



## Directors' Conflicts of Interest after the Companies Act 2006



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# Directors' Conflicts of Interest after the Companies Act 2006

## Preliminary

The Companies Act 2006 ("the Act") introduced a new regime for the management and authorisation of directors' conflicts of interest. The new rules took effect from 1 October 2008.

Previously the issue of such conflicts was governed by a combination of the common law on directors' fiduciary duties and the 1985 Companies Act. Regulating such matters in the Act was consistent with government's decision to enshrine the general duties owed by directors in legislation.

The most significant change under the Act as far as conflicts of interest are concerned is the introduction of the concept of "situational" conflicts of interest – i.e. conflicts which arise, or may arise, from a particular situation. These are to be contrasted with conflicts arising from particular transactions or arrangements ("transactional conflicts"), which were already the subject of regulation under the 1985 Act.

The background to situational conflicts lies in the existing fiduciary duties owed by a director, including the duty not to put himself in a position where his interests conflict with those of the company and not to exploit a business opportunity for his own benefit which could otherwise have been exploited by the company.

## Situational Conflicts

The relevant rules regarding situational conflicts are found in section 175 of the Act. It doesn't specifically define situational conflicts but rather states that a director must avoid situations which give rise to a direct or indirect, actual or potential, conflict of interest or duty. It goes on to say that this is particularly in respect of (but not limited to) the exploitation of property, information or opportunity. Indeed, the duty not to exploit property, information or opportunity which a director became aware of whilst a director continues after he ceases to be a director.

For smaller private companies, the most obvious examples of a situational conflict would be a director who is also a director or major shareholder in a competitor, customer or supplier to the

company (or is connected to such a person) or a director who is appointed by a significant shareholder, such as an investor.

## Transactional Conflicts

These will arise where the company is proposing to enter into a contract with the director. It will also apply where the director is indirectly interested in a contract because a person connected with him is the contracting party.

Section 175 does not apply to transactional conflicts nor to situations where it is not reasonably likely that a conflict would arise (although the operation of this latter exemption is unclear). The Act also excludes a situation which arose prior to 1 October 2008, which would continue to be governed by the existing common law.

## Dealing with Situational Conflicts

Once a situational conflict has been identified, the next question is how it should be dealt with. The Act now allows situational conflicts to be approved by those directors who are not affected by the situation in question ("non-conflicted directors"), whereas previously only the shareholders had this power. However, the right for directors to authorise such a conflict does not automatically arise – private companies incorporated before 1 October 2008 need to pass an ordinary resolution to opt in to the regime, whereas those incorporated after that date just need to ensure there is nothing in the company's constitution which would invalidate a board authorisation.

The board authorisation is given by a majority of the non-conflicted directors. Any conflicted directors will not be able to vote or count in quorum so, in a company where there are a small number of directors, it is advisable to provide in the articles of association that where there is only one non-conflicted director, that director constitutes a quorum. The directors authorising the situational conflict may decide to attach conditions to the authorisation such as whether the conflicted director should be permitted to attend meetings relevant to the conflict or receive confidential

information.

It is becoming common for companies to incorporate specific provisions in their articles of association dealing with the approval of situational conflicts. These may provide, for example, that the conflicted director is not obliged to share third-party confidential information with the board that has come into his possession through his involvement in the conflict. The articles may also permit a director to derive a financial benefit from an authorised conflict without accounting for it to the company. A good reason for including such provisions in the articles is that section 180(4)(b) of the Act states that where the articles contain provisions dealing with conflicts of interests, anything done in accordance with those provisions will not constitute a breach of the directors' general duties under the Act.

The power of shareholders to approve what would otherwise be a breach of the directors' duties remains under the Act. The Act is not specific on how such approval should be given, but the general view is that an ordinary or special resolution of the members would be appropriate.

## Dealing with Transactional Conflicts

The rules governing transactional conflicts have also been modified by the Act. There are two distinct parts to the rules – section 177 which deals with transactions or arrangements which the company is proposing to enter into and section 182 deals with existing transactions or arrangements.

Under section 177, a director must declare to the other directors the nature and extent of any direct or indirect interest which he may have in a proposed transaction or arrangement with the company. The director himself need not be a party to the transaction for this to apply – for example where his spouse has an interest in the transaction. Notice to the other directors should be given at a board meeting or by written notice to all the other directors. It is also possible, at a board meeting, for a director to give a general notice that he has an interest in another company or firm, or is connected to another person, and so

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should be taken as having an interest in any subsequent transaction with that company, firm or person.

No declaration under section 177 is required where the director is not aware of the transaction or of his interest in it (although a director will be deemed to be aware of things of which he ought reasonably to be aware); if his interest in the transaction cannot reasonably be expected to give rise to a conflict of interest; if the other directors are already aware of this interest or if the interest concerns the terms of his service contract.

If a director fails to comply with section 177, the relevant transaction may be voidable at the instance of the company and the director may be required to repay any profit he made from the transaction.

Under section 182, a director must declare his interest in any existing transaction or arrangement of the company. This may apply if he became a director, or acquired the interest, after the transaction was entered into or if he simply failed to comply with section 177 before it was entered into. If he has already notified his fellow directors under section 177 then no further notification is required (unless the original notification was incomplete or has become inaccurate).

As with section 177, the declaration may be made at a board meeting, by written notice or by way of a general notice and must be made as soon as is reasonably practicable. The same exceptions to the requirement to declare an interest apply to section 182 as for section 177.

Unlike section 177, breach of section 182 is a criminal offence. A guilty director may be subject to an unlimited fine, if convicted on indictment, or a fine of up to £5,000 on summary conviction. The validity of the transaction is not, however, affected.

## Review of Articles of Association

As can be seen, the law relating to directors' conflicts of interest is complex and has many traps for the unwary. All companies and directors should consider carefully whether and where any such conflicts may potentially exist and take the appropriate steps to comply with the legislation.

The first step may be to ask the company's legal advisers to review the current Articles of Association.

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