



DIRECTORS' DUTIES : CONFLICTS OF INTERESTS

GUIDANCE NOTE

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1 DEFINITIONS

“Council” City of York Council;

“Company” the newly incorporated Company, established as a wholly owned subsidiary of the Council for the purpose of trading in certain function related activities.

2 INTRODUCTION

2.1 A director of a company owes various duties to that company.

2.2 Until recently there was no codified list of directors’ duties as they had largely evolved through case law.

2.3 One of the most significant changes introduced by the Companies Act 2006 (the “Act”) was the codification of the **general duties** owed by directors and these are now set out in sections 171 to 177 of the Act. There are, however, other duties contained in other parts of the Act and also some that remain uncodified.

2.4 This note provides a summary of the duty owed by directors to avoid any potential conflicts of interest. Such a duty may be particularly relevant to the directors of the Company who are also employees and/or members of the Council. Should the Council require further guidance as to the other duties owed directors under the Act, we would be more than happy to circulate a note dealing with those issues.

2.5 Given that the Act is a relatively new piece of legislation it is not yet clear how many of its provisions (including those regarding directors’ duties and conflicts of interests) will be interpreted and applied. What has been made clear, however, is that in interpreting the new codified duties regard must still be had to the existing case law on director’s duties.

2.6 It should be noted that the duties are cumulative and where more than one duty applies the directors must comply with each applicable duty.

3 GENERAL DUTIES UNDER THE ACT

Most of the general duties under the Act came into force on 1 October 2007, however the duty to avoid conflicts of interest with the company came into force on 1 October 2008.

3.1 **Duty to avoid conflicts of interest** (section 175)

3.1.1 A director must avoid situations in which his direct or indirect (eg through his family) interests conflict or may conflict with those of the company.

3.1.2 This duty is particularly relevant in relation to the exploitation of property, information or opportunities.

- 3.1.3 The duty does not apply to a conflict relating to a transaction or arrangement with the company (these situations are dealt with elsewhere in the Act).
- 3.1.4 The duty is not infringed if:
- 3.1.4.1 the situation cannot reasonably be regarded as likely to give rise to a conflict of interest; or
 - 3.1.4.2 the matter is authorised by the directors (but see 3.1.5 and 3.1.6 below).
- 3.1.5 A private company formed on or after 1 October 2008 that wishes to take advantage of the ability of directors to authorise conflicts will need to check its constitution to ensure there are no provisions which prevent such authorisation being given. When incorporating the Company, we shall include the appropriate provisions in the Company's articles of association (the "**Articles**") dealing with conflicts of interests and the ability of directors to authorise them.
- 3.1.6 It should be noted that if a conflict is to be validly approved by the directors any interested director may not count in the quorum at the meeting where the authorisation is considered and their votes will not be counted in relation to the vote on the authorisation.
- 3.1.7 It is also important to note that before authorising any conflict the directors must consider their other duties under the Act.
- 3.1.8 Amongst other things the duty may make it difficult for directors to have multiple directorships, especially if the relevant companies are in the same business sector. Directors in this situation should seek advice as it may be necessary to ensure that each relevant company's constitution is altered (or, in the case of a private company formed before 1 October 2008 that its members have passed an appropriate resolution) and that the situation is then authorised by the other directors.
- 3.1.9 **Council members and/or employees proposing to be appointed as directors of the Company should be aware of any potential conflicts of interest that may arise when carrying out their roles for the Council and when acting as directors of the Company.**
- 3.1.10 **Any director who is also a Council member will still be bound by the codes of conduct relevant to the Council, in so far as those codes do not conflict with their legal obligations as directors.**

4 CONSEQUENCES OF A BREACH OF DUTY

- 4.1 All directors' duties are owed to the relevant company and only that company will be able to enforce them (although in certain circumstances members may be able to bring a derivative claim on the company's behalf (see 4.3 below)).
- 4.2 There are a number of potential remedies available in the event of a breach of duty. These include:
- 4.2.1 injunctions;
 - 4.2.2 damages (which may be payable by the director personally);
 - 4.2.3 fines (particularly in the case of a breach of a duty of internal management); and
 - 4.2.4 the relevant transaction being set aside.
- 4.3 In certain circumstances members may be able to bring a derivative claim on the company's behalf. The Act has widened these circumstances and they include a breach of duty.

5 EXECUTIVE AND NON-EXECUTIVE DIRECTORS

A board of directors acts as a whole and although some directors may be given additional powers or responsibilities by the constitution or by resolution, generally speaking the general duties and responsibilities are the same for executive and non-executive directors.

6 PROTECTION FOR DIRECTORS

- 6.1 The best protection for directors is for them to ensure that they are fully aware of their duties and responsibilities and at all times act in accordance with those duties. Should the Council require additional information and/or training in relation to the duties and responsibilities of directors in addition to the duty to avoid conflicts of interest then we would be delighted to discuss this further.
- 6.2 It is good practice for directors to establish a proper framework for holding board meetings, making decisions and recording those decisions. Such a framework has been contemplated in the initial draft of the Shareholder's Agreement we have provided for the Council, however the Council should consider those provisions further to ensure that it and the directors are comfortable with that framework.
- 6.3 The GC100 has produced a note on best practice for directors of public limited companies and directors would be well advised to review that note. An extract from the best practice note is attached at the Appendix.
- 6.4 There is a provision in the Act (section 239) that allows a company (by an ordinary resolution of the members) to ratify any conduct of a director which amounts to negligence, default, breach of duty or breach of trust. Ratification will bar the bringing

of a derivative claim. However, the votes of the relevant director and any person connected with him have to be disregarded for the purpose of determining whether the resolution has been passed.

6.5 Under section 1157 of the Act a court may also relieve a director from liability if it considers (amongst other things) that:

6.5.1 the director has acted honestly and reasonably; and

6.5.2 considering all the circumstances, he ought fairly to be excused.

6.6 It may be possible for a company to take out an insurance policy to cover its directors from any claims for negligence, default or breach of duty or trust (section 233 of the Act). We would recommend that the Council makes enquiries in order to put in place the appropriate insurance(s).

Cobbetts LLP
10 June 2011

APPENDIX

EXTRACT FROM THE GC100 GUIDANCE ON DIRECTORS' CONFLICTS OF INTEREST AUTHORISATION PROCESS (AUGUST 2008)

Directors' briefing

1 Background

The statutory duties relating to conflicts of interest under the Companies Act 2006 come into force on 1 October 2008, namely:

- Duty to disclose any interest in a proposed transaction or arrangement with the Company and a separate and independent duty to disclose any interest in an existing transaction or arrangement with the Company (transactional conflicts)
- Duty to avoid conflicts of interest (situational conflicts) unless authorised

The Act allows Board authorisation of situational conflicts where the directors have the relevant powers.

2 Directors' own responsibility

It is emphasised that the above duties are the personal responsibility of each director and not the Company. Only directors will ultimately be aware of any actual or potential situational conflicts. Directors should ensure that they keep these duties under review and inform the Chairman and Company Secretary (to the extent such person is appointed) on an ongoing basis of any change in their respective positions.

Transactional conflicts are not the same as situational conflicts and different rules apply to each (see below for more information). Situational conflicts require prior authorisation to avoid a breach of duty. Transactional conflicts require directors to declare their interest and under the Company's Articles of Association they cannot vote on a Board resolution relating to the relevant transaction. Failure to declare an interest in an existing transaction or arrangement with the Company and another party is a criminal offence whereas a breach of the other duties could only give rise to civil claims against a director.

3 Duty not to accept benefits from third parties

A director has a duty not to accept a benefit from a third party conferred by reason of his being a director or doing (or not doing) anything as a director. This duty does not apply if the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. If a director is in doubt whether any benefit is permitted, s/he should seek clarification from [the Group Company Secretary] before acceptance.

4 **Duty to disclose any interest in a proposed or existing transaction or arrangement with the Company and another party (transactional conflict)**

Directors continue to have a duty to declare an interest in a proposed transaction or arrangement with the Company and another party and also in an existing transaction or arrangement with the Company and another party. Their interest may be direct or indirect and interests of their connected persons may also be captured. These duties are broadly similar to the requirements of the existing law.

It should be noted that:

- transactional conflicts include auctions and **tender processes**;
- a transactional conflict where the transaction results in an ongoing relationship between the Company and another party may become a situational conflict.

If a director becomes aware that s/he has a direct or indirect interest in an existing or proposed transaction with that party, s/he should notify the Board at the next Board meeting or by a written declaration. Interests in proposed transactions should be notified before the transaction is entered into and directors have an ongoing duty to update any changes in these interests.

5 **Duty to avoid conflicts of interest (situational conflicts)**

From 1 October 2008 directors have a duty to avoid a “situation” in which there is, or may be, a conflict between the interests of the Company and the direct or indirect interests of the director or between the director’s duties to the Company and to another person. The 2006 Act has introduced a new statutory power for a board to authorise such situational conflicts, provided this is done in advance. Boards of public companies and existing private companies must be authorised to deal with conflicts before directors can approve these.

This change in the law will require the Company to operate more formal procedures regarding conflicts of interest but provided a potential situational conflict has been authorised, the change should not result in directors having to behave in a different way than they would at present.