From 1 October 2008 new rules come into force as to how company directors deal with conflicts of interest, as part of the latest changes brought in by the Companies Act 2006. In summary:

What's new?

- potential conflicts are caught, as well as actual conflicts
- "independent" directors can approve a conflict
- the old judge-made law is now revised and set down in statute.

What should you be doing now?

- checking your Articles and changing them where appropriate
- taking a fresh look at directors' actual and potential conflicts and tabling a list for board or shareholder approval
- reviewing board procedures to authorise conflicts.

What's the detail?

The new rule says a director of a company 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 (section 175, Companies Act 2006). This covers a very broad range of situations where:

- the director’s interest may be actual or potential, and direct or indirect
- the conflict with the company’s interests may be actual or potential.

Examples of conflicts caught by this wording include:

- investor directors on the board of a private equity investee company who may be employees of the private equity house and/or have an economic interest in the investing fund - their interests may not always be the same as those of the investee company (taking the company’s interests as being those of all shareholders and other stakeholders)
- directors of joint venture companies who will often be directors or employees of the shareholders, again with interests which may potentially conflict with the JV company
- non-executive directors with multiple directorships, and executive directors who have outside non-executive positions
- a director who also sits as a trustee of his employer’s pension scheme.

This is in addition to the more obvious conflicts, where a director takes and uses an opportunity or information which properly belongs to the company. And conflicts of interest also include conflicts of duties where, for example, a director sits on two boards and his duties to the two companies cannot be reconciled.

How can these conflicts be authorised?

If you anticipate that one of these actual or potential conflicts might arise, it can be authorised in advance in one of two ways, either by the shareholders or by the directors:

Shareholders can authorise an actual or potential conflict by an ordinary resolution (more than 50% support from those shareholders voting). This can be achieved by a vote at a general meeting or (in the case of a private company only) by getting agreement to a written resolution. A director who is also a shareholder can participate in the vote, even if he is one of the directors interested in the matter being authorised.
Directors can also authorise conflicts by a majority vote, but only those directors who are not themselves interested in the matter can vote and be counted in the necessary quorum for the meeting. That can mean, in a private equity or joint venture company, where many, or even all, of the directors may be taken as being "interested", that the only practical proposition is shareholder approval.

Can a conflict be ratified after the event?

Directors can only authorise conflicts in advance, but conflicts can be ratified after the event by shareholders. When shareholders ratify a conflict the votes of any shareholder who is also an interested director won't be counted. Nor will the votes of any shareholder who is connected with an interested director. (Note that where the vote is to authorise a conflict in advance, the votes of interested shareholders are allowed.)

Is directors’ approval a formality?

No. In making any decision, directors need to think also about their other duties to the company, particularly their duties to promote the success of the company, to act independently of other interests and to exercise reasonable care, skill and diligence. So any decision to authorise a conflict has to be justifiable as promoting the success of the company for the benefit of shareholders as a whole. That may mean that the approval is given subject to certain terms or conditions, and board minutes recording a decision to authorise a conflict should explain why the directors believe it to be in the company’s best interests.

Giving proper consideration to conflicts and these other duties will often be a difficult balancing act. This is a good reason for setting out in the company’s Articles a procedure for declaring and authorising directors’ conflicts: the Act creates a safe harbour by saying that if directors comply with the procedure in the Articles, they cannot be in breach of any of their duties (s.180(4)).

Do we need special provisions in the Articles?

The rules here differ whether you are dealing with a plc or a private company and, in the case of the latter, whether it was incorporated before 1 October 2008. (Charities and not-for-profit companies may have different considerations.)

Public company – the directors can only authorise conflicts if the Articles contain a specific authority for them to do so. That means that, to avoid the need for shareholder approval of conflicts, a plc’s Articles will have to be amended before 1 October 2008 (and to benefit from the safe harbour referred to above in Is directors’ approval a formality?).

Private company existing prior to 1 October 2008 – is effectively in the same position as a public company. It either needs to amend its Articles to allow for director authorisation, or it can ask its shareholders to pass an ordinary resolution to the same end. The neater solution will be to change the Articles so that a sensible code of practice dealing with conflicts can be set out in the company’s constitution which will also allow the directors to benefit from the safe harbour referred to above.

Private company incorporated on or after 1 October 2008 – only in this case is the directors’ power to authorise a conflict implied without the need for specific wording in the Articles. But if you want to set out a preferred way of managing such things, the Articles are the best place to do that (with the added benefit of creating the safe harbour for directors).

So what might the Articles say?

The Articles can set out the detail of:

- how, when and where an interest is to be declared by a director
- the procedure by which the independent directors authorise a conflict
- who can vote and form a quorum
- conflicting interests which are expressly permitted – such as other directorships in non-competing companies, representation of a significant shareholder (e.g. a JV shareholder or private equity investor), or an indirect economic interest in possible competitors. But all specific conflict situations which arise as a result of those general interests will need further specific approval.
- a waiver of the duty to disclose confidential information obtained from outside the company.
These general permissions and waivers can only go so far and cannot authorise future unspecified developments (see How long will authorisation of a conflict last? below). The Companies Act will also not allow a general waiver which effectively exempts the director from the duty to avoid a conflict (s.232).

Can specific permissions and waivers be put in a Shareholder Agreement?

The Articles are a public document, filed at Companies House, and it may be more appropriate to put detailed permissions and waivers in a Shareholder or Investment Agreement or in a Joint Venture Agreement. But that will only be effective if all shareholders sign the agreement, either when it is first entered into or by signing up to a later deed of adherence.

How long will authorisation of a conflict last?

Provided the facts and circumstances surrounding a conflict stay the same, an authorisation will last indefinitely (or for as long as the authorisation stipulates). But these things rarely do stay the same. A director’s other interests may have been approved because none of them competed with the company, but in time another company where he serves on the board may expand and begin to encroach on the first company’s territory. Authorisations need to be specific to the facts as they then exist; once they change, a new authorisation will be needed.

So directors and their boards need to keep these issues under close consideration. A review of all existing conflicts, and a question as to any new ones (for new and serving directors), should be a regular agenda item at board meetings.

Are there exceptions?

Apart from having a conflict authorised by the directors or shareholders as described above, there are two other situations where the duty to avoid a conflict will not be breached:

• if the situation is such that it cannot reasonably be regarded as likely to give rise to a conflict of interest. If the directors reach the honest view that there is no reasonable likelihood of an actual conflict arising, no authorisation is needed
• if the director’s conflict has arisen from a transaction or arrangement with the company, the need for authorisation is over-ridden by the director’s duty under section 177 (see Duty to declare an interest in a proposed transaction or arrangement below).

What about current conflicts at 1 October 2008?

If a conflict has arisen before 1 October 2008, it is the old law which continues to govern how it is dealt with – that is, it may be approved either under the Articles or by shareholders. But it will be good practice to review all existing conflicts prior to 1 October 2008 and to have them authorised with effect from that date under the new Act so that any changes to the surrounding facts and circumstances are picked up and approved. Remember also that the old law captures only actual conflicts, while the 2006 Act regulates potential conflicts as well.

Are there other related rules on conflicts?

Three other provisions in the Companies Act 2006 are relevant when considering conflicts:

Duty to declare an interest in a proposed transaction or arrangement – if a company is proposing to enter into a transaction or arrangement, and a director has a direct or indirect interest in that transaction or arrangement, he must declare that interest to the board (s.177).

The declaration must detail the nature and extent of the director’s interest and it must be made before the company enters into the transaction. No declaration is required if the director is either not aware of his interest or is not aware of the company’s transaction or arrangement. Nor is a declaration needed if the interest is not reasonably likely to give rise to a conflict, or if the other directors are already aware of the interest.
Declaration of an interest in an existing transaction or arrangement – if the transaction or arrangement has already been entered into by the company, and when it was proposed there was no declaration by the director under section 177 (see Duty to declare an interest in a proposed transaction or arrangement above), a director with an interest in the transaction or arrangement must declare the nature and extent of his interest to the board “as soon as is reasonably practicable” (s.182). The same exemptions apply as detailed above for proposed transactions. A key difference, however, is that failure to make a declaration under this section is a criminal offence.

Duty not to accept benefits from third parties – this is effectively an anti-bribery provision but, again, it is widely drafted and can catch other activities. A director must not accept a benefit from a third party which is offered either because he is a director or to influence him to do, or not do, something as a director (s.176). So, for example, a director must not accept entertainment which is offered in an attempt to influence how he does his job as a director. The only exception is if acceptance of the benefit could not reasonably be seen as likely to give rise to a conflict.

The board cannot approve such benefits; only the shareholders can do that. This provision is likely to reinforce the move by companies towards ethics codes and policies on gifts and entertainment.

Checklist

In readiness for 1 October 2008 we recommend that:

- directors are properly briefed on the new rules (it is their responsibility to comply with the new duties)
- new Articles providing for board approval of conflicts are adopted by plcs and private companies
- companies look at their procedures for dealing with conflicts, including record keeping
- directors review and declare their existing actual and potential interests
- boards are asked to approve existing actual and potential conflicts
- internal rules on gifts and entertainment are reviewed

If you have any comments, or if you would like further advice or assistance with any of the issues covered in this update, please email Martin Webster (martin.webster@pinsentmasons.com) or Michael Berreen (michael.berreen@pinsentmasons.com) or speak to your usual Pinsent Masons contact.

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