



JONES DAY COMMENTARY

CONFLICTS OF INTEREST FOR PRIVATE EQUITY PORTFOLIO COMPANY DIRECTORS

New statutory provisions governing directors' conflicts of interest will come into force on 1 October 2008. This *Commentary* provides guidance on the new provisions with reference to investor-appointed directors of private equity portfolio companies and the steps which should be taken in light of this change in the law.

THE NEW STATUTORY DUTY TO AVOID CONFLICTS OF INTEREST

From 1 October 2008, section 175 of the Companies Act 2006 will place an absolute duty on each director to avoid situations in which he has, or could have, a direct or indirect interest that conflicts, or could possibly conflict, with the company's interests. The section 175 duty would cover situations where a director or a person connected with him is:

- a major shareholder (or represents such a shareholder); or
- a director of a competitor, supplier, customer or advisor of the company.

Before 1 October 2008, a director would normally attempt to mitigate conflicts by, for example, excusing himself from board discussions or seeking shareholder consent in relation to the conflict. In contrast, section 175 will oblige directors to prevent such conflicts from arising in the first place unless either the board has, or members of the company have, given prior authorisation in accordance with the new legislation (see below). As such, the new statutory duty represents a potential hazard for directors appointed by private equity investors.

The section 175 duty does not extend to conflicts arising from specific transactions or arrangements with the company in which a director is interested, since those situations are addressed separately in the Companies Act 2006.

The section 175 duty only applies to conflicts arising (as distinct from "existing") on or after 1 October 2008. From a practical perspective, it may be difficult to identify the date on which a conflict actually arises. As such, directors might consider it best practice to

identify and approve pre-existing conflicts with effect from 1 October 2008.

PRIOR AUTHORISATION OF CONFLICT SITUATIONS

Board Approval. The new statutory duty will not be breached if the relevant conflict has been authorised by the directors (section 175(4)). The conflicted director must not be counted for the purposes of determining quorum at the relevant board meeting and must not participate in the decision to authorise his conflict. When deciding to authorise a conflict, each non-conflicted director must consider his duties, including his statutory duty to act in a manner that he believes will promote the success of the company for the benefit of its members as a whole. The non-conflicted directors should also consider if limitations or conditions should be imposed on the authorisation as they are free to apply limitations or conditions to any authorisation they may give.

The ability of the directors to authorise conflict situations in this way is subject to conditions. First, if the company was incorporated before 1 October 2008, the directors cannot authorise conflict situations unless a resolution of the company's members has been passed empowering them to do so (see example wording below). This is provided by Article 47(3) of Part 3 of Schedule 4 to the Companies Act 2006 (Commencement No. 5, Transitional Provisions and Savings) Order 2007 (SI 2007/3495). Secondly, the ability of the directors to provide such authorisation must not be contrary to any provision of the company's constitution (section 175(5)(a)).

In the case of a public company (whether quoted or not), the directors are only empowered to authorise conflict situations if the company's constitution allows them to do so (section 175(5)(b)). It will therefore be necessary to include appropriate empowering wording in the company's articles of association.

Generally, there is no obligation for companies to empower their directors to authorise conflict situations. However, those that do not will have less flexibility in dealing with conflict situations as they will need to rely on shareholder approvals which will involve more time and process than may be desired.

Shareholder Approval. In addition to the need to pass a shareholder resolution to enable the directors to authorise conflicts as mentioned above, the current law enabling members of a company to authorise conflict situations remains (it has been specifically preserved by section 180(4)(a)). This can be obtained by unanimous shareholder consent or by special resolution (on which all members can vote).

Section 180(4)(b) allows matters relating to the approval of conflict situations to be enshrined in the company's constitution, and private equity investors with investor directors on portfolio company boards should consider taking advantage of this flexibility (as long as the scope of the wording employed in doing so is not so broad as to render it void under section 232(1); that section renders void any provision that purports to exempt a director (to any extent) from any liability that would otherwise attach to him in connection with any negligence, default, breach of trust or breach of duty). Private equity investors may also wish to alter the articles of portfolio companies so that authorisation of conflict situations generally is subject to prior investor consent. Example wording is provided below.

SUBSEQUENT RATIFICATION OF CONFLICT SITUATIONS

Allowing a conflict situation which has not been previously authorised in accordance with the new Act to arise will amount to a breach of duty by the relevant director. Any such breach may subsequently be ratified by the company's members (section 239). However, neither the director (if also a member of the company) nor any person connected with him (as defined in section 252) is eligible to vote on the resolution.

DECLARATIONS OF INTERESTS

Declarations in Respect of Proposed Transactions or Arrangements. The current statutory obligation for directors to declare interests has been maintained and enhanced. The provisions described below also come into effect on and from 1 October 2008.

Under section 177, each director who is or ought to be aware that he is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company must declare the nature and extent of that interest to his co-directors before the transaction or arrangement is entered into. If such declaration is or becomes inaccurate in any way, the director must make a further declaration correcting it (section 177(3)). A director need not, however, make a declaration of interest if his interest cannot reasonably be regarded as giving rise to a conflict, if his other directors are or ought reasonably to be aware of it or if it concerns his service contract (section 177(6)).

There are no restrictions on the method for making such disclosures but specific provision is made for declarations to be made in writing (section 184) or by way of a general notice of declaration (section 185). This general notice, which must state the nature and extent of the interest and the connection with the relevant person, can be made:

- in respect of interests of the relevant director (whether as member, officer, employee or otherwise) in a specified body corporate or firm, in which case he is regarded as interested in any transaction or arrangement that may, after the date of the notice, be made with that body corporate or firm;
- in connection with any other specified person, in which case he is regarded as interested in any transaction or arrangement that may, after the date of the notice, be made with that person; and
- only at a meeting of the directors or if the director takes reasonable steps to ensure it is brought up and read at the next meeting of directors after it is given.

If a duty to disclose an interest in connection with a proposed transaction or arrangement arose under section 317 of the Companies Act 1985 (i.e. before 1 October 2008), the duty of disclosure continues under that Act and not the Companies Act 2006 (Article 48(2) of Part 3 of Schedule 4 to the Companies Act 2006 (Commencement No. 5, Transitional Provisions and Savings) Order 2007 (SI 2007/3495)).

Declarations in Respect of Existing Transactions or Arrangements. Under section 182, each director who is or ought to be aware that he is in any way, directly or indirectly, interested in an existing transaction or arrangement entered

into by the company must similarly declare the nature and extent of the interest to his co-directors. No further declaration needs to be made if a declaration in relation to the transaction or arrangement concerned has been made under section 177 (or, where applicable, section 317 of the Companies Act 1985), unless it is required pursuant to the obligation to correct a disclosure which was or has become inaccurate (section 182(3)).

Declarations under this section *must* be made as soon as reasonably practicable (section 182(4)) at a meeting of the directors, in writing (section 184) or by way of a general notice of declaration (section 185). No declaration need be made, however, if the interest would not be declarable in the circumstances described above under section 177(6).

ACTION POINTS

The directors of portfolio companies and their investors should as soon as possible:

- identify their existing actual or potential conflict situations (including conflicts arising from their connected persons);
- circulate an ordinary resolution to the company's members seeking to empower the directors to authorise conflict situations (and, ideally, circulate a special resolution to amend the company's articles to include specific conflict provisions); and
- convene a board meeting to consider and authorise conflict situations as they arise on a case by case basis.

EXAMPLE WORDING

Example wording which may be considered for addressing the situations discussed above is set out at the end of this *Commentary*. This should be considered carefully and adapted for use accordingly, with the benefit of specific advice according to the particular circumstances.

LAWYER CONTACT

If you would like further advice or assistance in relation to directors' conflicts of interest or the practical steps required to be taken to address the new legislation in respect of any company or investment documentation, please contact your principal Firm representative or the lawyer listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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EXAMPLE WORDING

- A. Wording for an ordinary resolution empowering the directors to authorise conflict situations (to be tailored accordingly and only to be passed if doing so does not conflict with the company's articles of association). This wording could be proposed at a general meeting or by way of written resolution:**

ORDINARY RESOLUTION

That, with effect from [1 October 2008 **OR** the date of this resolution] and subject to the provisions of the Companies Act 2006 and the Company's Articles of Association from time to time, the directors of the Company be and are hereby unconditionally empowered for the purposes of section 175 of the Companies Act 2006 to authorise any situation or matter in which any director has, or can have, a direct or indirect interest which conflicts, or possibly may conflict, with the interests of the Company.

- B. Wording to be included in Articles of Association to restrict the ability of directors to authorise conflict situations without investor consent (to be included in the investor protection veto rights):**

1. Investor Consent shall be required before the Company or any member of the Group shall:
 - (A) through its directors, authorise for the purposes of section 175 of the Companies Act 2006 or otherwise any situation or matter in which any director (other than an Investor Director) has, or can have, a direct or indirect interest which conflicts, or may possibly conflict, with the interests of the Company;
 - (B) amend or vary any authorisation referred to in Article 1(A).

"Investor Consent" should be defined by reference to the existing definition in the Articles of Association (or if none, as appropriate).

- C. Wording to be included in Articles of Association to approve investor director conflicts:**

Additional definitions

"associated company"	means, in relation to any company, a subsidiary or holding company for the time being of such company or a subsidiary for the time being of such a holding company;
"Conflict Situation"	means any situation or matter (other than one which cannot reasonably be regarded as likely to give rise to a conflict of interest) in which any director has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the Company including (without limitation) any such situation or matter which relates to the exploitation of any property, information or opportunity (irrespective of whether the Company could take advantage of the property, information or opportunity);
"Investor Group"	means, in relation to any corporate Investor, that Investor and its associated companies from time to time;

Additional article

- 1.1 [Subject to Article []] the directors are hereby empowered for the purposes of section 175 of the Companies Act 2006 to authorise any Conflict Situation that may arise and to amend or vary any such authorisation so given. Any such authorisation, amendment or revocation shall be given by resolution of the directors made in accordance with these Articles and, in the case of such authorisation, that section. The director may give any such authorisation subject to such terms as they shall consider appropriate and reasonable in the circumstances.
- 1.2 For the purposes of sections 175 and 180(4) of the 2006 Act and for all other purposes, it is acknowledged that an Investor Director may be or become subject to a Conflict Situation or Conflict Situations as a result of his also being or having been or being party to an agreement or arrangement or understanding or circumstances under which he may become an employee, director, trustee, member, partner, officer or representative of, or a consultant to, or a direct or indirect investor in and/or otherwise commercially involved with or economically interested in any of the following:
- (A) an Investor; and/or
 - (B) any Investor Affiliate, which for these purposes means any Person who or which, as regards any Investor or any other Investor Affiliate of that Investor:
 - (1) is a member for the time being of its Investor Group or an associated company; and/or
 - (2) is an investment manager or investment advisor to or of it and/or another Investor Affiliate; and/or
 - (3) is a Person in which the Investor and/or another Investor Affiliate may have or acquire a direct or indirect economic interest, including without limitation any portfolio company investee; and/or
 - (4) controls or is controlled, managed, advised (in an investment advisor capacity) or promoted by the Investor and/or such an Investor Affiliate; and/or
 - (5) a trustee, manager, beneficiary, shareholder, partner, unitholder or other financier or any participant in or of it and/or that Investor Affiliate, and/or
 - (C) any carried interest or similar incentive arrangement associated with any Person or arrangement referred to in paragraph (A) and/or (B) of this Article,
- where for these purposes "Person" shall mean any individual, body corporate, fund, trust, partnership or other entity whether or not having separate legal status.
- 1.3 An Investor Director's duties to the Company arising from his holding office as director shall not be breached or infringed as a result of any Conflict Situation envisaged by Article 1.2 having arisen or existing in relation to him and he shall not be held accountable to the Company for any benefit he directly or indirectly derives from his involvement with any person or entity referred to in Articles 1.2(A) or 1.2(B) (irrespective of whether the activities of such person or entity are or may become competitive with those of the Company and/or any of its subsidiaries).
- 1.4 Any Investor Director the subject of a Conflict Situation envisaged by Article 1.2 shall be entitled to:
- (A) receive notice (including any relevant board papers) of, attend, count in the quorum towards and vote at board meetings relating in any way to, and deal generally with, matters concerning, connected with or arising from the Conflict Situation concerned; and
 - (B) keep confidential and not disclose to the Company any information which comes into his possession as a result of such Conflict Situation where such information is confidential as regards any third party.
- 1.5 The provisions of this Article [1] shall become effective on and from 1 October 2008 or such other date as section 175 of the Companies Act 2006 comes into force.

¹ Include this wording if the investor protection veto for which wording is provided in Section B above is to be included (in which case, cross refer to the relevant Article in which it is incorporated).