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Directors' duties in relation to conflicts of interest

The Companies Act 2006 (the "2006 Act") effects the most sweeping and significant alteration of UK companies legislation for over 20 years. Significant portions of the 2006 Act were implemented on 1 October 2007, 6 April 2008 and 1 October 2008, with the remainder coming into force on 1 October 2009. One of the main sets of provisions of the 2006 Act which became effective on 1 October 2008 relates to new statutory duties for directors in connection with conflicts of interest which are discussed in more detail below.

The newly codified duties concern directors' obligations to avoid conflict situations, to declare interests and not to accept benefits from third parties.

Duty to avoid a situation in which a director has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company (section 175 of the 2006 Act)

A director must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. This applies, in particular, to the exploitation of property, information or opportunity, whether or not the company could take advantage of that 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, since that is covered by the separate duty to declare to the company any interest in a proposed or existing transaction or arrangement with the company (see below).

A director will, therefore, be in breach of this duty if he is in a situation, or allows a situation to arise, which involves, or could involve, a conflict. This is unless the situation cannot reasonably be regarded as likely to give rise to a conflict of interest or the conflict situation was authorised in one of the ways mentioned below.

A conflict situation may be authorised:

- **by the board of a company.** For a private company, the board (excluding the conflicted director) is entitled to authorise a conflict unless there is an express prohibition on doing so in the articles of association of the company. If the company was incorporated before 1 October 2008, the directors must first be empowered to authorise such conflict situations by ordinary resolution passed by the members (companies incorporated after that date need not take that additional step). For a public company, this position is reversed and the board may only authorise a conflict of interest if the company's articles of association expressly permit them to do so;
- **by approval of the company's members.** This can be obtained either by unanimous member consent or by special resolution; or
- **under the company's constitution.** Section 180(4)(b) of the 2006 Act allows companies to enshrine provisions for dealing with conflicts of interests in its articles of association (or other part of its constitution) and anything done in accordance with such provisions will not lead to a breach of this duty by a director.

Where the board authorises a conflict, each non-conflicted director must consider his duties, including his statutory duty to act in a manner that he believes will promote the success of the company for the benefit of its members as a whole. The non-conflicted directors should also consider if limitations or conditions should be imposed on the authorisation as they are free to apply limitations or conditions to any authorisation they may give.

The fact that a conflicted director cannot vote at the board meeting to authorise the conflict situation relating to him might mean that, in situations where many, or even all, of the directors may be taken as being "interested", the only practical option to ensure the conflict situation is effectively authorised is for it to be authorised by the company's members.

Allowing a conflict situation which has not been previously authorised in accordance with the 2006 Act to arise will amount to a breach of duty by the relevant director. Any such breach may subsequently be ratified by the company's members (by ordinary resolution). However, neither the director (if also a member of the company) nor any person connected with him is eligible to vote on the resolution.

In addition to considering conflict situations which could arise directly in relation to himself, each director should also consider if any of his connected persons holds positions that could lead to the director being in breach of this duty. Connected persons include family members (including a spouse or civil partner, anyone with whom the director lives as a partner in 'an enduring family relationship', children and step children (both the director's own and his partner's) and the director's parents); bodies corporate to which the director is connected (detailed rules determine when this is the case); trustees of a trust of which the director (or a family member or a body corporate with which he is connected) is a beneficiary; and a business partner.

The scope for conflict situations arising is potentially very broad and so careful consideration should be given to the question of where they may exist or may possibly come to exist. The following situations are examples of potential conflict that may arise:

- where a director is on the board of, is a significant shareholder in, or is himself, a supplier to or customer of, or a major shareholder in, the company;
- where a director also has a role with one of the company's advisers;
- where a director accepts an appointment as a director with another company, especially one which is in a competitive field of activity;
- where a director is also a director of a joint venture company partially owned by the company;
- where a director is also a director of the company's pension trustee company or a trustee of the pension fund; and
- where a potential bidder for the company approaches a director and the director is offered a role with the potential bidding group.

Each situation requiring approval of the board (i.e. where it is not authorised by the members or under the company's constitution) is not simply a formality and will need to be considered carefully by the board and minuted appropriately and the decision to authorise the conflict by the board should be made only if, on balance, the board considers it in the best interests of the company to retain the services of the conflicted director in the relevant matter. As mentioned above, any such approval given may be given subject to such limitations or conditions as the board considers appropriate in the circumstances. For example, the authorisation might be subject to annual review or review on the occurrence of certain circumstances. Also, an authorisation might need to be limited because circumstances could change, for example, where a director is seeking sanction for his role as a director of another company, the board may decide to approve this role but may not want to authorise all of the consequences that flow from the role. These consequences might be, for example, if that company decides to acquire the company or becomes a competitor.

Directors who sit on multiple boards will always need to consider carefully whether they are in a position that can "reasonably be regarded as likely to give rise to a conflict" and should seek independent legal advice in the case of any uncertainty. It is worth noting that the government has commented that the situation of multiple directorships as one that is capable of being authorised by the directors and therefore one which, subject to appropriate conditions (and according to the circumstances), the board should feel comfortable authorising. Also, those directors appointed as representatives of private equity investors, or other significant shareholders, should have particular regard to these rules. Directors should also bear in mind their duties of confidentiality to both of the companies involved in any conflict (or potential conflict) and may encounter difficulties if they are unable to disclose the circumstances of a particular conflict because of such duties of confidentiality. Again, legal advice should be sought in the case of any uncertainty.

The section 175 duty only applies to conflicts arising (as distinct from "existing") on or after 1 October 2008. From a practical perspective, it may be difficult to identify the date on which a conflict actually arises. As such, directors might consider it best practice in any event to identify and approve conflicts which existed on 1 October 2008.

Leaving aside the potential for derivative actions by members on behalf of the company (new, enhanced rights in relation to which have been provided in the 2006 Act), the duty in respect of conflicts of interest is owed to the company and section 178 states that the consequences of a breach will be the same as for a breach of the corresponding common law rule or equitable principle from which the statutory duty was drawn. Depending on the circumstances of the case, remedies for breaches might include the granting of an injunction, the setting aside of a transaction, restitution and account of profits, the restoration of company property held by the director and damages.

A breach of this duty (or any other codified duty) could also be grounds for the termination of a service contract, or for disqualification as a director under the Company Directors Disqualification Act 1986.

Duty to declare interests in proposed transactions or arrangements with the company (section 177 of the 2006 Act)

The statutory obligations concerning declaration of directors' interests have been enhanced under the 2006 Act.

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 this duty to apply. For example, 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. That would be the case if the director was economically interested in the other contracting party, for instance.

The declaration must be made before the company enters into the transaction or arrangement and where a declaration of interest proves to be or becomes inaccurate or incomplete, a further declaration must be made if the company has not yet entered into the transaction or arrangement when the director becomes, or should reasonably have been, aware of the inaccuracy or incompleteness.

No declaration will be required:

- where the director is not aware of the interest or where the director is not aware of the transaction or arrangement (unless he ought reasonably to have been aware of the relevant matters). The Attorney General has commented that the relevant test on this issue is whether, objectively, the matter is one of which the director ought reasonably to be aware, as distinct from the question of whether the director ought to be aware of his own interests in other transactions (this is because the directors' interests which are relevant for this purpose include both his direct and indirect interests). It would, therefore, be prudent for directors to do some due diligence into the interests of their connected persons;
- if the interest cannot reasonably be regarded as likely to give rise to a conflict of interest;
- if, or to the extent that, the other directors are already aware of the interest (and for this purpose the other directors are deemed to be aware of anything of which they ought reasonably to be aware); or
- if it concerns the terms of the director's service contract which have been (or are to be) considered at a board meeting or board committee.

There are no restrictions on the method for making such disclosures but the 2006 Act makes specific provision for declarations to be made in writing or by way a general notice of declaration. This general notice, which must state the nature and extent of the interest and the connection with the relevant person, can be made:

- in respect of interests of the relevant director (whether as member, officer, employee or otherwise) in a specified body corporate or firm, in which case he is regarded as interested in any transaction or arrangement that may, after the date of the notice, be made with that body corporate or firm;

- in connection with any other specified person, in which case he is regarded as interested in any transaction or arrangement that may, after the date of the notice, be made with that person; and
- only at a meeting of the directors or if the director takes reasonable steps to ensure it is brought up and read at the next meeting of directors after it is given.

If a duty to disclose an interest in connection with a proposed transaction or arrangement arose under section 317 of the Companies Act 1985 (i.e. before 1 October 2008), the duty of disclosure continues under that Act and not the 2006 Act.

In addition, the Explanatory Notes to the 2006 Act state that a director may, subject to the company's articles of association, participate in decision-taking relating to transactions the subject of a declaration of interest.

Unlike section 182 (discussed below), a breach of section 177 is not a criminal offence. The consequences of a breach will be the same as for a breach of the corresponding common law rule or equitable principle (this is specifically prescribed by section 178). In equity, non-disclosure by a director of an interest in a contract may render the contract voidable at the instance of the company and in certain cases the director could be called upon to account for profits he made from the transaction.

Requirement to declare interests in existing transactions or arrangements entered into by the company (section 182 of the 2006 Act)

A director must declare the nature and extent of his direct or indirect interest in an existing transaction or arrangement entered into by the company. Again, the director need not be a party to the transaction for this duty to apply. However, this obligation does not apply if or to the extent that the interest has already been declared under the duty to declare an interest in a proposed transaction or arrangement as described above.

The declaration must be made as soon as is reasonably practicable and even if the declaration is not made as soon as it should have been, it must still be made. Where a declaration of interest proves to be, or becomes inaccurate or incomplete, a further declaration must be made.

No declaration will be required if any of the circumstances which exclude a director from having to make a declaration under section 177 of the 2006 Act apply.

In this case, declarations must be made:

- at a meeting of the directors;
- by written notice; or
- by general notice (see above).

Breach of section 182 is a criminal offence (as prescribed by section 183). On conviction on indictment, the maximum liability is an unlimited fine. On summary conviction the fine must not exceed the statutory maximum (currently £5,000). The Explanatory Notes to the 2006 Act note that the section does not affect the validity of the transaction or impose any other civil consequences for failure to comply with the section.

The Attorney General has commented that a failure to comply with section 182 was made an offence under the 2006 Act because civil consequences probably wouldn't

have arisen from a failure to declare an interest in an existing transaction, whereas there would probably have been civil consequences from a failure to disclose an interest in relation to a proposed transaction: the transaction might have been voidable, and the company might have been able to claim financial redress

Duty not to accept benefits from third parties (section 176 of the 2006 Act)

Directors must not accept any benefit from a third party which is conferred because of his being a director because of his doing or not doing anything in his capacity as a director. This duty will not be 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 associated companies, or persons acting on their behalf, and benefits received from a person who provides the director's services to the company, are excluded.

This duty will continue to apply after a person ceases to be a director in relation to things done or omitted by him while he was a director.

It should be noted that there is no "de minimis" that applies in relation to this duty. Unlike the duty to avoid conflicts of interest where conflicts can be authorised by the board, a director obtaining a benefit from a third party can only be authorised by the members of the company.

The practical consequences of this new legislation have been considered in the context of corporate hospitality offered to company directors. Certainly, receipt of disproportionate corporate entertainment could fall within its scope. It is, therefore, suggested that companies establish and properly maintain policies for receipt, and recording, of benefits by directors and a requirement for prior approval in appropriate circumstances.

The consequences of a breach of this section are the same as the consequences of a breach of section 175, which are summarised above.

Concluding comments and recommended practical steps

Giving careful consideration to conflicts and the other directors duties will often be a difficult balancing act. The 2006 Act creates, by virtue of sub-section 180(4), a safe harbour providing that if directors comply with a procedure set out in the company's articles of association, they cannot be in breach of any of their duties. This is, therefore, a good reason for setting out in the company's articles of association a procedure for declaring and authorising directors' conflicts. This is especially the case for private companies incorporated after 1 October 2008 because, as mentioned above, such companies are not required to have provisions authorising conflicts in their articles of association.

Articles of association might therefore include provisions addressing the following:

- the procedure to be carried out in relation to the declaration of an interest including how, when and where an interest is to be declared by a director;
- the details of the authorisation procedure including who can vote and be included in the quorum;
- details of any conflicting interests, and conflict situations arising from them, which are expressly authorised. These might include such matters as other directorships in non-competing companies

and representations of significant shareholders (e.g. a JV shareholder or private equity investor).

Depending on whose interests are being protected in any particular case (i.e. the company's or those of a significant shareholder), it may be appropriate for this express authority to provide that specific conflict situations which arise as a result of those general interests will need further approval; and

- a waiver of the duty to disclose confidential information obtained from outside the company and other provisions in relation to the handling of confidential information.

It should be noted that the articles of association of a company will be a public document so the conflicts procedure will not be confidential. Although this publicity is unlikely to cause a problem, consideration could be given to including conflicts procedures in any shareholder or investment agreement or in a joint venture agreement as appropriate (provided all shareholders sign up to the document or an appropriate deed of adherence).

It should also be noted that any attempt to exempt a director to any extent from any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company of which he is a director is void (section 232). Consequently, provisions in articles of association should not be so widely drafted as to fall within the scope of this limitation.

Other practical steps which boards should consider in relation to conflict issues (to the extent not already addressed) include:

- the identification of existing, actual or potential conflict situations of directors (including conflicts arising from their connected persons); the circulation of an ordinary resolution to the company's members seeking to empower the directors to authorise conflict situations (and,

ideally, the circulation of a special resolution to amend the company's articles to include specific conflict provisions as mentioned above);

- the convening of a board meeting to consider and authorise conflict situations as they arise on a case by case basis;
- developing board procedures for addressing and authorising conflicts (these might be set out in the articles or a general memorandum to the board);
- dealing with any confidentiality issues surrounding the appointment of a director to the board of another company; and
- deciding which body will conduct reviews of on-going authorisations.

Further information

This commentary is intended to provide a summary of the main provisions of the 2006 Act in connection with the new statutory duties of directors which came into force on 1 October 2008.

Visit www.berr.gov.uk/whatwedo/businesslaw/co-act-2006/ on which the Government sets out its proposals in relation to secondary legislation and revised drafts of model articles of association for private and public companies, together with checklists for existing private companies summarising the key areas of change and a set of Frequently Asked Questions about the implementation of the 2006 Act.

For a fuller explanation of all statutory duties of directors under the 2006 Act from that date, please see our separate commentary entitled "Statutory Duties of Directors of English Companies from 1 October 2008"

For a fuller commentary on the newly codified obligations to avoid conflict situations in the context of private equity appointed investor directors, please see our separate commentary entitled "Conflicts of Interest for Private Equity Portfolio Company Directors". **These can be found on our website www.jonesday.com/pubs/pubs.aspx**

By James Goold, partner. Private Equity.