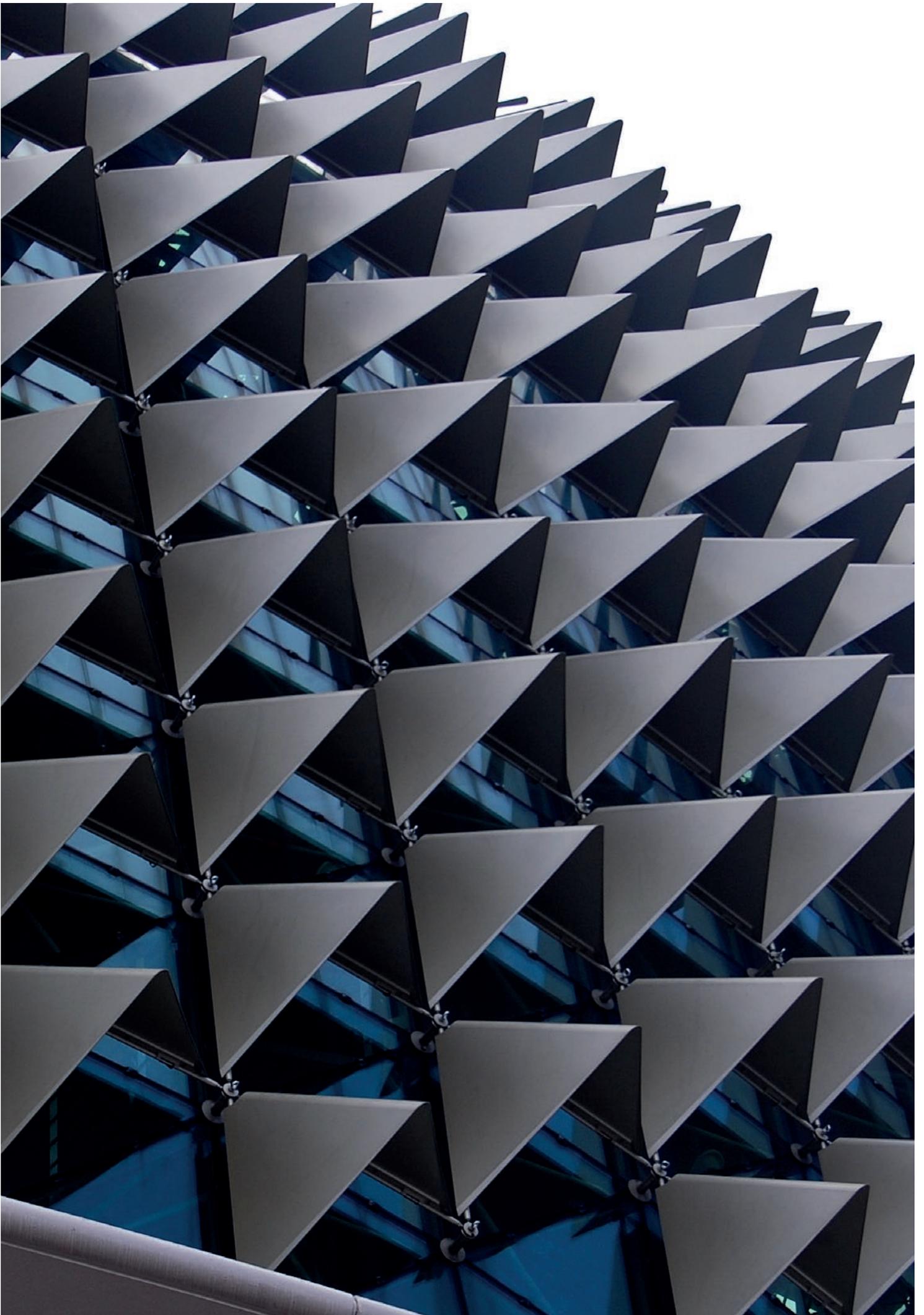


Directors' conflicts of interests
under the Companies Act 2006



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Introduction

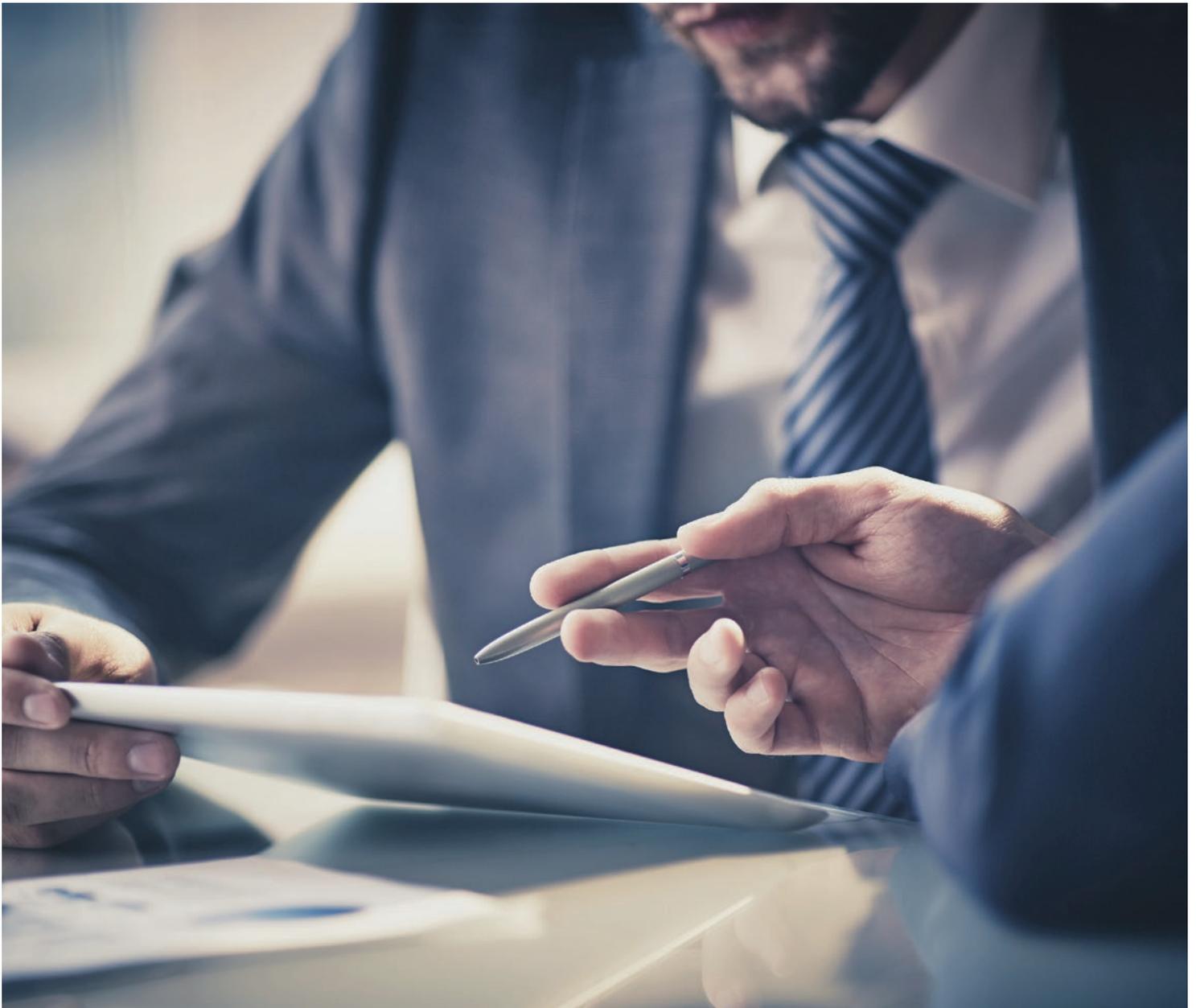
The provisions in the Companies Act 2006 (the “Act”) relating to directors’ conflicts of interests and their disclosure came into force on 1 October 2008.

This note explains the changes made to the law and sets out practical steps companies should take to ensure compliance with the law.

Directors’ conflict duties

The Act includes the following directors’ duties:

- a duty to avoid a situation which gives rise or may give rise to a conflict of interest;
- a duty to declare interests in transactions and arrangements (which must be disclosed to the board but need not be approved);
- a duty not to accept benefits from third parties which are conferred on them either because they are directors or for doing (or not doing) something as a director.



What is a conflict?

Section 175 of the Act contains a duty for a director of a company to avoid a situation where he has or can have, a direct or indirect interest that conflicts or may conflict with the company's interests.

This does not apply to conflicts which arise in connection with a transaction or arrangement with the company - these are dealt with in separate provisions (see below). A 'conflict' is not defined, but includes situations where an individual is a director of another company which becomes a competitor of, or a major supplier to or customer of, his company and in particular relates to the exploitation of any property, information or opportunity by a director for personal purposes, whether or not the company could itself take advantage of it.

Conflicts can, as stated, be indirect. The definition of a director's connected persons (section 252) has been broadened to cover, amongst others, the director's parents, anyone with whom the director lives as partner in an enduring family relationship and the director's children and step-children who are over 18. It is not considered that all the interests of a director's connected persons would automatically be covered. However, it would be safest for a director to review all potential indirect interests, including at least the interests of his connected persons of which he is aware.

There are two savings provisions in the Act which allow potential conflicts, namely where:

- "the situation cannot reasonably be regarded as likely to give rise to a conflict"; or
- the matter has been authorised by the directors.

The GC 100 (a group comprising senior legal officers and company secretaries of more than 85 FTSE 100 companies) published a paper in January 2008 which gives guidance on conflicts (<http://corporate.practicallaw.com/1-217-4955?qp=&qo=&q=GC100>). They give the following examples of situations which may constitute conflict situations:

- a director being a director of a competitor;
- a director being a major shareholder;
- a director being a potential customer of or supplier to the company;
- a director owning property adjacent to the company's property the value of which could be affected by the activities of the company;
- a director who has an advisory relationship (for example financial or legal) with the company or a competitor;
- a director being a director of the company's pension trustee company;
- a director wanting to take up an opportunity that has been offered to, but declined by, the company;
- a director being in a situation where he can make a profit as a result of his directorship whether or not he discloses this to the company; and
- in each of the above situations, the director being a director of another company and that other company having the relevant relationship with the relevant company or being in the situation described above.

Who can authorise?

The rules relating to conflicts provide that, so long as specified criteria are met, the board of directors of a company is able to authorise directors' conflicts of interest.

Under the Act board authorisation can only be given:

- **in the case of a public company**, where the articles of association contain express power for the directors to authorise the matter; and
- **in the case of a private company**, where nothing in the company's articles invalidates such authorisation by the board. There is a point to note here, however. If the company was formed before 1 October 2008, then the shareholders also have to pass an ordinary resolution resolving that authorisation may be given by the board (which must be filed at Companies House).

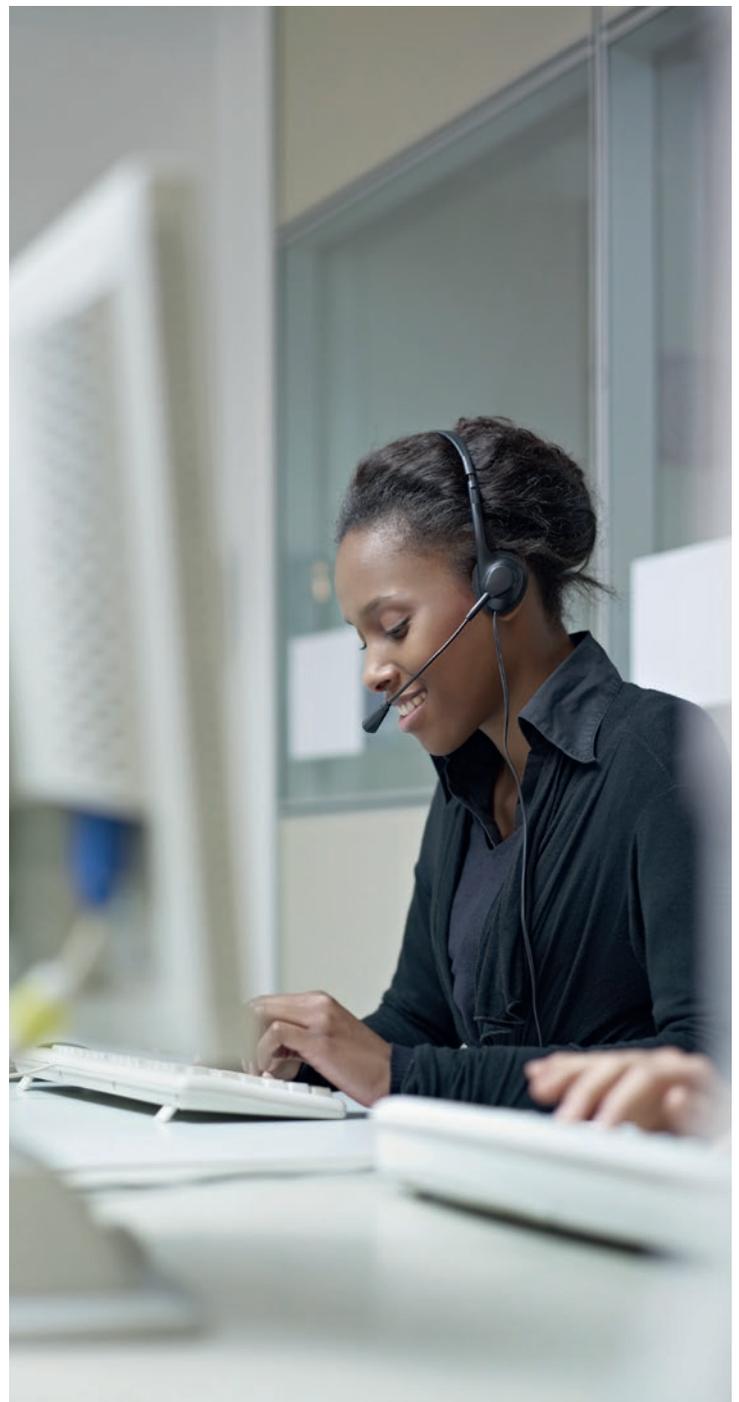
Listed companies and other public companies with a large number of shareholders will almost certainly want to confer power on their boards to authorise such matters. Most companies have already made the necessary changes to their articles at their AGM and those that have not should consider doing so at their next AGM.

For private companies formed before 1 October 2008 it is not essential (provided that an ordinary resolution is passed) that the articles are changed so long as there is nothing in them which would invalidate the authorisation. However, it would seem sensible for private companies to consider the changes to their articles that would be appropriate to reflect the new statutory regime, including the conflict provisions.

There is a specific safe harbour in the new Act (section 180(4)(b)) which provides that, where a company's articles contain provisions for dealing with directors' conflicts of interest, directors' general duties are not infringed by anything done (or omitted to be done) by them when following those provisions

Groups of companies may decide that they prefer to deal with conflicts or potential conflicts in relation to directors of subsidiaries by passing a shareholders' resolution to approve the conflict rather than by vesting power in the subsidiary board to authorise the conflict. However, even so, it may be sensible for the articles of the relevant subsidiaries to be amended to take advantage of the safe harbour referred to in the previous paragraph.

Companies which have directors representing particular shareholders, as, for example, in the case of joint ventures or private equity backed ventures, should give special consideration to the position of those directors. It would seem sensible for the articles of such companies to be amended to cover their position.



Authorising conflicts

Any board authorisation of a conflict situation will only be effective if:

- any quorum requirements for the relevant board meeting are met without counting the director in question or any other interested director; and
- the matter is agreed to without the director or any other interested director voting or would have been agreed to if their votes had not been counted.

If the board wish to pass a written resolution to authorise conflicts, then the articles of association must be checked to see if a written resolution can be passed without all the directors, as interested directors cannot be counted.

In deciding whether to approve a conflict situation, the directors must act in accordance with their general duties, including their duty to promote the success of the company. Where the board is asked to approve a potential conflict situation that will bring obvious benefits to the company, for example access to industry or sector expertise, then the board should not have any difficulty in deciding that it is acting in the interests of the company in approving the conflict. A board should also be able to approve a matter if, on balance, it concludes that it is in the interests of the company for the company to retain or appoint the relevant director who is in the potential conflict situation, but they would need to consider the impact of the relevant matter on the director's ability to perform his functions as a director effectively.

Boards of companies will also need to decide the extent of any authorisation which they give and the conditions which should be attached to it. The GC 100 paper referred to above contains useful guidance on this.

In relation to listed companies which have sought power for their boards to authorise conflicts, shareholders have generally been willing to approve the necessary changes to the company's constitution. Shareholders are unlikely to raise objections provided that companies have an existing sound corporate governance structure and have procedures in place for ensuring that the board's authorisation powers are operated effectively. The ABI requires public companies to report annually on what procedures are in place and that they have operated effectively. This report is usually found in the corporate governance section of the Directors' Report in the annual accounts.

The GC 100, in addition to the paper referred to above, also produced a template briefing note for directors on conflicts, a questionnaire for directors and a checklist for company secretaries relating to the duty to avoid conflicts (<http://corporate.practicallaw.com/9-382-9498?qp=&qo=&q=GC100>), which can be adapted for a particular company's circumstances.

The following are actions which a company may wish to take:

- Company secretary (or appointed representative) to supply each new director with a briefing note explaining the duties in section 175 of the Act and the requirement for the prior authorisation of conflict situations.
- Questionnaire to be sent to all new directors to assist with the identification of any conflict situation. Companies will need to decide if they are going to require directors to check all their connected persons' interests – see above.
- Put in place a process for authorising conflicts, including the basis on which authorisation is to be granted and the terms/conditions attached – for example whether a director should be excluded from the board meeting, whether board papers should be withheld, whether the director would be required to step down from his directorship on a temporary basis. Also consider confidentiality issues, including whether, if a company is to release a director from disclosing confidential information relating to a third party, it will want to make sure that the director has an equivalent release from the third party in respect of confidential information relating to the company.
- Consider appointing a committee to review conflict authorisations (possibly the Nominations Committee).
- Advise directors they may need to take independent legal advice if a direct conflict situation arises.
- Prepare board papers setting out details of each director's conflict situation for the board then to consider and authorise, if appropriate.
- If the board wish to pass a written resolution to authorise conflicts then the articles of association must be checked to see if a written resolution can be passed without all the directors as interested directors cannot be counted.

- In the induction process for new directors include a briefing on the duties and a questionnaire on their conflict situations.
- Decide how to record authorisations. It would seem useful for company secretaries to maintain a register of authorisations which can set out the terms and conditions rather than simply rely on board minutes.
- Decide how to deal with conflict situations affecting directors of subsidiary company - see additional practical steps for private companies below.

Additional practical steps for public companies

- Consider changes to public company articles to enable conflicts to be authorised (likely to have been done already at AGM).
- Decide how to report on conflict procedures in annual report.

Additional practical steps for private companies

- Private companies incorporated before 1 October 2008 will need to pass an ordinary resolution permitting the board to use the authorisation powers (and file the resolution at Companies House).
- Private companies should consider changing their articles to include procedural provisions to deal with conflicts.

Interests in transactions and arrangements

Directors are not under any obligation to avoid interests in transactions or arrangements with the company but such an interest has to be declared to the board under section 177 and section 182 of the Act. Although there are certain changes of detail from the provisions in this regard under the Companies Act 1985 there are no material differences.

The obligation to make a declaration applies where a director is interested in a transaction or arrangement into which the company is proposing to enter (section 177) and where he is interested in a transaction or arrangement into which the company has already entered (section 182).

A director is treated for this purpose as being aware of matters of which he ought reasonably to be aware and again it would be prudent for the director to consider interests of his connected persons.

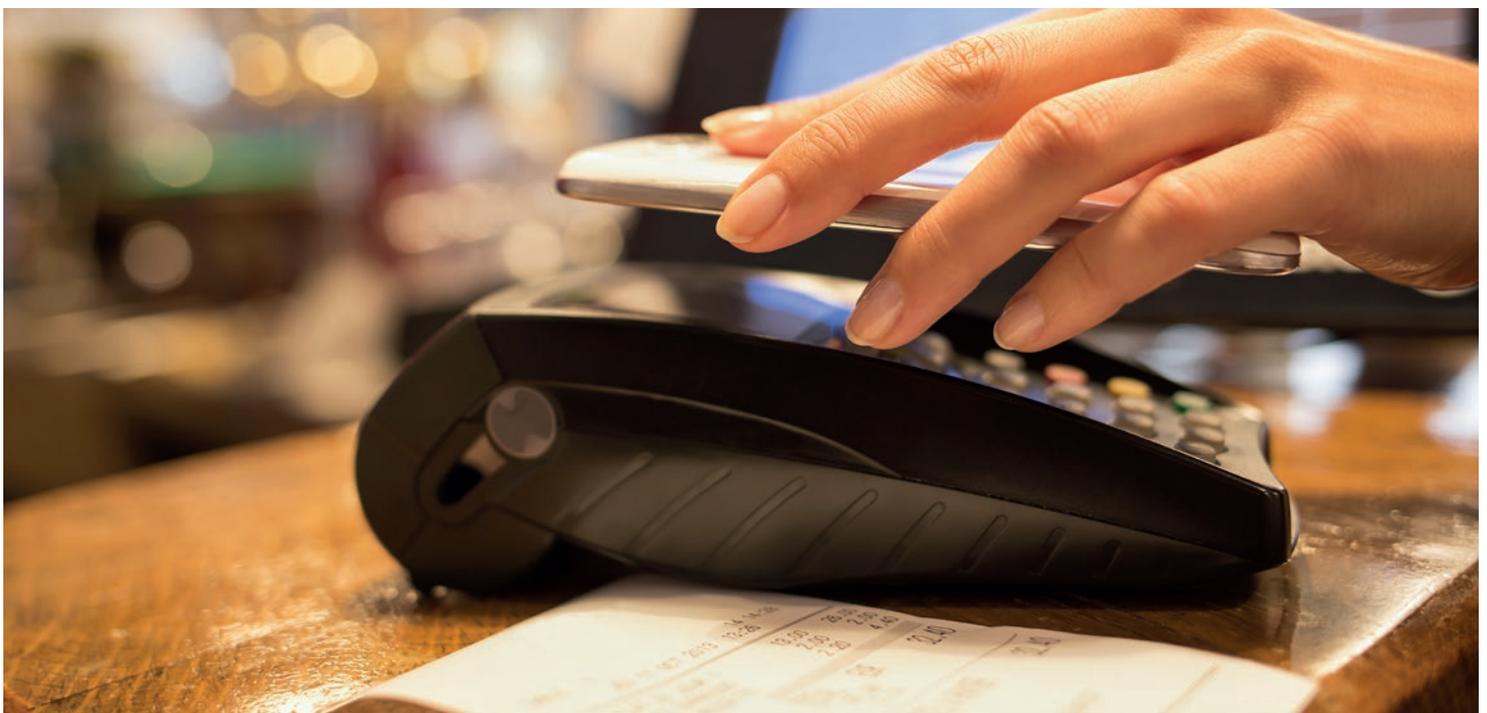
Interests already disclosed under the Companies Act 1985 (ie pre-1 October 2008) do not need to be disclosed again, unless there is a change.

Interests do not need to be disclosed if they cannot reasonably be regarded as likely to give rise to a conflict of interest or if, or to the extent that, the other directors are already aware of this interest or ought reasonably to be aware of it.

Although, as stated above, directors are not under a duty to avoid having an interest in transactions or arrangements with the company, we consider that this applies just to the transaction or arrangement itself so that, where there is an underlying conflict situation connected with the transaction (for example the entry into a supply contract with a major supplier of which the director is a major shareholder), then the conflict or potential conflict arising from that situation (in this example the director's interest in the supplier) would still fall under section 175.

Practical steps for all companies

- Disclosure of such interests to be made at board meetings in accordance with agreed procedures
- If interests were disclosed under the Companies Act 1985 they do not need to be disclosed again, unless there is a change.



Duty not to accept benefits from third parties

The duty to avoid conflicts is supported by a statutory duty on directors not to accept benefits from third parties (section 176 of the Act). This duty cannot be waived by the company's board. The duty is not however infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. So limited corporate hospitality should not give rise to a breach of this duty.

Practical steps for all companies

- Consider establishing or revising a policy on the acceptance of corporate hospitality and gifts by directors.



Former directors

The duty to avoid conflicts continues to apply to a former director as regards the exploitation of any property, information or opportunity of which he became aware at a time when he was a director and the duty not to accept benefits from third parties also continues to apply to a former director as regards anything which he did or did not do before he ceased to be a director.

Further information

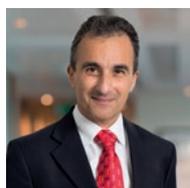
If you would like further information on any aspect of Directors' conflicts of interests under the Companies Act 2006, please contact the person at Hogan Lovells with whom you usually deal or any of the contacts below.



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