

EMPLOYMENT

Director Service Agreements

Contracts for executive directors, including the Companies Act requirement for shareholder approval of long guaranteed terms.

Why a director needs a separate agreement

A director holds an office under the company's articles and the Companies Act. An executive director who also works in the business usually has a contract of employment, often called a service agreement. The two are separate. The director's office can end by a shareholder vote, and the contract may continue, with consequences for pay and notice.

Many owner-managed companies have no written agreement for the people who run them. That leaves questions unanswered: whether the director is an employee, what notice applies, what happens on illness, and what they can do after leaving.

Employee or office-holder only

A director is not automatically an employee. Whether they are depends on the facts: a contract, a salary through payroll, duties and control. A director who is an employee has statutory employment rights and the company has payroll and employer duties, which affect tax and National Insurance. A non-executive director normally has a letter of appointment, not a service agreement.

What the agreement should cover

- the role, duties and reporting line, and the time to be devoted to the business
- salary, bonus, benefits, pension and expenses
- notice, probation if any, and garden leave
- sickness, holiday and other leave
- confidentiality, intellectual property and restrictive covenants
- the position if the director is removed from office, which should not by itself entitle them to a payment
- termination rights, including summary dismissal for serious misconduct

Who is a director?

The label matters less than the role. A person named as a director at Companies House is a director in law, and a person who acts as one without being appointed, or whose instructions the board follows, may be treated as one. A company should therefore know who is on the board, who is not, and who might be treated as a shadow director. Duties and liabilities follow the role.

Key points

- The office of director and the contract of employment are separate.
- A guaranteed term of more than two years needs shareholder approval (section 188).
- Payments for loss of office have their own approval rules.
- A director can be removed by ordinary resolution whatever the contract says.
- Service contracts must be kept available for member inspection.
- Review the agreement when pay or duties change.

Guaranteed terms and shareholder approval

The Companies Act 2006 restricts long guaranteed terms for directors. If a company agrees a term of employment for more than two years that cannot be ended by the company by notice, or can be ended only in specified circumstances, the term needs prior approval by resolution of the members (section 188). A term that is not approved is treated as terminable on reasonable notice. The rule is meant to stop boards locking in long deals without the shareholders' say.

It also applies to a notice period that is too long. A notice period longer than two years can have the same effect. Where the director is also a shareholder, the usual route is a written resolution of the members, with the memorandum of what is proposed.

Loss of office payments

Payments to a director on leaving, other than what the contract already requires, normally need shareholder approval, and there are rules about disclosure (sections 215 to 222). The agreement should be drafted so that what is payable on exit is clear, and does not accidentally promise something that needs approval.

Records and disclosure

The company must keep a copy of each director's service contract, or a memorandum of its terms, at its registered office or another permitted place, and members can inspect it (section 228). Accounts also disclose directors' remuneration to the extent the company's size requires.

Tax and status

How a director is paid, through salary, dividends or both, is a tax matter for the company's accountant. The service agreement should say what is paid as salary and how bonuses are decided.

Pay, bonus and benefits

Executive directors are often paid a mixture of salary, bonus, pension contributions and benefits. The agreement should say who sets each element and when, and that bonuses are discretionary unless intended otherwise. Where the company is closely held, directors who are also shareholders should avoid setting their own pay in a way that is not recorded. A board minute, signed off by the other directors where there are any, protects both sides.

Before you start

- Is the director to be an employee?
- Is the notice period within two years?
- Who decides pay and bonus, and how?
- What covenants are appropriate?
- What is payable on exit?
- Where will the contract be kept?

How MTM can help

0161 835 2080
client@mtmlp.co.uk

We draft service agreements and letters of appointment, prepare the shareholder resolutions where approval is needed, and update the company's records. For practices, we can review a client's existing arrangements and recommend changes. The tax and payroll treatment of the director's pay stays with you.