

## Director tools

This is part of a series of Director Tools prepared by the Australian Institute of Company Directors. The tools have been designed to assist members with general background information and as a starting point for undertaking a board-related activity. These tools are not designed to replace legal advice or to replace a detailed review of the subject matter.

# Conflicts of interest and duty

## Introduction

Every decision made by a board must be impartial and in the best interests of the company and its shareholders. Every individual director has a duty to ensure that his or her decisions are in the best interests of the company of which they are a director.

Conflicts of interest and duty are interrelated concepts.

A conflict of interest is any situation that puts a director in a position to abuse their role for personal or business gain. If a particular decision is likely to benefit a director in any way, or benefit someone close to a director, that director is no longer in a position to make an impartial decision and he or she has a conflict of interest.

A conflict of duty, on the other hand, is a conflict between two different legal or ethical duties. A conflict of duty arises when a director's obligations to one company are compromised by his or her obligations to another company. For example, you may be a director of one organisation which is about to contract with another organisation of which you are an employee.

It is quite common for all directors to have a conflict of interest on a particular matter. For example, directors of a bank voting to increase the interest rate paid to depositors where all the directors hold small deposits with the bank. This would normally not be regarded as a conflict of interest. Corporate governance is concerned with what are known as "material conflicts of interest".

The statutory law does not formally define a material conflict of interest. The extent to which an interest is material depends on the circumstances of each case.

Case law suggests that the word "material" means that a reasonable person might conclude that the conflict has the potential to influence the vote of the particular director. The interest need not be of a direct financial nature. For example, a director's personal relationships may be relevant, if for instance, the director's spouse was an employee of the company and the board is considering a remuneration decision which would impact the spouse.

It is incumbent upon every director to determine whether she or he has a material personal interest. A conflict of interest cannot be declared by other directors for a director who they believe has such a conflict.

Most directors will face one or both of these conflicts at some point in their careers – and there is nothing fundamentally wrong with this. A conflict does not necessarily create a breach of duty and, in some cases, is allowed by law.

The problem is less the conflict itself than how it is handled.

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## Points to consider:

- If you sit on more than one board, you have a potential conflict as soon as they form any kind of relationship. For instance, one might be a supplier or a customer of the other, or you might be on the boards of both a bank and a company that would like to borrow money from that bank.
- Self-interest can lead to conflict. Directors who are strongly motivated to maintain their position and income are likely to be very compliant – reluctant to ‘rock the boat’ for fear of making themselves unpopular. In focusing on their own interests, rather than those of the company, they lose their impartiality.
- Conflict of interest is first and foremost an ethical issue. The law makes it clear the director must act in the best interests of the company and be free from any conflict; however it is up to individual directors to act with good conscience in identifying relationships and behaviours which may give rise to a conflict.

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## Steps to take when you may be in conflict

1. If you suspect a conflict, inform your fellow directors immediately.
2. Companies may maintain a standing register of conflicts of interest. These allow a chairman or other designated individual to take action prior to a board meeting – for example to restrict access to board papers about the matter for the conflicted director.
3. Be ruthless in questioning your relationships, especially where an outcome is particularly close to your heart. Ask yourself whether a reasonable person would conclude that a conflict exists; this is the yardstick used by the courts.
4. Don’t dismiss any conflict as too trivial to report. For instance, while a sum of money may be a fraction of the company’s annual outgoings, it could be significant if is being paid to your spouse.
5. How you handle a conflict will depend upon the type of legal entity of which you are a director. For example under the Corporations Act the requirements are different for directors of a proprietary company (Pty Ltd) than a public company (Ltd). In a private company, provided the conflict is known to the other directors, a director may vote on the issue where he or she has a conflict. You must look at the particular legislation that created the organisation and the constitution to determine what actions must be taken.
6. For directors of a public company, once a conflict has been declared by a director, the director may take no further part in deciding how it should be resolved. The rest of the board may decide to:
  - exclude you from further discussions on the subject
  - allow you to be present at discussions but not to vote
  - ensure that you receive no further information relating to the issue.

This is also good practice for many other types of companies and boards.

7. If you are so deeply conflicted that you find yourself excluded from most of the board’s decision-making you are no longer able to discharge your duties. In this situation you may have no choice but to eliminate the conflict completely or resign from the board.
8. If the board does ask for your vote, make sure that there is a clear record of your motivation and that this is aligned with the interests of the company as a whole. Again, ask yourself what a reasonable person would conclude.
9. If you are a nominee director – acting on behalf of another person, or a firm such as a bank, investor or lender – take particular care with the information you are asked to disclose. Like the rest of the board, you are bound to act in the best interests of that company. At the same time, failure to disclose certain information to the company that nominated you could amount to a breach of duty.
10. If you have a relationship with two companies, disclose your interest in one before acting for the benefit of the other.

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11. Speak out if you suspect that a colleague has a conflict; keeping quiet is a breach of your duty to the company. Raise the matter with the chairman or, if the chairman is the subject of your concern, a senior independent director. You could also speak to an expert and impartial adviser at an organisation such as the St James Ethics Centre.
  12. Remember that while you can and should raise a perceived conflict of interest that you believe exists for another director, the board cannot take action to exclude that director unless he or she agrees. If they do not agree they have a conflict of interest you may need to approach legal counsel for an opinion, ASIC or the courts.
  13. Keep a register and ask at every board meeting whether anyone needs to report a potential conflict.
  14. Encourage a boardroom culture where conflicts of interests are discussed as a matter of course and the whole group takes responsibility for them.

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