rule-based, being found in a number of laws that apply to companies and directors, including the Companies Act of South Africa of 2008. In addition, further enforcement takes place by regulations such as the JSE Securities Exchange Listings Requirements.

### 4.1 King IV

King IV assumes application of the principles set out within it, this is why it has adopted the 'apply and explain' regime. The disclosure is an explanation of the practices that have been implemented and how these support achieving the associated governance principle. The governing body can choose where and how to make the disclosures, which should be publicly accessible.

King IV also aligns best practices in corporate governance to shifts in the approaches to:

- ◆ capitalism – financial capital to inclusive capital market systems;
- ◆ reporting – 'silo', that is by capital: financial, human, intellectual, manufactured, social and natural to **'integrated' reporting**; and
- ◆ capital markets – short-term to sustainable capital markets.

The focus of King IV is on outcomes-based governance. It places accountability on the governing body within an organisation to attain four governance outcomes:

- ◆ ethical culture and effective leadership;
- ◆ performance and value creation in a sustainable manner;
- ◆ adequate and effective controls; and
- ◆ trust, good reputation and legitimacy with stakeholders.

King IV also introduces a principle applicable to institutional investors.

The King Reports have repositioned corporate governance in South Africa as a method of achieving sustainability of organisations rather than just a method of protecting investors. The integration of corporate responsibility and ethics into the definition of corporate governance is also seen as essential in a region struggling with issues such as corruption, health issues and lack of much needed skills. It is hoped that through this repositioning, more organisations will see the appropriateness of corporate governance to their sustainability with the consequential economic development it should produce.

**integrated reporting**  
Reporting on all aspects of the company's activities that have relevance to the creation or loss of value in six areas of capital: financial, manufactured, human, intellectual property, natural and social. Similar to sustainability reporting, but directed at the company's shareholders.

## 5. Corporate governance frameworks in Germany

Germany, unlike the UK, South Africa and the US, operates what is called a two-tier board system. It also has a concentration of share ownership in large companies. Franks and Mayer (2001) reported that, in 1990, 85% of a sample of 171 large listed industrial companies in Germany had a single shareholder with an ownership stake of more than 25% of the share capital, and 57% had a single shareholder who owned more than 50%.

The concentration in ownership would appear, as we will see for China later in the chapter, to give the majority shareholder complete control of the company. This is not the case in Germany, however, as safeguards have been put in place in Germany's Stock Corporation Act, last amended in 2016, to protect the minority shareholders. The Act provides that the **supervisory boards** of large listed companies, that is, companies of with 2,000 or more employees, are elected 50% by the company's employees and 50% by the company's shareholders. The supervisory board is then responsible for appointing and dismissing the **management board**. It is the management board who has responsibility for managing the company. The Act also contains provisions that stop unfavourable contracts being imposed on the company by its majority shareholder.

### supervisory board

A board of non-executive directors, found in a company with a two-tier board structure. The supervisory board reserves some responsibilities to itself. These include oversight of the management board.

### management board

A board of executive managers, chaired by the CEO within a two-tier board structure. The chair of the management board reports to the chair of the supervisory board. The management board has responsibility for the operational performance of the business.

The German Government set up the Cromme Commission to look at the corporate governance regime for listed companies in Germany. The Cromme Code was published in May 2003. It recommended that a maximum of two former executives could sit on the supervisory board of a listed company at one time. Historically, many executives saw as part of their retirement a place on their supervisory board. The Cromme Code was replaced in 2017 by the German Corporate Governance Code, which applies to all listed companies.

The German Code consists of three types of provisions:

- ◆ Legal stipulations that oblige the company to follow applicable law
- ◆ 'Shall' recommendations, which follow the comply or explain regime
- ◆ 'Should' suggestions, where companies do not need to disclose their deviation from them.

The commitment of companies to corporate governance practices are judged by their application of the 'shall' recommendations.

## 6. Corporate governance frameworks in Japan

Shareholding in Japan is dispersed and held predominantly by financial institutions and businesses, like the UK and the US. There is therefore a separation of ownership and control, with managers running the day-to-day affairs of the company. However, historically, the corporate governance model in Japan has been more like the European model with management giving a strong priority to the interests of employees rather than the shareholder focus of the Anglo-American corporate governance model. In recent years, it appears that Japan, with its new corporate governance regime, is becoming more market-orientated and adopting its own hybrid approach to corporate governance, which contains elements of both the European and Anglo-American corporate governance models.

The change to a more market-orientated corporate governance regime is predominantly government driven as part of the reforms brought in as a response to Japan's long-running economic problems.

### Principles for Responsible Institutional Investors: Japan's Stewardship Code

In an attempt to open the market to foreign investors, Japan issued its 'Principles for Responsible Institutional Investors: Japan's Stewardship Code', in 2014. The Code was updated in 2017. By September 2017, there were nearly 300 signatories in support of the Stewardship Code, the majority of which were domestic investors.

The Stewardship Code comprises a set of seven principles, the aim of which is to provide a framework for institutional investors in fulfilling their stewardship responsibilities with due regard both to their clients and beneficiaries and to investee companies which contributes to the growth of the economy of Japan as a whole. It adopts a 'comply or explain' regime. The principles are:

1. Institutional investors should have a clear policy on how they fulfil their stewardship responsibilities, and publicly disclose it.
2. Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.
3. Institutional investors should monitor investee companies so that they can appropriately fulfil their stewardship responsibilities with an orientation towards the sustainable growth of the companies.
4. Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.
5. Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist; it should be designed to contribute to the sustainable growth of investee companies.

6. Institutional investors in principle should report periodically on how they fulfill their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries.
7. To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment and skills and resources needed to appropriately engage with the companies and make proper judgement in fulfilling their stewardship activities.

### 6.1 Japan's Corporate Governance Code

Japan's Corporate Governance Code defines corporate governance as 'a structure for transparent, fair, timely and decisive decision making by companies with due attention to the needs and perspectives of shareholders and also customers, employees and local communities.'

The Code adopts a principle-based approach based on the G20/OECD Principles of Corporate Governance discussed later in this chapter. It also adopts the 'comply and explain' approach developed by the UK Corporate Governance Code. The Code, which applies to all companies listed on the Tokyo Stock Exchange, was first published in 2015 and revised in June 2018.

#### *Securing the rights and equal treatment of shareholders*

Companies should take appropriate measures to fully secure shareholder rights and develop an environment in which shareholders can exercise their rights appropriately and effectively. In addition, companies should secure effective equal treatment of shareholders. Given their particular sensitivities, adequate consideration should be given to the issues and concerns of minority shareholders and foreign shareholders for the effective exercise of shareholder rights and effective equal treatment of shareholders.

#### *Appropriate co-operation with stakeholders other than shareholders*

Companies should fully recognise that their sustainable growth and the creation of mid- to long-term corporate value are brought as a result of the provision of resources and contributions made by a range of stakeholders, including employees, customers, business partners, creditors and local communities. As such, companies should endeavour to appropriately cooperate with these stakeholders. The board and the management should exercise their leadership in establishing a corporate culture where the rights and positions of stakeholders are respected, and sound business ethics are ensured.

#### *Ensuring appropriate information disclosure and transparency*

Companies should appropriately make information disclosure in compliance with the relevant laws and regulations, but should also strive to actively provide information beyond that required by law. This includes both financial information, such as financial standing and operating results, and non-financial information, such as business strategies and business issues, risk and governance. The board should recognise that disclosed information will serve as the basis for constructive dialogue with shareholders, and therefore ensure the

such information, particularly non-financial information, is accurate, clear and useful.

#### *Responsibilities of the board*

Given its fiduciary responsibility and accountability to shareholders, in order to promote sustainable corporate growth and the increase of corporate value over the mid- to long-term and enhance earnings power and capital efficiency, the board should appropriately fulfil its roles and responsibilities, including: (1) setting the broad direction of corporate strategy; (2) establishing an environment where appropriate risk-taking by the senior management is supported; and (3) carrying out effective oversight of directors and the management from an independent and objective standpoint. Such roles and responsibilities should be equally and appropriately fulfilled regardless of the form of corporate organisation.

#### *Dialogue with shareholders*

In order to contribute to sustainable growth and the increase of corporate value over the mid- to long-term, companies should engage in constructive dialogue with shareholders even outside the general shareholder meeting. During such dialogue, senior management and directors, including outside directors, should listen to the views of shareholders and pay due attention to their interests and concerns, clearly explain business policies to shareholders in an understandable manner so as to gain their support, and work to develop a balanced understanding of the positions of shareholders and other stakeholders and acting accordingly.

## 7. Corporate governance frameworks in China

China's listed companies have a concentrated ownership structure, unlike the UK, US and Japan where ownership and control are separated. The focus of their corporate governance regime is, therefore, on protecting minority shareholders, regulating controlling shareholders and disclosure and transparency.

China follows the **two-tier board** system originating in continental Europe, whereby Chinese companies have:

- ◆ a board of directors which is responsible for the management of the company including the oversight from an operational perspective of the management who run the company on a day-to-day basis; and
- ◆ a supervisory board which is responsible for ensuring that the board of directors and management do not violate laws or the company's articles of association. It is also entitled to inspect the company's financial records.

China's corporate governance framework is rules based and consists of:

- ◆ Laws, such as Accounting Law (2000), Companies Law 2006, Securities Law 2006, and the Law on State-owned Assets of Enterprises (2009);

**two-tier board**  
Board structure in which responsibilities are divided between a supervisory board of non-executive directors led by the chairman and a management board of executives led by the CEO.

- ◆ Code of Corporate Governance for Listed Companies (2018); and
- ◆ Listing Stocks and Trading Rules made by the individual stock exchange.

The Chinese Code, which was first published in 2001, is based on the *Principles of Corporate Governance*. It was revised in 2018.

The 2000 edition of the Chinese Code contained provisions on shareholders and shareholders' meetings, listed companies and controlling shareholders, directors and board of directors, supervisors and the supervisory board, performance assessment and incentive and disciplinary systems, stakeholder and information disclosure and transparency. The 2018 version includes greater emphasis on environmental, social and governance (ESG) disclosure, the role of institutional investors as stewards, the accountability of board directors, and board member skills and diversity.

## 8. Corporate governance frameworks in Scandinavia

Scandinavian law is distinct from other contemporary legal systems which tend to be based on the Anglo-Saxon or German models. Scandinavian law is adopted by five countries: Denmark, Finland, Sweden, Norway and Iceland, known as the Nordic countries. Companies adopting this legal system mark the one-tier board of directors from the Anglo-Saxon model, but have instead beneath it a management structure which can be either the CEO on their own or a group of senior executives including the CEO. The management structure is subject to the instructions of the board of directors. A member of the management structure can also be a member of the board of directors, but cannot be its chair and they must be in the minority.

The liability of the management is for the day-to-day affairs of the company, anything outside of this must be submitted to the board of directors for a decision. Like the **unitary board** of the Anglo-Saxon model, the board of directors in the Scandinavian model enjoys both executive and oversight powers. In the traditional two-tier German model, the executive powers are vested in the management board and the oversight powers in the supervisory board.

Shareholders in the Scandinavian model sit above the internal structures of the board of directors and management structure creating a hierarchical system. Only those in the level directly above can appoint and dismiss the members of the body beneath them. Shareholders therefore appoint and dismiss the members of the board of directors and the board of directors appoints and dismisses the members of the management structure.

Share ownership in Scandinavia is concentrated but is not seen as problematic. Scandinavian law supports the supremacy of a dominant majority shareholder giving them the power to appoint all of the board of directors and as such control the company. This is countered, however, by the potential for a dominant shareholder to be held liable under Scandinavian law for any reckless behaviour in their decision making or where the dominant shareholder is seen

**unitary board**  
A board structure in which decisions are taken by a single group of executive and non-executive directors, led by the company chairman.

to be coercing either the board of directors or management into a particular action for the benefit of that shareholder.

Despite having the same legal systems, the Nordic countries developed their own self-regulating corporate governance codes which had significant differences within them. In 2007, there was an attempt to bring the regulators responsible for these codes together to see if they could be brought closer together in an attempt to help foreign investors understand the Scandinavian model.

## 9. Corporate governance frameworks in the Netherlands

The Dutch model of corporate governance accommodates both the two-tier German model, which is followed by the majority of Dutch listed companies, and the one-tier Anglo-Saxon model. This is because of the Anglo-Dutch companies, such as Unilever and Shell, that were required by their listings in the UK and the US to adopt a one-tier system. Chapter 5 of the Dutch Corporate Governance Code 2016 applies specifically to one-tier board companies, with the rest of the code focusing on two-tier companies.

### Test yourself 4.1

Why have different countries' corporate governance best practices developed in different ways?



## 10. Governance in other sectors

The recognition that there have been benefits of good corporate governance for the private sector has led to organisations in the public and not-for-profit sectors taking an interest in how they can improve their own governance practices. This has led to the adoption of corporate governance guidelines or codes by these types of organisations.

We saw earlier that since King III, the corporate governance codes in South Africa have applied to all types of organisations. The UK, in contrast, has taken the route of developing different corporate governance codes and guidelines for different sectors within the economy. This is because, although the principles of corporate governance apply in all sectors, the governance challenges are different sector by sector so to ensure that the practices deal with the particular challenges different codes or guidelines are applicable.

- ◆ Conflict in family-owned businesses between controlling family members, informal governance structures and often inexperienced boards and management teams.



### Case study 4.3

Buyers of tobacco in Malawi introduced stricter quality controls on bales of tobacco bought from local farmers. As a result, according to buyers, 85% of bales submitted to buyers were rejected. This had a devastating impact on the economy of Malawi, which is one of the poorest countries in the world.

The decision to introduce the stricter quality controls came from an overseas holding company, which was part of a joint venture with a local Malawian company, and was implemented by the expatriate manager without recourse to the local board. It was claimed that the crisis may have been diverted if the expatriate manager had consulted the local board.

### Chapter summary

- ◆ Corporate governance has developed in different ways in different countries to reflect their distinct legal systems and also the specific issues that they are dealing with.
- ◆ There is a convergence in governance practices – all countries recognise the importance of independent directors and the importance of the principles of corporate governance: responsibility, accountability, transparency and fairness.
- ◆ There is a growing recognition of the value of having a governance professional within the organisation.
- ◆ The corporate governance frameworks recognise the differing roles of the shareholder, director and manager and the relationship and dialogue between them.
- ◆ The adoption of corporate governance practices in other sectors such as the public and not-for-profit sectors is growing. There are, however, different challenges to be dealt with in these sectors so the focus is on different aspects of corporate governance.
- ◆ Many of the key issues in corporate governance are global issues.

# Part two

## The board of directors and leadership

### Overview

The second part of this study text considers the knowledge and skills necessary for company secretary to advise the board on its governance role and the role its various participants. It also addresses best practice on composition, appointments and succession policies, and describes the behaviours and practices that can enhance board effectiveness.

Chapter 5 sets the scene by summarising the duties and powers of directors under the CA2006 and the general law, which form the foundation of the UK corporate governance regime.

Chapter 6 examines the practical role that the UK Corporate Governance Code expects boards to play in the management of the company's business and the specific roles of chair, CEO, executive directors, NEDs and the senior independent director.

**Chapter five**  
Directors' duties and powers

**Chapter six**  
Role and membership of the board of directors

**Chapter seven**  
Board composition and succession planning

**Chapter eight**  
Board effectiveness

Chapter 7 addresses issues regarding the composition and balance of the board (including diversity), the appointment process and succession policies, all matters which fall within the remit of the nomination committee.

Chapter 8 discusses other behaviours and practices that can enhance the effectiveness of the board and the Company secretary's role in promoting them. In particular it looks at decision-making processes, the supply of information, independent professional advice, board evaluations, induction and professional development.

## Learning outcomes

Part Two should enable you to:

- ◆ advise the directors on their duties and on the possible consequences of any breach of those duties;
- ◆ advise the directors on their powers and the possible constraints on those powers, including when shareholder approval may be required;
- ◆ critically appraise and apply corporate governance principles and best practices on the role of the board;
- ◆ advise the board of the benefits of adopting a schedule of matters reserved for the board and to understand what such a schedule should cover;
- ◆ explain the role of the chair and how it should be separated from that of the CEO;
- ◆ explain the role of the CEO and how they exercise delegated powers;
- ◆ understand the role of non-executive directors and be able to advise the board on the criteria for independence and measures that can be taken to enhance their effectiveness;
- ◆ advise the board on the role of the senior independent director;
- ◆ advise the board on the role of the three main board committees required under the Code and the rules on their composition;

- ◆ explain the role of the company secretary envisaged under the Code;
- ◆ understand and advise the board on the factors that will affect the composition, size and balance of the board, including diversity;
- ◆ advise the board on best practices on diversity and the associated reporting requirements;
- ◆ explain the role of the nomination committee;
- ◆ identify best practices on the appointment and re-election of directors and succession planning;
- ◆ identify common failings in the decision-making process;
- ◆ understand the company secretary's role in the supply of high quality and timely information and the role of board portals in this regard;
- ◆ understand the board's role in monitoring and embedding a healthy corporate culture throughout the organisation;
- ◆ advise the board on the alternative procedures that could be adopted regarding independent professional advice;
- ◆ advise the board and the chair on what the annual board evaluation should cover and how it might be conducted; and
- ◆ understand the objectives of induction and professional development programmes and the basic principles of their design.

## Chapter five

# Directors' duties and powers

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## 1. Introduction

This chapter sets the scene for considering the corporate governance role of the board and its members by outlining the position under the general law regarding the duties and powers of directors. In particular, it examines the general duties of directors under the CA2006, some of which lie at the heart of the UK corporate governance regime.

## 2. Powers of directors

In the UK, the directors of a company derive their powers from its **articles of association**, rather than anything in legislation. Although the Companies Act 2006 (CA2006) requires every company to have at least one director (or at least two for public companies), it does not really confer any management powers on them. It deliberately leaves the division of powers between the shareholders and

the directors to be determined in the company's articles of association.

Almost without exception, articles of association delegate wide powers to the directors. If they did not do so, nearly all decisions would have to be taken by a majority vote of the shareholders, either by written resolution or at a general meeting. This would be impractical for most purposes even in a small owner-managed company, let alone a listed company with thousands of shareholders.

### 2.1 General management powers

Articles of association routinely make the directors collectively responsible for 'managing the company's business' and confer upon them (acting as a board) all the powers of the company necessary to do so. For example, article 3 of the CA2006 **model articles** for public limited companies states: 'subject to the articles, the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company.'

The wording in article 3 does not mean that each individual director can exercise these powers. The directors must exercise their powers collectively by a majority decision of the board, unless they are allowed under the articles to delegate those powers to someone else.

Provisions such as article 3 above are known as the 'general management clause'. They confer on the directors the powers necessary to manage the business and can only be used for those purposes. For example, the general management clause does not give the directors power to reject a share transfer. They need a 'special power' to do that.

In addition, the directors' general management powers can be subject to limitations which arise under:

- ◆ an objects clause, which limits the powers of the company, and therefore the powers of the directors (for example, if a company has an objects clause which limits the types of business the company may operate, the directors would be in breach of their duty to act within the company's powers if they decided to expand the business into an area not covered by the objects clause);
- ◆ an article imposing some sort of specific limit on the directors' powers, like a borrowing limit;
- ◆ an article allowing the members to give directions to the directors (see below);
- ◆ a shareholders' agreement – which could require shareholder approval for certain types of decisions which would normally fall within the directors' powers;
- ◆ the Companies Acts and other rules or regulations – which often impose a requirement for shareholder approval and may impose procedural conditions.

Company secretaries/governance professionals have to be alert to these potential restrictions and are expected to advise the board on whether matters are within the directors' powers.

### model articles of association

Part of a company's constitution. Model articles are set out in CA2006 and automatically apply if a limited company is incorporated in the UK without registering its own articles.

## 2.2 Special powers

Invariably, articles of association also give the directors various special powers that they would not otherwise have under the general management clause. The power to delegate is one of those special powers. If a decision that the directors are proposing to make does not feel like a management decision, there are no special powers authorising them to make that decision, and their approval may be required. Share transfers are a good example of this. A share transfer does not feel like a decision concerning the management of the business. It relates to the composition of the company's membership. Accordingly, directors need a special power in order to reject share transfers.

## 2.3 Power to delegate

Articles of association invariably allow the directors to delegate their powers, and, in practice, this is what they do, recognising that a board which meets once a month cannot possibly manage the business on a day-to-day basis. For example, article 5 of the Model Articles for public limited companies:

### 5. Directors may delegate

◆ Subject to the articles, the directors may delegate any of the powers conferred on them under the articles—

- (a) to such person or committee;
- (b) by such means (including by power of attorney);
- (c) to such an extent;
- (d) in relation to such matters or territories; and
- (e) on such terms and conditions; as they see fit.

◆ If the directors so specify, any such delegation may authorise further delegation of the directors' powers by any person to whom they are delegated.

◆ The directors may revoke any delegation in whole or part, or alter its terms and conditions.

Boards usually delegate extensive management powers to the executive directors. These powers typically flow through the chief executive officer and leader of the executive team. Executives are usually allowed to sub-delegate their powers to other people in the organisation. This does not necessarily happen by a literal chain of delegation down to the most junior employees. Boards use a combination of formal delegation (e.g. to executive directors) and the adoption of company-wide policies and procedures, which set authority limits for the various tiers of management.

## 2.4 Shareholders' reserve power to give directions

As a general rule, where a company's articles confer a power on the directors, the shareholders cannot then exercise that power themselves unless the articles

provide some sort of mechanism enabling them to do so. This is the case even though the shareholders are, in effect, the people who delegated those powers to the directors.

Most articles give shareholders a reserve power to issue directions to the directors but invariably require them to do so by passing a special resolution for these purposes. For example, article 4 of the Model Articles for public limited companies allows shareholders to instruct the directors by special resolution to take, or refrain from taking, specified action. However, it provides that a resolution of this nature has no effect on the validity of anything which the directors have already done before the resolution is passed. For example, there would be no point in the members passing a special resolution to prevent the directors from selling part of the business, if that sale had already taken place.

In practice, shareholders rarely use these powers. Shareholder activists sometimes do so as part of a campaign designed to put pressure on the company to change, say, its environmental policies. They typically do so more to gain publicity for their cause than in the expectation of victory. It is easier for shareholders who oppose the actions of management to seek the removal of the existing directors and to appoint new people in their place, both of which can be done by ordinary resolution, albeit one that requires special notice.

## Test yourself 5.1

1. Where might you find limitations on the directors' management powers?
2. Identify at least two special powers that are usually conferred by articles on the directors.
3. Is setting the company's strategy a management decision?
4. Can shareholders interfere in the management of a company?

## 3. General duties of directors under the Companies Act 2006

Directors have many duties under the CA2006. Most of these duties give rise to potential criminal sanctions. For example, the directors of a company can be prosecuted if it fails to file its accounts at Companies House on time. The Act usually places a cap on the financial penalties that can be imposed for each offence, which in the case of late filing of the accounts is £5,000. These financial penalties are paid into general government funds.

Directors also have a number of civil duties under the CA2006. These duties are set out in Part 10, Chapter 2, ss. 171–177 and are referred to as the 'general duties of directors'. Some people still refer to them as the common law or fiduciary duties of directors as they derive from common law and equitable principles developed by the courts over many years. The UK government



decided to codify these duties in the CA2006 in order to make them more accessible and easier for directors to understand.

The general duties are owed by the directors to the company and concern the manner in which they carry out their functions as agents of the company. The CA2006 sets certain minimum standards of conduct and behaviour on the part of the directors. If they act in breach of these duties, they can be sued by the company in civil proceedings, which may result in them having to pay the company compensation for any losses that it suffered or account to the company for any **secret profits** they made. There is no limit to the amount of compensation that may be awarded in these civil cases.

#### secret profit

A profit that is not revealed. In the context of corporate governance, a director should not make a secret profit for his/her personal benefit and at the expense of the company.

As the duties are owed to the company, only the company can bring an action against the directors for a breach of the general duties. As an exception to this rule, shareholders can bring what is known as a 'derivative' action in the name of the company. However, if they win, any compensation is still paid to the company, rather than to the shareholders who brought the action.

### 3.1 Common law and fiduciary duties of directors

Section 170 of the CA2006 confirms that the general duties of directors set out in the Part 10, Chapter 2 (ss. 171–177) 'are based on certain common law rules and equitable principles as they apply to directors, and have effect in place of those rules and principles as regards the duties owed to a company by a director'. It goes on to say that the statutory general duties should be interpreted in the same way as the common law rules and equitable principles. Accordingly, most of the historic case law is still relevant today for the purpose of interpreting the relevant statutory provisions.

Most of the common law rules developed by the courts for directors were based on the rules that they already applied to trustees. This is why some of the duties are referred to as fiduciary duties.

A 'fiduciary' is a person in a position of trust. A **fiduciary duty** is therefore owed by a person in a position of trust. A trustee is an obvious example of a person in a position of trust. The courts decided that company directors are also in a position of trust because they act as agents of the company, make decisions on its behalf and control the company's property.

The fiduciary duties that trustees owe to the beneficiaries of a trust include the following:

- ◆ to act in good faith in the interests of the beneficiaries;
- ◆ to act in accordance with the trust deed;
- ◆ not to make a profit from their position;
- ◆ not to place themselves in a position where their own interest conflicts with their fiduciary duties;
- ◆ not to act to their own advantage or the benefit of a third person without the beneficiary's informed consent;
- ◆ to properly invest trust property.

You will see close parallels between these duties and the general duties of directors which follow, subject to one notable exception. That exception relates to the duty of directors to exercise due skill, care and diligence. Strictly speaking, this duty does not derive from the fiduciary duties and was developed separately by the courts.

### 3.2 Summary of the general duties of directors

The general duties of directors under ss. 171–177 of the CA2006 are as follows:

- ◆ to act within their powers in accordance with the company's constitution (and to use those powers for proper purposes) (s. 171);
- ◆ to promote the success of the company (s. 172);
- ◆ to exercise independent judgement (s. 173);
- ◆ to exercise reasonable care, skill and diligence (s. 174);
- ◆ to avoid conflicts of interest (s. 175);
- ◆ not to accept benefits from third parties (s. 176); and
- ◆ to declare any interest in proposed transactions or arrangements (s. 177).

Section 170 confirms that these duties are owed by a director to the company and apply equally to any **shadow director**. It is also worth noting that the duties apply to both executive and non-executive directors.

#### shadow director

A person in accordance with whose instructions the directors of a company are accustomed to act and who has not been formally appointed as a director.

### 3.3 Consequences of a breach of the general duties

The CA2006 states that the consequences of a breach of a director's general duties are the same as if the corresponding common law rule or equitable principle applied, but it does not set out in detail what those consequences are. In practice, the remedies available to the company depend on the nature of the breach.

As a general rule, directors can be made to repay any illegal payments they have received or secret profits they have made. Where there is a breach of the duty of skill and care or the directors have acted beyond their powers, the company can be awarded compensation for any losses that it has suffered. Where the directors have acted outside their powers, the courts cannot normally declare the transaction void. However, where the directors have used their powers for improper purposes, the transaction can be declared void (see Section 4.1). Where a director has failed to disclose an interest in a transaction, the company can choose whether or not to treat that transaction as void.

Further details on these remedies can be found in the succeeding paragraphs for each of the general duties. It is, of course, part of the company secretary's job to ensure that the directors understand their duties, and it is a good idea to reinforce such training with practical examples from case law of the consequences of a breach.