

## Conflicts of interest by Company Directors

Why does it matter if a Director has a conflict of interest?

All Directors are under a fiduciary duty to act in the best interests of their Company. Whilst the Company is solvent, the “best interests of the Company” equates to the interests of the Company’s shareholders as a whole, although should the Company become insolvent, these interests will rank behind the interests of creditors. A Director finding himself in a position of conflict does not automatically breach this duty, but he must resolve the conflict by exercising his discretion in the best interests of the Company. Failure to do so can result in the Director having to account personally to the Company for any loss attributable to the breach.

### Common situations of conflict

#### 1. Companies with several shareholders

In companies with two or more shareholders, their interests may be different, and it may be hard for Directors to identify the ‘best interests of shareholders as a whole’. If there are minority shareholders, Directors may find themselves trying to reconcile the duty to act bona fide in the interests of the shareholders as a whole with the will of the majority. Even if the majority is determined that its will should prevail, both the majority and the Board will normally want to avoid giving the minority grounds for a claim that the Company’s affairs are being or have been conducted in a manner which is unfairly prejudicial to the minority. As part of such a claim, the Directors could find themselves facing an action for breach of fiduciary duty.

#### 2. Group companies

Conflicts often arise for Directors of companies that are part of a group. They may be expected by the parent Company to subsume the interests of their individual Company to the interests of the group as a whole, or the interests of another group Company. But to do so could expose the Directors to personal liability for having failed to act in the best interests of their own Company. Even worse, an individual could find himself Director of two group companies that are entering into transactions with each other: unless there is a genuine balance between upside and downside for each Company, if the Director approves the deal he will inevitably fail to act in the interests of one Company. A Director in that position is “hopelessly conflicted” and should preferably abstain from voting.

#### 3. Joint Venture companies

The problem of conflicts is still more acute if a Director has been appointed by a shareholder specifically to act as its eyes and ears on the Board. Almost invariably this will be the case with companies established to operate a Joint Venture Company between two or more parties. In most cases, such a Director will be an employee of his appointing shareholder. At times, acting in the best interests of the Joint Venture Company could mean acting to the detriment of the Director’s employer and appointor. Frequently, Directors will come into possession of confidential information about their Company which would be of interest to their employer/appointer or vice versa.

The following describes some practical steps which can be taken to manage conflicts of interest for Directors of Joint Venture companies.

## **Practical steps to manage conflicts in Joint Venture companies**

### **1. Identify conflicts up front**

Wherever possible, identify potential conflicts at the outset and make arrangements to deal with them. In a Joint Venture, the same conflicts are likely to arise for Directors appointed by both shareholders, so it should be possible to agree suitable conflict management mechanisms and include them in the Shareholders' Agreement and/or Articles of Association.

### **2. Modify the duties of Directors**

Consider modifying the extent of a Director's duties by contract, in the Articles or in his service contract. For example, it could be stipulated that a Director appointed by either Joint Venture Company shareholder is entitled to act in the best interests of his appointor, and may pass confidential information to his appointor without breaching any duty of confidentiality he may owe to the Joint Venture Company. Whilst such a provision may help to clarify the expectations of the shareholders, the question of whether it would be effective to protect the Director from a claim by the Company for breach of fiduciary duty has not yet come before a Court and is therefore uncertain. Undoubtedly, a Director will take a risk in relying on such a provision if the action he approves is clearly not in the best interests of the Joint Venture Company. There is also a danger of the provision being void under section 310 of the Companies Act if its effect is to exempt the Director from breach of fiduciary duty to the Company.

### **3. Appoint a separate shareholder representative**

Where a Joint Venture Company's constitution gives specific rights to each shareholder, for example a right of veto on certain issues, in order to avoid putting a shareholder-appointed Director in a clear position of conflict, it can be better to ensure that he does not exercise these powers. For this purpose, when the Joint Venture Company is set up, each shareholder could appoint a separate representative who is specifically empowered to exercise certain shareholder rights and to receive certain confidential information. Care should be taken, however, that the shareholder representative does not become too involved in taking decisions that should properly only be taken by the Board, or he may be categorised as a de facto Director. Such a structure can also make operation of the Joint Venture Company unwieldy.

### **4. Exclude Directors from Board discussions that relate to transactions or disputes with their appointing shareholder**

In certain situations, there may be a contractual relationship between the Joint Venture and one or more of its shareholders. So as to minimise the potential for conflict, it should be agreed at the outset that should any dispute arise between shareholder and Joint Venture Company in relation to a contractual matter, then the appointed Director should take no part in any negotiations to resolve the dispute. Going further, the shareholders could identify areas of potential competition between the Joint Venture Company and its shareholders, and provide at the outset that an appointed Director will not receive information or be involved in discussions in those areas.

### **5. Shareholder ratification**

Where his conflicted position means that a Director's approval of a course of action may well put him in breach of fiduciary duty to the Company, he can be partially protected if the shareholders ratify the decision. Ratification can absolve the Director from liability to the Company for breach of duty. Most decisions taken by Directors can be ratified by the shareholders, provided that they are not ultra vires the Company's constitution, do not involve a fraud on any minority shareholder or the misappropriation of the Company's property in bad faith, and provided that the Company is not insolvent. Ratification should only be used for specific decisions – it should not attempt to provide a blanket absolution for the Directors in other circumstances.

#### 6. Use Members' written resolutions

Provided the Articles allow members to pass resolutions in writing, certain decisions may be taken without involving the Directors. Care should be taken, however, that the shareholders do not take too active a role in managing the Company, or they may be deemed shadow Directors.

#### 7. In cases of difficulty, take advice

At any time where a significant conflict cannot be resolved in one of the usual ways, Directors should consider taking legal advice on their position. If their Company may be in financial difficulty, the Directors should certainly obtain independent legal advice as soon as possible and should be particularly careful not to take decisions which may favour the shareholders over the creditors or, worse, one shareholder above anyone else.

### **General**

Unfortunately, there are no simple solutions to many problems of conflict of interest. As it stands, the law does little to resolve the conflicts that are inherent in many commercial arrangements, such as Joint Ventures, and in particular does not recognise the concept of a Director representing the interests of one shareholder above another.

It is possible that future Company Law White Papers may tackle the issue of Directors' conflicts but, until the law is clarified, those involved in Joint Ventures should consider the measures outlined above, and Directors would do well to heed the advice of the Financial Law Panel to be "methodical in the way they make decisions; record reasons for business decisions at the time when they are made; and take advice in cases of doubt and record the advice given. This advice should be followed at all times, not only when there is a reason for nervousness."

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