

DBULLETIN

Directors' Conflicts under the Companies Act 2006

Whilst the principle of directors avoiding conflicts of interest has been the subject of much case law, the Companies Act 2006 has introduced new statutory duties that company directors owe to a company.

When making decisions, directors need to be methodical and consider a number of issues to ensure that they do not fall foul of their statutory duties regarding conflicts.

Duty to avoid conflicts of interest – Situational Conflicts

Section 175 of the Companies Act 2006 which came into force on 1st October 2008 imposes an absolute duty on each director to avoid situations in which he has or could have a direct or indirect conflict with the interests of the company. This is known as a "situational conflict".

Situational conflicts can be ongoing, for example when a director is also an advisor, shareholder, competitor or customer of the company or, being a director of a subsidiary is also a director of the subsidiary's holding company. Those conflicts can also relate to a particular instance for example when a director is involved with a competitor of the company and wishes to take up an opportunity that the company has declined.

Further examples of potential conflict situations include:

- Joint venture companies – the directors of the joint venture company may also be the directors of one of the joint venture partners.
- Listed and AIM companies – non-executive directors are likely to hold a number of other directorships.
- Private equity and venture capital backed companies – the director representing the investor is likely to hold a number of other

directorships including directly with the investor.

Prior to 1st October 2008, directors would normally seek to mitigate any conflict of interest by declaring their interest and abstaining from voting on the matter or seeking shareholder approval in relation to the conflict.

The position now, under section 175, imposes a duty on a director to avoid or prevent these conflicts from arising in the first instance.

A director, however, will not be deemed to be in breach if "the situation cannot reasonably be regarded as likely to give rise to a conflict of interest or if the matter has been authorised by the directors" (section 175(4)).

In other words, it is still open to the other (independent) directors to approve conflicts in order that the conflicted director can remain in the meeting and vote on the resolution at hand. The way in which this approval can be given differs depending on whether the company is a private or public company and whether it was incorporated before, on or after 1st October 2008.

In the case of private companies incorporated before 1st October 2008, shareholders can provide by ordinary resolution that the board is authorised to approve situational conflicts. In the case of private companies incorporated on or

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after 1st October 2008, the board is deemed authorised to approve a conflict unless the Articles provide otherwise. In the case of public companies, the board can only approve a conflict if the Articles expressly permit it.

Amending the Articles to include a general authorisation will provide a safe harbour to directors whose interests conflict or may conflict with the company's but who comply with the provisions of the Articles.

The terms of approval will vary according to the circumstances and may, for example, provide that the interested director be excluded from the receipt of documents and information and/or participation in discussions (whether at meetings of the directors or otherwise) related to the conflict, or whether he shall or not participate in any future directors' vote in relation to the conflict. This is particularly relevant where directors are appointed by and are representatives of a parent company on the board of different members within a group of companies, or where directors represent the interests of the shareholders who appointed them (or a class of shareholders).

It is important to note that this board approval has to be made by the independent directors without the interested director counting in the quorum or his vote counting towards the resolution.

The new duty under section 175 does not apply to conflicts of interest arising in relation to a transaction or arrangement with the company – these are dealt under sections 177 and 182 of the Companies Act 2006.

Duty to Avoid Conflicts of Interest – Transactional Conflicts

Under section 177, directors have a duty to

declare any interest in a proposed transaction or arrangement with the company. Under section 182, directors must also declare any interest in any existing transaction or arrangement with the company.

This is known as a “transactional conflict” and was previously dealt with under s.317 Companies Act 1985. An example of a transactional conflict would be if a director sold or purchased a property or other assets to or from the company. Another example would be an intra-group loan agreement where the directors of the lending or guarantor company are also directors of the borrower. This would trigger a declaration under section 177 in respect of the specific loan/guarantee transaction or arrangement.

In relation to a proposed or existing arrangement or contract with the company, which has to be declared under section 177 or section 182, a company's Articles of Association usually provide that a director can vote and be counted as part of the quorum in respect of issues arising from that arrangement/contract. We generally recommend keeping the existing provisions.

It is worth noting that a situational conflict caught under section 175 may also develop into a transactional conflict which instead falls within section 177. An example of this would be a situation where a director of a company is also a director or shareholder of a company on that company's list of preferred suppliers: the general relationship may fall within section 175. However, if the company enters into a contract with the director, this would fall within section 177.

Directors should disclose all direct or indirect interests in transactions (either existing or proposed), together with those interests of

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'connected persons'. Companies should note that the definition of 'connected persons' has also been substantially widened under the Companies Act 2006. Connected Persons now include a director's spouse or civil partner, children and step-children, any person with whom the director lives as partner in an enduring family relationship, children and step-children of such a person and the director's parents.

Consequences of breach

The consequences of breach (or threatened breach) of sections 175 to 177 are the same as would apply if the corresponding common law rule or equitable principle applied. The duties in those sections are, accordingly, enforceable in the same way as any other fiduciary duty owed to a company by its directors. It should be noted however that a breach of section 182 carries criminal penalties.

The remedies for breach of fiduciary duty vary in accordance with the severity of the breach. Possible remedies include injunction, setting aside of the transaction, restitution and account of profits, damages and disciplinary proceedings.

Directors' benefit or remuneration

Finally, depending on their individual circumstances, companies may consider provisions in the Articles whereby directors who receive any benefit or remuneration as a result of any approved transaction/arrangement or interest are not accountable to the company for these benefits and are not in breach of any duty.

Action points

We would recommend that our clients:

- Identify existing actual or potential conflict situations (situational and transactional).
- Consider amendments to current Articles to include specific conflict provisions or an ordinary resolution of the members empowering the directors to authorise conflicts.
- Ensure that the relevant quorum for each approval is present to enable resolutions to be circulated and approved.

The content of this article is intended to provide a general guide to the subject matter and does not constitute legal advice. Specialist advice should be sought about your specific circumstances. Please contact a member of our corporate team for further assistance.