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18. Managing directors’ conflicts

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Historically, with their roots in the common law regime, the rules on conflicts of interest have been difficult for directors to navigate. This task should have been made easier by the introduction of a statutory framework for conflicts under the Companies Act 2006 (the Act), which became effective on October 1, 2008. While the Act has not really simplified or clarified the rules on conflicts, or significantly affected what is expected from directors in terms of behaviour, it has restated those rules in a statutory context.

Overview
The Act sets out seven ‘general duties’ owed to a company by a director, three of which relate directly to directors’ conflicts of interests. These are:

- to avoid a situation in which a director has, or can have, an interest that does or may conflict with the interests of the company of which he is a director
- not to accept benefits from third parties
- to declare any interest in a proposed transaction or arrangement with the company.

The duties are owed to the company, not to any individual shareholder(s) who may, in limited circumstances, take action to enforce the duties in the name of the company.

In addition, there is a separate obligation (not, strictly speaking, a general duty) to declare any interest in an existing transaction or arrangement with the company. Failure to comply with this obligation (unlike the general duties) is a criminal offence.

There was considerable debate around the time that the new statutory provisions came into force over the extent to which they changed the existing common law rules. It is now generally accepted that they modified the common law rules on directors’ conflicts in two key respects. First, directors now have the power to authorise certain conflicts of interest that previously could only be authorised by shareholders. Second, certain transactions or arrangements between directors and the company are now permitted (without the need for separate authorisation) provided they have been appropriately disclosed to the other directors.

Duty to avoid conflicts of interest
Under Section 175 of the 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 has come to be known as a ‘situational conflict’.

The duty only applies to situations arising after October 1, 2008. It applies in particular to the exploitation of any property, information or opportunity, whether or not the company could take advantage of it for its own purposes.

The duty does not apply to transactions or arrangements with the company (although it appears to catch transactions or arrangements with subsidiaries of the company), which are generally subject to separate disclosure (as opposed to authorisation) requirements under Sections 177 and 182 for proposed and existing transactions respectively. As discussed below, however, certain transactions between a director and the company require specific shareholder approval.

The scope of the Section 175 duty is very broad. It applies to both actual and potential conflicts and, although principally aimed at preventing directors from exploiting situations for their own benefit at the company’s expense, it also catches conflict
situations where the director does not benefit personally (for example, where he is a director of two or more group companies whose interests conflict).

The definition of ‘conflict of interest’ includes a conflict of interest and duty, and a conflict of duties.

Authorisation of conflicts by directors
Section 175 gave directors a new power to authorise situational conflicts of interest. The duty to avoid situational conflicts is not breached if the relevant matter has been authorised in advance by the directors, provided that:

- in the case of a public company, the company’s constitution allows the directors to give the authorisation
- in the case of a private company, the company’s constitution does not contain anything that invalidates the authorisation.

Many public companies have amended their articles of association to take advantage of the authorisation regime. Private companies incorporated before October 1, 2008 must pass a shareholder resolution giving directors the power to authorise.

Authorisation of a situational conflict under the new statutory power must be given at a quorate meeting of the board of directors. The authorisation is only effective if quorum requirements are met without the relevant director voting or would have been met without his votes being counted. Generally, conflicted directors should not attend a board meeting (or the relevant part of the meeting) at which the matter is being considered.

Each board member, in considering whether to authorise a conflict of interest, will of course need to consider his other duties — including, in particular, the overriding statutory duty to act in a way that he considers, in good faith, would be most likely to promote the success of the company for the benefit of its shareholders as a whole.

Authorisation by the company
The directors’ power to authorise situational conflicts does not replace or restrict the power of the company — whether through shareholder resolutions or provisions in the articles — to authorise matters that would otherwise be a breach of the directors’ general duties (see ‘safe harbours’, below).

GC100 guidance on conflicts of interest
In January 2008, the GC100, a grouping of the senior legal officers of more than 85 FTSE 100 companies, published a detailed note on conflicts of interest. This provides helpful guidance on the exercise of the Section 175 power to authorise conflicts and related issues. The GC100 also published a suggested checklist for company secretaries, a draft briefing paper for directors and a questionnaire designed to help directors identify conflicts of interest. The Association of British Insurers has advised that listed companies should undertake to follow emerging best practice in line with GC100 guidance.

Duty not to accept benefits from third parties
Under Section 176 of the Act, a director must not accept a benefit from a third party conferred by reason of his being a director or doing (or not doing) anything as a director. The duty is intended to prevent a director from exploiting his position for his own benefit.

The duty does not prevent a director from receiving benefits from either the company, an associated body corporate or a person acting on behalf of the company or an associated body corporate; or from a person by whom his services (as a director or otherwise) are provided to the company.
The duty is wide enough to catch gifts and corporate hospitality. However, it is not breached if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. As such, low-level gifts or corporate hospitality in the normal course of business are unlikely to result in a breach.

The duty sits alongside the UK Bribery Act 2010 and other legislation intended to combat bribery and corruption. Companies should ensure that their policies and procedures for dealing with bribery and corruption are kept up to date and that directors are aware of their responsibilities.

**Declaring interests in transactions or arrangements with the company**

**Proposed transactions with the company**

*Section 177*

A director has a statutory duty to declare to the other directors the nature and extent of any interest, direct or indirect, in a proposed transaction or arrangement with the company. Authorisation by the directors under Section 175 of the Act is not possible; that authorisation procedure only applies to situational conflicts (and not to conflicts of interest arising in relation to a transaction or arrangement with the company). Consequently, for a proposed transaction or arrangement with the company, the directors have to decide whether to proceed and, if so, whether any special conditions should apply to deal with the conflict.

The declaration must be made before the company enters into the transaction or arrangement, and a director should also update any previous declaration of interest if it proves to be, or becomes, inaccurate or incomplete. The requirement to update previous declarations is not subject to a materiality threshold, so a relatively trivial change could trigger that obligation.

**Existing transactions with the company**

*Section 182*

There is a separate requirement for a director to declare to the other directors the nature and extent of any interest, direct or indirect, in an existing transaction or arrangement with the company. This may happen, for example, when a new director is appointed and has some interest in a pre-existing transaction.

There is no need to declare an interest in an existing transaction or arrangement if that interest has already been declared as a proposed transaction, although directors will have to provide an update for previous declarations if they prove to be, or become, inaccurate or incomplete.

The declaration must be made as soon as possible and it is a criminal offence (rather than a breach of duty) to fail to declare an interest in an existing transaction (or to update a previous declaration) in accordance with Section 182.

**Declaring interests under Sections 177 and 182**

A declaration under Section 182 must (and a declaration under Section 177 may) be made at a meeting of the directors, by notice in writing to the other directors (email can be used if the directors agree) or by general notice to the other directors.

A general notice, for these purposes, should state that the director has an interest in a particular entity or is connected to a specified person and he/she is therefore to be regarded as interested in any future transaction or arrangement with that entity or person.

The general notice should state the nature and extent of the director’s interest in the other entity or the nature of the connection to the other person. The notice should be given at a meeting of the directors, failing which the director should take reasonable steps to have it brought up and read at the next meeting after the general notice has been given.
As a concession to common sense, directors are not required to declare interests (or update previous declarations) if they are not aware of the interest or the relevant transaction or arrangement. Directors are, however, presumed to be aware of matters of which they ought reasonably to be aware. There is no need to declare an interest if the other directors are already aware (or ought reasonably to be aware) of it, or if it concerns the terms of a director’s service contract that has been or is being considered by the other directors.

**Safe harbours**

**No reasonable likelihood of a conflict**
There is no breach of the various statutory provisions if the relevant matter cannot reasonably be regarded as likely to give rise to a conflict of interest. It will not always be easy for directors to determine whether particular circumstances fall within this safe harbour and, where there is any doubt, they should declare the matter and seek director and/or shareholder authorisation as appropriate.

**Authorisation of conflict by the company or under its articles of association**
There is no breach of the general duties (including Sections 175, 176 and 177 of the Act) if:

- the company has specifically or generally authorised (whether by shareholder resolution or through the articles of association) an act or omission by any or all of the directors that would otherwise constitute a breach; or
- there are provisions in the company’s articles dealing with conflicts of interest, and those provisions have been followed.

As a practical matter, shareholder approval under this safe harbour — where it can be readily obtained — may well be the best solution for resolving a conflict if there is any doubt as to the availability of another exemption or safe harbour.

**Specific transactions requiring shareholder approval**
There is no breach of the general duties on conflicts of interest under Sections 175 and 176 of the Act where shareholder approval for specific transactions is required and that approval has been obtained. Transactions where such approval may be required include directors’ long-term service contracts, substantial property transactions, loans, quasi-loans and credit transactions, and payments for loss of office.

**Ratification**
Shareholders can ratify any breach of the general duties on conflicts of interest by ordinary resolution or unanimous approval. The vote of the conflicted director, and any shareholder connected to him, cannot be counted for the purpose of any ratifying resolution.

**Consequences of breach**
An action for breach of duty will generally be brought against a director by the company. Remedies for breaches of the duties set out above may include an injunction, setting aside of the transaction, restitution and account of profits, restoration of company property held by the director, damages, or termination of the director’s service contract. As stated above, failure to comply with Section 182 is a criminal offence.

**Duties continue after cessation of directorship**
Certain statutory duties continue even after a person has ceased to be a director. A former director has a continuing obligation to avoid a conflict of interest under Section 175 in relation to the exploitation of any property, information or opportunity of which he became aware while he was a director.

There is also a continuing duty not to accept benefits from third parties under Section 176 in relation to things done or not done while a director.
Managing directors’ conflicts

Benchmarking and briefing directors
Companies will wish to monitor best practice in this area and consult their legal and other advisers where appropriate. Companies should also ensure that directors are aware of their statutory duties as well as the relevant internal policies and procedures. These should be covered in the induction process for new directors.

Continuing duty
Directors need to monitor their personal positions on an ongoing basis in order to identify any actual or potential conflicts of interest that should be avoided or authorised under Section 175, or declared or updated under Sections 177 or 182. Directors should also be reminded that reputational damage can easily result from a situation that may not technically constitute a breach of duty or other obligation relating to conflicts of interest.

Consider the provisions of articles
Many companies will have updated their articles of association to reflect the statutory provisions on conflicts of interest around the time those provisions came into force — in October 2008. Any requirements in the articles relating to notification, quorums and voting should be carefully followed.

Directors’ other duties
In considering whether to authorise a conflict of interest under Section 175, each non-conflicted director must have regard to his other duties, including the overriding duty to act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its shareholders as a whole.

Anticipate issues
Directors should seek to anticipate the types of issues that could arise from a conflict situation. For example, where the director is also a director of a competitor or ‘represents’ a major shareholder, there is plenty of scope for difficulties. Directors should seek to identify and consider such issues as soon as possible.

Authorisations
It may be appropriate to make any authorisation subject to conditions or restrictions, such as placing a time limit on the authorisation or stating that it can be revoked at any time, and restricting the disclosure of confidential information.

Review of authorisations
Companies should keep a record of authorisations that have been granted and put in place procedures to review authorisations from time to time, perhaps annually.

Annual report
The Association of British Insurers has indicated that it would expect boards of listed companies to report annually that there are procedures in place to deal with conflicts of interest and that they operate effectively.
### Situational conflicts

*Examples of situations where a director could face an actual or potential conflict may include:*

**Where the director is, or has been, appointed by a private equity investor**
In considering whether to grant authorisation, the directors will need to have regard to their general and other duties to the company, including the duty to act in a way they consider, in good faith, would be most likely to promote the success of the company for the benefit of the shareholders as a whole. In practice, the directors will often wish to authorise this type of conflict, especially where the private equity investor has a contractual right to appoint a director. They may, however, wish to attach conditions to any authorisation in order, for example, to safeguard confidential company information and to set out what should happen if circumstances change.

**Where a director is, or in some way represents, a customer, supplier or competitor of the company**
This situation could arise, for example, where the wife of a director is employed by a competitor of the company, or where a director also serves on the board of a company that is a customer or competitor. The other directors will need to consider whether they wish to authorise such conflicts given their general and other duties. The matter may be relatively straightforward if they believe that the arrangement brings clear benefits to the company (such as access to the director’s particular expertise or industry knowledge) and that the conflict can be appropriately managed (through, for example, safeguards to protect confidential information).

**Where a director is, or in some way represents, an adviser of the company**
If the directors are prepared to authorise this type of conflict situation in the particular circumstances, it is likely that the company will also agree that the director has no obligation to disclose confidential information that he obtains through his role with the adviser. By way of reciprocation, it is also likely that the adviser will agree that the director has no obligation to disclose confidential company information.

**Where a director is also a director of the corporate trustee of the company pension scheme**
Companies may consider authorising this type of conflict through the articles of association in order to avoid the need to go through the Section 175 procedure each time there is a change of relevant personnel. The directors should of course consider the surrounding circumstances carefully before authorising the conflict. A director who is also a director of the company pension scheme trustee will need to monitor his position continuously to identify any actual or potential conflicts. The Institute of Chartered Accountants in England and Wales and the Pensions Regulator have each published helpful guidance on conflicts of interest for trustees of company pension schemes.
Other areas for consideration

**Listing Rules — related-party transactions**

The rules on ‘related party’ transactions contained in the Listing Rules (LR) may be relevant for certain conflicts involving directors of listed companies, as the definition of ‘related party’ includes a company’s current, and certain previous, directors. The rules — set out in LR11 and applying only to companies with a Premium Listing — are intended to prevent related parties from taking advantage of their position and to prevent any perception that they may have done so. Related-party transactions require (among other things) shareholder approval in accordance with LR 11.1.7R, although there are some exceptions and also modified requirements for certain smaller transactions.

**Takeover Code — management buyouts**

Under the Takeover Code, where an offer is a management buyout or similar transaction, a director of the target company will normally be regarded as having a conflict of interest if it is intended that he/she should have any continuing role (whether in an executive or non-executive capacity) in either the acquiring or target company in the event of the offer being successful. Where a director has a conflict, he/she should not normally be joined with the remainder of the board in the expression of its views on the offer, and the nature of the conflict should be clearly explained in the target board’s circular.

Any conflicted director should disclose the conflict to the other directors as soon as possible. The target company will wish to put certain safeguards in place, including setting up an independent committee of the board to deal with the proposed transaction, so that conflicted directors are excluded from the discussions. The board committee will also need to give specific consideration at an early stage to the disclosure of confidential information by a conflicted director to third parties.

**Conclusion**

Although the Companies Act 2006 has codified the rules on directors’ conflicts of interest in a statutory context, this remains a complex area for companies and directors. The new UK regime on directors’ conflicts has, however, probably resulted in:

- more attention being paid to conflicts (actual and potential) by companies and directors
- the adoption by many companies of more formal procedures for dealing with conflicts
- directors being less likely than before to fall foul of the rules on conflicts, particularly if they follow developing best practice.
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