

LEGAL UPDATES AND FACTSHEETS

DIRECTORS' STATUTORY DUTIES: COMPANIES ACT 2006

1 ABSTRACT & INTRODUCTION.

- 1.1 The content of this fact sheet outlines the changes to the law on directors' duties under the [Companies Act 2006 \(2006 Act\)](#). The [2006 Act](#) applies in Northern Ireland because the legislation is UK-wide. So, although the Belfast Companies' registry will continue to function, the separate legislation for NI (such as the [Companies \(NI\) Order 1990](#), and ancillary legislation) will be repealed as the new provisions come into force.
- 1.2 [Chapter 2 of Part 10](#) (general duties of directors) will come into force on 1 October 2007, other than the provisions relating to directors' conflict of interest duties ([sections 175 to 177](#)), which will come into force on 1 October 2008.
- 1.3 An exposition of the main provisions (and the new statutory duties) follows a synopsis of the current law. Three appendices, including a brief comment (see [Appendix 1](#)) focus on some of the more controversial issues raised by the changes, in particular the 6 named factors directors must now consider when exercising their general duty to promote the success of the company.

2 CURRENT LAW.

- 2.1 A director's fiduciary and common law duties evolved through case law. Broadly, they comprise the following duties:
 - Duty to exercise skill and care.
 - Duty to act in good faith in the best interests of the company.
 - Duty to act within the powers conferred by the company's memorandum and articles of association and to exercise powers for proper purposes.
 - Duty not to fetter discretion.
 - Duty to avoid conflicting interests and conflicting duties.
 - Duty to not to make a secret profit.

3 KEY CHANGES UNDER THE 2006 ACT.

- 3.1 One of the [2006 Act's](#) most significant and controversial proposals is the codification of directors' duties. It introduces a statutory statement of duties to replace many existing common law and equitable rules.
- 3.2 The new statement of duties does not cover all the duties a director may owe the company. Other duties are incorporated in the [2006 Act](#) (such as, the duty to deliver accounts ([section 441](#))). And some duties remain uncodified (such as the duty to consider creditors' interests in times of threatened insolvency). Companies may provide more onerous duties in their articles but the articles may not dilute the duties except to the extent expressly allowed by the [2006 Act](#).
- 3.3 The codified duties will be owed to the company and only the company will be able to enforce them. (In certain circumstances, the shareholders may be able to bring a derivative action, albeit essentially on the company's behalf (see [sections 260 to 264](#))).
- 3.4 The [2006 Act](#) itself does not contain all the necessary details on directors' duties as regard is to be had to the common law rules and equitable principles that already exist in interpreting and applying the general duties ([section 170\(4\)](#)).
- 3.5 The codified duties will apply to all the directors of a company, including shadow directors and, in the case of the duties in [sections 175](#) (duty to avoid conflicts of interests) and [176](#) (duty not to accept benefits from third parties), even former directors of the company.
- 3.6 The DTI has published guidance on the new statutory Directors' duties¹. The most significant changes are:
 - 3.6.1 Exercising duty of good faith by reference to the '6 factors'. The statutory requirement for directors to have regard, among other things, to a list of 6 factors in exercising their duty of good faith.²

¹ The paper gives guidance on directors' duties under [Part 10 of the 2006 Act](#). It is by Margaret Hodge, Minister of State for Industry and the Regions and consists of selected (edited) extracts from Hansard which have been chosen to assist interpretation of the codified duties. An abstract of the guidance is also appended – see [Appendix 2](#).

3.6.2 Directors' authorisation of conflicts of interest. Allowing independent directors to authorise a director's conflict of interest.

4 RELEVANT SECTIONS OF THE 2006 ACT.

4.1 *Chapter 2 of Part 10* of the *2006 Act* contains the provisions on the general duties of directors, most of which are now in force. Other than *sections 175* (duty to avoid conflicts of interest), *176* (duty to accept benefits from third parties) and *177* (duty to declare interest in proposed transaction or arrangement), which will come into force on 1 October 2008, all other general duties of directors came into force on 1 October 2007.

4.2 The statutory Directors' duties in the *2006 Act*.

There are 7 main duties. A brief exposition of each follows (paragraphs 4.2.1 to 4.2.7 below refer).

4.2.1 Duty to act within powers. (*section 171*).

A director must act in accordance with the company's constitution and must only exercise his/her powers for their proper purpose. The *2006 Act* defines a company's constitution, for purposes of the general duties, as including the company's articles; decisions taken in accordance with the articles; and other decisions taken by the members or a class of them if they can be regarded as decisions of the company (*section 257*).

4.2.2 Duty to promote the success of the company. (*section 172*).

A director must act in the way s/he considers, in good faith, is most likely to promote the success of the company for the benefit of its members as a whole (*section 172(1)*). (Where the company's purposes consist of or include purposes other than for the benefit of its members (for example, charitable companies), the director must act in the way s/he considers, in good faith, is most likely to achieve these purposes (*section 172(2)*).

In fulfilling the duty in *section 172*, a director must have regard to (amongst other matters):

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

4.2.2.1 *Enlightened shareholder value.* This duty to promote the success of the company relates to the so-called principle of "*enlightened shareholder value*". The list of factors to which directors must have regard is not exhaustive. In having regard to the factors listed, the duty to exercise reasonable care, skill and diligence (*section 174*) will apply. The duty is subject to any enactment or rule of law requiring directors in certain circumstances to consider or act in the interests of the creditors of the company (for example, where the company is insolvent or threatened by insolvency) (*section 172(3)*).

4.2.2.2 *Common law fiduciary duty replaced.* The duty to promote the success of the company broadly "*success for the benefit of the company's members as a whole*" is unclear - the government has stated that "*success*" for commercial companies in this context will usually mean "*long-term increase in value*". The government has also said that the decision as to what will promote the success of the company, and what constitutes such success, is one for the director's good faith judgment. The government's view is that this ensures that business decisions on, for example, strategy and tactics, are (subject to good faith) for the directors, and not subject to decision by the courts.

4.2.3 Duty to exercise independent judgement. (*section 173*).

A director must exercise independent judgement. This duty is not infringed by a director acting in accordance with an agreement entered into by the company that restricts the future exercise of the directors' discretion or in a way authorised by the company's constitution. The duty does not confer a power on the directors to delegate, nor does it prevent a director from exercising a power to delegate conferred by the company's constitution, provided its exercise accords with the company's constitution.

4.2.4 Duty to exercise reasonable care, skill and diligence. (*section 174*).

² See *Appendix 3* and the text box contrasting the old & new director's general duty.

A director must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both the general knowledge, skill and experience that may be reasonably expected of a person carrying out the functions carried out by the director in relation to the company and the general knowledge, skill and experience that the director actually has³. In applying the test regard must be had to the functions of the particular director, including his/ her specific responsibilities and the circumstances of the company. [Section 178](#) makes clear that this statutory duty is not a fiduciary duty.

4.2.5 Duty to avoid conflicts of interest. ([section 175](#)). [Comes into force on 01/10/2008]

A director must avoid situations in which s/he has or can have a direct or indirect interest that conflicts with or may conflict with the company's interests. This applies in particular to the exploitation of property, information or opportunity (whether or not the company could take advantage of the property, information or opportunity). This duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company (these do not have to be authorised by either the members or by the board and instead directors must declare their interests in transactions or arrangements with the company under [section 177](#) (in the case of proposed transactions) or under [section 182](#) (in the case of existing transactions) unless an exception applies under those sections). The duty is not infringed if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest, or if the matter is authorised by the directors. Such directors' authorisation may be given in a private company where the constitution does not invalidate the authorisation, or in a public company, where the constitution specifically allows the directors to authorise the matter being proposed. Board authorisation is only effective if the required quorum is met without counting the director in question or any other interested director and if the conflicted directors have not participated in taking the decision or if the decision would have been valid without the participation of the conflicted directors. Board authorisation is not allowed in respect of acceptance of benefits from third parties ([section 176](#)). In allowing independent directors to authorise a director's conflict of interest, [section 175](#) represents a change to the requirement of shareholder approval under the present law.

4.2.6 Duty not to accept benefits from third parties. ([section 176](#)). [Comes into force on 01/10/2008]

Directors must not accept any benefit (including a bribe) from a third party which is conferred because of his being a director or his doing or not doing anything as a director. This duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. Benefits conferred by the company, its holding company or subsidiaries and benefits given by the director's service contract are excluded. This duty has been categorised separately from the general duty to avoid conflicts of interest under [section 175](#), so that a director obtaining a benefit from a third party can only be authorised by the members of the company, rather than by the board.

4.2.7 Duty to declare interest in proposed transaction or arrangement with the company. ([section 177](#)). [Comes into force on 01/10/2008]

Directors must declare to the other directors the *nature* and *extent* of any interest, direct or indirect in a proposed transaction or arrangement with the company. The director need not be a party to the transaction for the duty to apply. An interest of another person in a contract with the company may require the director to make a disclosure under this duty, if the other person's interest amounts to a direct or indirect interest on the part of the director. Such declarations must be made before the company enters into the transaction or arrangement. The declaration *may* (but need not) be made at a board meeting or by way of notice in writing under [section 184](#) or general notice under [section 185](#). Where a declaration of interest proves to be, or becomes inaccurate or incomplete, a further declaration must be made. However, this is only necessary if the company has not yet entered into the transaction or arrangement at the time the director becomes aware of the inaccuracy or incompleteness (or ought reasonably to have become so aware). No declaration is required where the director is not aware of his/ her interest or where the director is not aware of the transaction or arrangement in question - for these purposes directors are treated as being aware of matters of which they ought reasonably to be aware.

Further, a director need not make a declaration of interest if his/her interest cannot reasonably be regarded as likely to give rise to a conflict of interest (this replaces the materiality test in [Regulation 85](#)), or if the other directors are already aware of it or, if it concerns the terms of his/ her service contract which have been (or are to be) considered at a meeting or committee of the board.⁴

4.2.8 Under [section 180](#), where the duty to avoid conflicts of interest ([section 175](#)) or the duty to declare an interest in a proposed transaction or arrangement ([section 177](#)) is complied with by

³ This provision is modelled on the tests laid down in [section 214](#) of the [Insolvency Act 1986](#), and the corresponding provisions in the [Insolvency \(NI\) Order 1989](#) and the [Insolvency \(NI\) Rules 1991](#).

⁴ The DTI suggests that as the duty requires disclosure to be made to other directors, no disclosure is required where the company has only one director.

authorisation by or disclosure to the *directors*, the transaction or arrangement is not liable to be set aside by any common law rule or equitable principle requiring the consent or approval of the shareholders.

This is without prejudice to any enactment, or provision of the company's constitution, requiring such consent or approval. This therefore changes the law on directors' conflicts of interest as it allows the directors to authorise the conflict. [Section 180\(2\)](#) also provides that compliance with the duty to avoid conflicts of interest ([section 175](#)) and the duty not to accept benefits from third parties ([section 176](#)) is not necessary where [chapter 4](#) of [Part 10](#) of the [2006 Act](#) (transactions requiring approval of the members) applies and approval either is given under [chapter 4](#) or [chapter 4](#) specifies that approval is not needed. All other applicable duties continue to apply. Under [section 180\(3\)](#), compliance with the general duties does not remove the need for approval under applicable provisions of [chapter 4](#) of the [2006 Act](#) in the case of certain transactions with a director (or in some cases, with a connected person), such as long service contracts.

- 4.2.9 Under [section 178](#), the consequences of breach or threatened breach of the duties are the same as for breach of the corresponding common law or equitable principles. With the exception of the duty to exercise reasonable care, skill and diligence ([section 174](#)) these statutory duties are enforceable in the same way as other fiduciary duties owed by directors to their company.
- 4.2.10 [Section 179](#) provides that more than one of the general duties may apply in any given case. The cumulative effect of the duties means that where more than one duty applies, the directors must comply with each applicable duty, and the duties must be read in this context. For example, the duty to promote the success of the company will not authorise the director to breach his/ her duty to act within their powers, even if s/he considers that it would be most likely to promote the success of the company. As well as complying with all the duties, the directors must continue to comply with all other applicable laws. The duties do not require or authorise a director to breach any other prohibition or requirement imposed on him by law.
- 4.2.11 [Section 232](#) states that any provision that purports to exempt a director from liability for negligence, default, breach of duty or breach of trust in relation to the company is void. This is subject to the proviso that the company's articles may include such provision as has previously been lawful for dealing with conflicts of interest ([section 232\(4\)](#)).

APPENDIX 1

COMMENT ON THE NEW DIRECTORS' DUTIES

1 CONFLICTS AND INCREASED BEUROCRACY ARISING FROM 'ENLIGHTENED SHAREHOLDER VALUE' & 'THE 6 FACTORS'.

- 1.1 There has been much criticism of the codification of directors' duties. In particular, concern has been expressed that as [section 172](#), with its principle of *enlightened shareholder value*, sets out an apparently mandatory list of factors to which directors must have regard, this will create greater bureaucracy at board level and expose directors to greater potential liability. Care should be taken, however, not to blur the distinction between the express duty to promote the success of the company and the factors to which the directors must have regard. There is no guidance in the [2006 Act](#) as to the weight to be given to each factor and how conflicts between the factors should be resolved. It will be up to the directors to exercise their good faith judgment to resolve any conflicts that may arise between the different factors (which is what directors currently do under the present regime).
- 1.2 It has been suggested that board minutes will have to be more detailed to show that the directors have contemplated the list of factors in [section 172](#). However, one could argue that such an approach would limit the speed and flexibility of the board's decision making process and is likely to lead to extra administration and a "box-ticking" approach. Care should be taken in the drafting of standard board minutes which list the prescribed factors, as this could fetter the directors' ability to exercise their business judgment when making decisions; and a lack of paperwork should not be taken as an inference that the factors have not been considered. In reality, a well run board of responsible executives is likely to be taking these factors into account already to safeguard the reputation of the company.

2 HOW WILL EXISTING COMMON LAW REMEDIES BE APPLIED?

- 2.1 Since the codified duties in the [2006 Act](#) use different terminology from the common law duties, this may make it difficult to identify precisely how the existing common law remedies will apply.
- 2.2 Concern has also been expressed that the changes made to directors' duties together with the re-cast provisions governing when shareholders can bring a claim against the directors in the name of the company⁵, may expose directors to increased litigation.
- 2.3 It is essential that directors are made aware of the changes in the law in this area. In addition, implementation of these directors' duties means that profiles of directors' roles may need to be reviewed and amended; engagement letters may need to be checked/ amended; and existing corporate practices will need to be reviewed in the light of the changes.⁶

3 CONFLICTS OF INTEREST.

The government sought preliminary views on the application of certain provisions of the [2006 Act](#) to existing companies. Following responses to its paper, in relation to directors' conflicts of interest in particular, the government decided as follows:

3.1 Personal exploitation of opportunities.

Transitional arrangements should require existing companies to seek the approval of their members if they want to permit independent director authorisation of conflicts of interest relating to personal exploitation by a director of any property, information or opportunity of the company.

3.2 Directors' transactions with the company.

Transitional arrangements will be introduced to preserve whatever current arrangements existing companies have with regard to conflicts of interest arising from directors' transactions with the company.

⁵ A so-called derivative claim or action.

⁶ The General Counsel 100's (GC100's) has published its views on best practice guidelines for compliance with the new law relating to directors' duties. This is available on the internet. See also the article appended as [Appendix 3](#) hereto.

APPENDIX 2

DIRECTORS' DUTIES: DTI GUIDANCE⁷

The Department of Trade and Industry (now the Department for Business, Enterprise and Regulatory Reform) has published guidance on directors' duties under *Part 10* of the *Companies Act 2006* (the *2006 Act*).

1 BACKGROUND.

The *2006 Act* codifies directors' duties for the first time⁸ Most of the changes in *Part 10* of the *2006 Act* will be implemented on 1 October 2007.

2 FACTS.

2.1 The guidance is practical but is no different to what currently applies in many boardrooms and which prudent business persons would bring to the way they go about their business. The guidance states that directors should:

- Act in the company's best interests, taking everything they think relevant into account.
- Obey the company's constitution and decisions taken under it.
- Be honest, and remember that the company's property belongs to it and not to them or to its shareholders.
- Be diligent, careful and well informed about the company's affairs.
- Make sure the company keeps records of directors' decisions.
- Remember that they remain responsible for the work they give to others.
- Avoid situations where their interests conflict with those of the company. When in doubt, they should disclose potential conflicts quickly.
- Seek external advice where necessary, particularly if the company is in financial difficulty.

⁷ Source: *Companies Act 2006: Duties of Company Directors/ Ministerial Statements*, 26 June 2007, available at www.dti.gov.uk/files/file40139.pdf. Published on 23-Jul-2007.

⁸ For background, see Opinion "Directors' duties: don't make a mountain out of a minute", Nick Folland, interview by Sara Catley, PLC; appended in full as *Appendix 3* hereto.

APPENDIX 3**THE ARTICLE BY THE 'GENERAL COUNSEL 100 GROUP' (GC100)****"DIRECTORS' DUTIES: DON'T MAKE A MOUNTAIN OUT OF A MINUTE"****1 A CHALLENGE TO THE SUGGESTION THE CODIFICATION OF DIRECTOR'S DUTIES SHOULD INCREASE CORPORATE BEUROCRACY.**

1.1 The *Companies Act 2006* (*2006 Act*) codifies directors' duties for the first time. One of the most controversial provisions requires directors to have regard, among other things, to six named factors in exercising their general duty to promote the success of the company for the benefit of the members as a whole (see box "*Directors' general duty: old and new*").

1.2 As the Companies Bill (the Bill) passed through Parliament, the business community expressed concern that this requirement might have the effect of increasing bureaucracy for companies, particularly when coupled with the changes to the rules on derivative actions that arguably may make it easier for individual shareholders to take action against directors for breach of duty

2 WHAT IS WRONG WITH CODIFYING DIRECTOR'S DUTIES?

2.1 Codification of directors' duties is not a problem in itself. In fact, we are supportive of codification and the concept of enlightened shareholder value. What concerns GC100 is ensuring that the new law does not have the effect of increasing the corporate bureaucracy that could hamper the efficiency of UK plc.

3 WHY MIGHT BEUROCRACY INCREASE?

3.1 We think there is a risk that the practice will develop in this area of requiring directors to establish processes to prove that they have specifically considered the six named factors by formally documenting their decision-making process. This is not what the *2006 Act* requires, as the Attorney General, Lord Goldsmith, made clear in the House of Lords: "There is nothing in this Bill that says there is a need for a paper trail...I do not agree that the effect of passing this Bill will be that directors will be subject to a breach if they cannot demonstrate that they have considered every [factor]."

4 WHY DOES IT MATTER?

4.1 Where there is already a formal process in operation, such as for board or committee decision-making, there is usually quite a lot of paperwork produced. Adding to it, say by routinely forcing consideration of the six factors, either in papers going to the board or in minutes recording its decisions, will, we think, create a pointless burden on UK plc.

4.2 The Explanatory Notes to the *2006 Act* make it clear that it is not sufficient to pay lip service to the requirement to consider the six named factors but, rather, directors will have to exercise their duty to use reasonable care, skill and diligence (*paragraph 328*). That's right and we agree, but we are also arguing that this should not impose a routine, rote, recitation of how each factor was considered. Papers and minutes don't do that today and shouldn't tomorrow.

4.3 More importantly, this approach overlooks the fact that, as anyone who has seen a company in operation will know, the vast majority of the decisions are taken in an everyday context with speed and little or minimal process. They are, appropriately, delegated outside a formal board meeting and handed to the person with relevant responsibility.

4.4 Requiring supporting paperwork for these decisions means pushing them through a more formal process. Even if this is possible (and we think it will be completely unworkable in most cases), companies will lose valuable flexibility.

5 WHAT SHOULD HAPPEN INSTEAD?

5.1 GC100 has produced a paper that we hope will influence both best practice in this area and any guidelines produced on this subject. The thrust of the paper is that directors are not at the moment, and should not be as a result of the new legislation, forced to evidence their thought processes, whether with regard to the six named factors or anything else. They should only do that where it is appropriate.

6 DOES THAT MEAN JUST IGNORE IT ALL?

6.1 Absolutely not. We must take the new legislation seriously and we think that the single most important step companies should take is to ensure that their directors are aware that the law has changed. In practice, this means giving them a thorough briefing when the provisions commence or on their

appointment. It also means amending any written description of their role and responsibilities or terms of appointment and reviewing terms of reference for boards and committees.

7 HOW SHOULD THINGS CHANGE IN PRACTICE?

- 7.1 Where a decision the directors are taking is already supported by a formal process it will nearly always be supported by background papers. Background papers are a key way of assisting directors in taking into account all relevant factors but their role should not be misunderstood. They are there to assist directors, not to act as a straightjacket. We think templates, and instructions like “you must consider the six named factors”, will stand in the way of directors using their own business judgment.
- 7.2 The management team responsible for preparing the papers should ensure that all of the relevant factors, including the six named factors if appropriate, are properly considered in the preparation of the papers. Best practice should be to record consideration of particular factors only where the circumstances make it particularly relevant or necessary (that is, not to include negative statements).
- 7.3 Responsibility for considering the relevant factors can properly be delegated to the members of the management team responsible for preparing the papers in the usual way, provided the directors are satisfied that those responsible are suitably qualified.

8 WHAT ABOUT BOARD MINUTES?

- 8.1 Board minutes are important, but they are a summary of what went on at the meeting. Companies have legitimate reasons for keeping board minutes brief (such as not wanting to undermine legal privilege by citing advice). Board minutes should not set out each factor or become a medium for recording whether each factor was considered.

9 AND OTHER DECISIONS?

- 9.1 Where directors take decisions outside a formal board process, it is highly unlikely to be appropriate for a formal paper to be prepared. GC100 believes that it has to be recognised that, even where there is a formal scheme of delegation, in practice the timeframe for decision making will not allow for a formal paper or minute.
- 9.2 Fundamentally, we think that a lack of process (or rather paperwork) should not be taken as an inference that the factors have not been properly considered any more than it is now, for example, in relation to the existing requirement to have regard to the interests of the company’s employees.”

Nick Folland is company secretary and group legal director at Emap plc. He is a member of the executive committee of the General Counsel 100 Group (GC100), a group for the general counsel and senior legal officers of FTSE 100 companies, and jointly leads the GC100 company law reform working group.

Interview by Sara Catley, PLC.

DIRECTORS' GENERAL DUTY:**OLD AND NEW****Current law**

Directors' fiduciary and common law duties have evolved through case law. These include the general duty that directors must act in good faith in the best interests of the company, which for this purpose, means all its shareholders, both present and future.

In carrying out their functions, directors must have regard to the interests of the company's employees in general, as well as the interests of its members.

Directors' duties are owed to the company itself, not to individual shareholders.

Companies Act 2006

The [Companies Act 2006 \(2006 Act\)](#) introduces a statutory statement of directors' duties that will replace many existing common law and equitable rules.

The general duty is replaced by a duty to act in the way that the director considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a whole ([section 172\(1\) 2006 Act](#)). The intention is that this duty "enshrines in statute what is commonly referred to as the principle of 'enlightened shareholder value'" ([paragraph 325, Explanatory Notes, 2006 Act](#)).

In fulfilling this duty, directors must have regard (among other matters) to:

1. The likely consequences of any decision in the long term.
2. The interests of the company's employees.
3. The need to foster the company's business relationships with suppliers, customers and others.
4. The impact of the company's operations on the community and the environment.
5. The desirability of the company maintaining a reputation for high standards of business conduct.
6. The need to act fairly as between the members of the company.

([Section 172\(1\) 2006 Act](#).)

Directors must exercise reasonable care, skill and diligence in considering the factors ([section 174 2006 Act](#)).

The duty is owed to the company itself, not to individual shareholders ([section 170\(1\) 2006 Act](#)).

It is expected that the provisions relating to directors' duties will commence by October 2008.

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