



Companies Act 2006 Update

New duties relating to conflicts of interests

Directors' general duties are to be codified in statute for the first time on 1 October 2007. Codification is intended to be of the current law except for a director's duties in relation to conflicts of interests, where changes are being made. In order to give directors and companies time to get to grips with these changes, the Government has decided to delay implementation of the conflict duties until 1 October 2008.

In this note you can read about:

- The current law regarding conflict duties.
- The changes being made to conflict duties.
- Guidance for companies and directors on what they should be thinking about in readiness for 1 October 2008.

The current law

Currently, a director must not put himself in a position in which he has or could have, an interest that conflicts with the interests of the company (the "no-conflict" rule). If he does, then the company will be given a remedy by the courts. A conflict of interest may arise, in particular, when a director makes personal use of information, property or opportunities available to the company or when a director enters into a contract with his company. Conflicts of interests may also arise whenever a director makes a profit in the course of being a director, by virtue of his directorship, without the knowledge and consent of the company.

The current position is that all conflicts of interests must be authorised by the company's shareholders. Shareholders are unable to authorise conflicts in certain circumstances, including if this would constitute a fraud on the minority (broadly, where the wrongdoing directors would benefit personally and are in control of the company's shares). The company's Articles may also override the no-conflict rule (for example, Regulation 85 Table A CA 1985, which permits a director to have an interest in a proposed transaction or arrangement with the company provided that the interest is disclosed to his fellow directors).

In addition to the no-conflict rule, section 317 Companies Act 1985 imposes a statutory requirement (but not a duty) on directors to disclose the nature of any interest in a proposed transaction or arrangement with the company.

The new law

The Act separates the no-conflict rule into three distinct duties:

- To avoid conflicts of interests (section 175).
- Not to accept benefits from third parties (section 176).
- To declare an interest in a proposed transaction or arrangement with the company (section 177).

The company's shareholders continue to be able to authorise conflicts of interests where they are permitted to do so under the current law and a director continues not to be in breach of duty if he acts in accordance with any provision in the company's Articles for dealing with conflicts of interests.

There are, however, two key policy changes:

- To permit independent board authorisation of most conflicts of interests arising from third party dealings by the director (the Government is concerned that the strict requirement for shareholder approval in the current law stifles entrepreneurial activity).
- To reflect the current practice of most companies to permit a director to have an interest in a proposed transaction or arrangement with the company provided that the interest is disclosed to his fellow directors.

These changes do not apply, however, if the company's Articles expressly require shareholder approval for the particular conflict concerned.

Section 182 of the Act, which also comes into force on 1 October 2008, imposes a requirement (but not a duty) on directors to declare an interest in an existing transaction or arrangement with the company and subject to some minor changes, replaces section 317 Companies Act 1985.

Another notable change is that the new law (specifically the section 175/177 duties together with the requirement in section 182) applies to indirect interests on the part of a director as well as to direct interests. An interest of another person (for example, a family member) or another company (in which the director has an interest as director, shareholder or employee) or firm, may amount to an indirect interest on the part of the director. The widening of the law in this way means that directors, particularly those who hold multiple directorships, need to proceed with more caution than previously. There has been much criticism of this aspect of the new conflict duties, coming at a time when UK companies are already facing difficulties recruiting non-executive directors.

Duty to avoid conflicts of interest with the company

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).

This duty is intended to codify the no-conflict rule in respect of all conflicts, actual or potential, between the interests of the director and the interests of the company except as regards conflicts relating to transactions or arrangements with the company. Conflicts relating to transactions or arrangements with the company are dealt with by section 177 in the case of proposed transactions or arrangements with the company (read more) and in respect of existing transactions or arrangements, by section 182 of the Act.

As under the current law, the duty applies in particular to the exploitation of any property, information or opportunity and it is immaterial whether the company could take advantage of the property, information or opportunity in question. A former director also continues to be subject to this duty as regards the exploitation of any property, information or opportunity of which he became aware when he was a director.

Apart from the widening of the duty, which now applies to indirect as well as direct interests on the part of a director, other changes are that a director will not be in breach of duty if:

- The situation cannot reasonably be regarded as likely to give rise to a conflict of interest, or
- The matter has been proposed to and authorised by the company's directors (independently of the conflicted director and any other conflicted directors)
This exception is only available if the company's Articles do not require shareholder approval to authorise the conflict and in the case of existing private companies, if the company's Articles have been amended to permit independent board authorisation.

Duty not to accept benefits from third parties

A director of a company must not accept a benefit from a third party conferred by reason of his being a director or his doing (or not doing) anything as director (section 176).

This duty is intended to codify the no-conflict rule as regards prohibiting the exploitation of the position of director for personal benefit. As under the current law, a former director continues to be subject to this duty as regards things done or omitted by him before he ceased to be a director.

However, a change is that the duty is not now infringed if acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.

Duty to declare interest in proposed transaction or arrangement with the company

A director of a company must not accept a benefit from a third party conferred by reason of his being a director or his doing (or not doing) anything as director (section 176).

If a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, he must declare the nature and extent of that interest to the other directors before the company enters into that transaction or arrangement (section 177).

This duty is intended to codify the no-conflict rule as regards interests in proposed transactions or arrangements with the company.

Apart from the widening of the duty, which now applies where a director has an indirect or direct interest in a transaction or arrangement with the company, the no-conflict rule has been modified to reflect the current practice of most companies (in Regulation 85 Table A CA 1985) to permit a director to have an interest in a proposed transaction or arrangement with the company provided that the interest is disclosed to his fellow directors. This is subject to any provision of the company's Articles requiring shareholder approval to authorise the conflict. Assuming, however, that there is no such provision, then subject to the company's Articles, conflicted directors may, once the declaration has been made, participate in decision-making.

Another change is that since the declaration has to be made “to the other directors” no disclosure is required where the company has only one director. This avoids the charade under the current law that requires a sole director to make a declaration of an interest in a transaction to himself.

No declaration is also required in other circumstances, including if the director’s interest in the transaction cannot reasonably be regarded as likely to give rise to a conflict of interest or to the extent that it concerns the terms of his service contract.

If the transaction is a long-term service contract, substantial property transaction, loan or payment for loss of office, then the company may need shareholder approval to enter into the transaction pursuant to the specific rules governing such transactions (the existing rules governing such transactions are being carried forward in the Act, subject to some changes).

Declaration of interest in existing transaction or arrangement

A director of a company must not accept a benefit from a third party conferred by reason of his being a director or his doing (or not doing) anything as director (section 176).

A director is also required to declare to the company’s other directors the nature and extent of any direct or indirect interest that he has in any existing transaction or arrangement with the company (section 182).

Apart from the widening of this requirement, which now applies where the director has a direct or indirect interest in the transaction or arrangement concerned, the Act now sets out certain circumstances where the requirement does not apply, including if the interest cannot reasonably be regarded as likely to give rise to a conflict of interest, if it concerns the terms of his service contract or if or to the extent that the duty has already been declared under section 177. Further, since the declaration must be made “to the other directors”, a sole director does not need to comply with it.

Guidance for companies and directors

Duty to avoid conflicts of interest:

- Directors can seek to limit their exposure in relation to this new duty by attempting to negotiate as broad an authority as possible in the Articles to potential conflict situations (the Act states that a director will not be in breach of duty if he acts in accordance with any provision in the company’s Articles for dealing with conflicts of interests).
- Directors should be aware, however, that the company’s shareholders might want to limit the scope of any such authority.
- Companies need to consider whether they wish to permit independent board authorisation of conflicts. If so, changes to the company’s Articles will be required.

Duty not to accept benefits from third parties:

- Where the benefit concerned is more than trivial, the director should disclose the benefit to the board and seek to have it recorded in the board minutes that the benefit is not regarded by the board as likely to give rise to a conflict of interest. The views of an independent board are likely to weigh heavily with the Court should a shareholder seek to bring a derivative action against the director for alleged breach of this duty.

- The only way a director can guarantee, however, that he will not be in breach of this duty is to obtain shareholder approval for the acceptance of the benefit. Independent board authorisation is not permitted unless this is expressly provided for in the company's Articles.
- Companies may wish to consider amending their Articles to permit independent board authorisation of acceptance of benefits from third parties (the Act providing that a director will not be in breach of duty if he acts in accordance with any provisions in the company's Articles for dealing with conflicts of interests).

Declarations of interests in transactions or arrangements:

- A director can reduce the risk of breaching the requirements in relation to declarations of interests by giving general notice of his interest in other companies and firms and with other persons. Once general notice is given, the director is treated as having made a declaration of any interest in any existing or future transaction or arrangement with the company, firm or person named in the general notice.
- In order to be effective, the notice must include certain prescribed information and be given at a meeting of the directors or considered at the next meeting of the directors after it is given.
- Directors will still, however, need to ensure that they make appropriate declarations in relation to transactions or arrangements that they are directly involved in.
- Companies should review their Articles and in particular, consider whether once a director has made a declaration of his interest, they wish him to be able to participate in the decision-making process. If so, then changes to the company's Articles may be required.

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