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COMPANIES ACT 2006 AND DIRECTORS' DUTIES

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Seminar Notes for delegates

Talk to Chamber of Commerce- 13th January 2009

Introductory Note: The talk and these notes do not offer advice in relation to any particular transaction or individual situation. These should be discussed with a qualified legal advisor and for further information please contact Gill Gardner at:

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Summary of Talk	Delegate Notes
COMPANIES ACT 2006 – DIRECTORS' DUTIES **TALK TO LANCASTER CHAMBER OF COMMERCE ON 13 JANUARY 2009** 1. **What is the background to the 2006 Act?** The Government's intention behind the new legislation is to reflect modern needs. In doing so it wanted to make it easier to set up and run a company both now and in the future. 2. **When does the 2006 Act come into force?** Royal Assent has been given to the Act and therefore it has become law. However the Act is being introduced in stages with all of it coming into effect by October 2009. Significant parts of the Act are now in force and major areas were enacted on 1 October 2008. The remainder of the Act will come into force on 1 October 2009. 3. **What are the main areas which the new legislation was designed to deal with?** The company law commission and the government looked at all aspects of the existing legislation and company law contained in case law to review, update and change the existing regime and some of the headline changes are as follows: • The codification of director's duties. • Relaxation of the authorisation required for director's conflicts of interest. • Shareholder litigation. • Political donations and expenditure. • Simplifying procedures for shareholder meetings and resolutions by using electronic notifications. • Removing the requirement for a company secretary for a private company.	

- Lifting the prohibition on financial assistance for private companies.

- Simpler procedures for reduction of share capital.

- New formation procedure making the memorandum of association an historic document with the articles of association becoming the principal document of governance; a company incorporated under the 2006 Act will have unlimited powers (post 1 October 2009).

- New accounting arrangements from April 2008 (reducing the deadline for production of accounts to Companies House from 10 months to nine).

- Companies are now able to agree a limit on the auditors' liability with shareholder consent, but must be 'fair and reasonable'.

- Abolition of authorised share capital but shares must still have a nominal capital. The cap on authorised share capital can be removed by special resolution (proposed to be in force October 2009).

- Confidentiality of officers' home addresses

PART ONE –ADMINISTRATIVE CHANGES

1. What will be the effect or benefit of the new electronic communications regime?

Changes were implemented in January 2007 under the Companies Act 2006 and (for listed companies) under the Disclosure Rules and Transparency Rules sourcebook.

The communications provisions in the 2006 Act apply to all private and public companies. Sections 308, 309, 333, 1143 and schedules 4 (communications sent to a company) and 5 (communications sent by a company).

It recognises the use of email and the internet in everyday transactions and the streamlining will be very welcome for all companies. The de-regulation of private companies administration was one of the government's prime aims pursuing its 'think small first' policy.

The 2006 Act introduces a new provision which allows a shareholder to communicate with the Company by electronic means where the Company has given an electronic address in a notice calling a meeting or in an instrument of proxy (or proxy invitation) or in a circulated written resolution.

Schedule 5 to the 2006 Act also allows companies to send or supply documents and information to shareholders in electronic form and by a website (subject to shareholder approval).

Companies wishing to take advantage of the new communications regime need to take certain steps and also fulfil certain requirements.

2. What does the Company need to do if it wants to allow members to send documents or information to it in electronic form?

- Amend the meeting notice to include an electronic address for the Company.

- Amend the proxy instruments and invitations.

- Amend the form of written resolution to allow for circulation and return by electronic means, including an electronic address.

- Consider how to verify the identity of the sender.

- Consider whether or not any conditions or limitations need to be imposed on the use of the Company's electronic address.

- If the Company has no specific rules on authentication, the default position is that if a communication contains, or is accompanied by, a statement of the identity of the sender and the Company has no reason to doubt the truth of the statement, the document will be sufficiently authenticated.

What does the Company need to do if it wants to send documents or information to members in electronic form or by website?

- Some companies already have in place, with an individual shareholders' agreement and his electronic address, the entitlement to circulate annual report and accounts and summary financial statement of AGM notice by electronic means. This has been possible under the 1985 Act. This will continue.

- Whilst there are specific proposals relating to listed companies, in relation to private companies, a request letter will need to be sent to each member of the Company asking for agreement to receive documents or information in electronic form. The members must also be asked to supply an electronic address for this purpose. Members' individual consents will be needed if satisfactory existing arrangements are not in place.

- Documents sent electronically are deemed to have been delivered 48 hours after they are sent.

What to do to send documents by means of a website?

- Individual shareholder consent will also be required to communicate in this format.

Will the Articles need to be amended?

- In relation to the 2006 Act generally all Articles of Association should be reviewed. In this particular context they need to be reviewed to consider whether they need to

be amended to:

- Permit the Company to communicate with its members via a website where the Articles do not already allow this; or

- Permit the Company to go further than the terms of the Articles, e.g. provide more general cover for other documents that the Company wishes to communicate by a website.

The recommended best practice is that companies should seek shareholder approval by an authorising resolution or change of Articles unless it is absolutely clear that the Articles have already been drafted in clear anticipation of the deemed agreement provisions for website communication. It is unlikely that existing Articles will actually do that unless they have been drafted with the 2006 Act in mind.

A member will still be entitled to request a hard copy of any document or information; therefore it will be important to include additional numbers of documents in any print run to ensure the Company can meet the requests.

No charge can be made for sending the document or information in hard copy form.

Obviously, record keeping in terms of consent will also be necessary.

3. What are the simplified procedures for shareholder resolutions?

Before the 2006 Act resolutions generally required a minimum of 14 days notice and 21 days notice for a special resolution and an AGM. This could only be circumvented with an agreement to short notice by shareholders 95% of the voting rights or a written resolution of all the shareholders (sometimes also requiring auditors' confirmation); even when the resolution in question required only an ordinary majority.

This was universally agreed as cumbersome and the new procedure will be very welcome. A written resolution of a private company signed by shareholders will now be effective where the company receives resolutions signed by the requisite majority i.e. over 50% for an ordinary majority and 75% for a special resolution. Coupled with the electronic regime this will significantly reduce the time for resolutions to be passed; and avoid the need for meetings.

This legislation is already in force and is proving very useful indeed: Part 13 of 2006 Act (sections 281-361).

If a private company decides that it does wish still to hold a meeting, then only 14 days notice will be required any resolution. For a public company 21 days notice is still required for an AGM. Short notice for a private company has been reduced to 90% approval.

As with the Companies Act 1985, the written resolution regime does not extend to the removal of a director.

There are express provisions (also now in force) relating to the authorisation of political donations. There were similar provisions in the 1985 Act but some changes have broadened the requirement for shareholder consent.

4. Do we need an AGM?

Private companies no longer hold an AGM but shareholders can demand a meeting if shareholders holding not less than 10% of voting rights request one.

Under transitional legislation this relaxation is overridden by any requirement in a company's articles that it should hold an AGM (Table A 1948 does this).

5. Have there been any other changes to voting procedures?

An interesting change has been that a chairman's casting vote in the event of an equality of votes on a show of hands is no longer effective, even if the company's articles contain such a provision.

There are also some changes relating to proxies which will need checking, if relevant.

6. What is financial assistance and how will its abolition for private companies affect us?

Under the Companies Act 1985 it was unlawful for a company to provide 'financial assistance' in relation to the acquisition of its own shares (as a protection for creditors). There were provisions in the Companies Act 1985 for private companies which relaxed these requirements where a 'white-wash' procedure was undertaken involving a special resolution, statutory declaration by directors and an underlying auditors' report relating to that declaration. The typical situation which occurred on a takeover was that the target company was required to enter into bank security for the purchaser's indebtedness. This would require the 'white-wash' in order to be legal.

Under Part 18 of the 2006 Act (now in force), only public companies will be subject to the requirement. This is a quite radical departure from the past and the laws on the maintenance of capital (which still apply to private companies) will have to be reviewed in relation to any individual transaction.

In practice this abolition will cut down the time required and the cost implications of corporate transactions where this was generally an issue.

However, private company directors will still need to give consideration to:

(i) their directors' duties and whether the transaction is for the company's benefit;

(ii) the solvency of the company; and

(iii) capital maintenance

before they allow a company to give security that constitutes financial assistance, which will typically constitute a guarantee supported by a charge or a third party charge.

The new regime may give the banks some concern. Banks still need to be certain that the security is given for the company's benefit and that the company is solvent after the giving of security constituting financial assistance, to ensure that it is valid. It must not constitute an unlawful reduction of capital.

Corporate benefit has long exercised lawyers. Corporate benefit must be clearly established. Further directors must, in particular, act in accordance with Section 172 Companies Act 2006, as to which more below. If the recipient of security is on actual or constructive notice of a breach of Section 172, the security itself will be unenforceable.

It has, of course, always been established practice for directors to record in Board Mintues the reasons why they believe the granting of security is in the best interests of a company. This will continue. In the event of any doubt, the members of the company should be asked to pass a Special Resolution, directing that the security be given.

7. Could you just summarise what we should be considering by way of action points relating to administration?

- Conduct an in-depth review of the articles of association of the company (however this may be premature in the light of new model articles being circulated currently, but not yet finally agreed).
- Consider the timing of any changes (should they be after 1 October 2008 or 1 October 2009?).
- Review timing/necessity of AGMs.
- Implement new electronic communications regime.
- Consider whether infinite resolution for authorised share capital is desirable.
- Does the company wish to retain a company secretary?
- Consider if the abolition of a chairman's casting vote has consequences for joint venture companies.

PART TWO – DIRECTORS' DUTIES AND OTHER PROVISIONS AFFECTING DIRECTORS

1. **How will the codification of directors duties affect the day to day running of our Company?**

    - Directors will for the first time be able to look at specific legislation to understand the nature and extent of their duties to their company.
    - At directors meetings they should consider these duties and the matters to which they are required to have regard.

This should not require significant changes to the board decision making procedures.

- Board minutes should be kept and where relevant, there should be minuted that the directors have discussed the matter and its implications for the company.

The 2006 Act has for the first time in company law history codified directors' duties. Until this point the duties existed in case law and the purpose of the 2006 Act has been to reflect the current duties as set out in the common law. There has however been a significant amount of commentary that the new duties are different to the existing common law, particularly in the new expression that directors are required to 'act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole'.

Directors in particular may need to have a different approach when considering e.g. to wind a company up; consider significant changes to control and ownership. Inevitably some of these queries will be capable of clarification in the courts. In the meantime we recommend:

- Ensuring all directors are aware of the relevant provisions of the 2006 Act (sections 170 -174).

- Ensuring directors are aware of prospective duties relating to conflicts of interests (sections 175-177) which came into force on 1 October 2008.

- Directors consider the factors listed below (see question 2 for detail) – this does not have to be minuted, but it would be prudent to do so where there are controversial decisions being made, as evidence that this was done.

- An induction policy be prepared for new directors.

Note 1: Directors should also be aware of the increased shareholders' protection. See question 4 below. The combination of the new codified directors' duties and the extended shareholder rights relating to derivative actions may very well lead to increased litigation.

Note 2: There are of course other duties imposed on directors contained in other statutes, e.g. health and safety, insolvency.

2. What are the duties?

There are 7 general duties all of which are now in force:

- **Duty to act in accordance with the company's constitution and to use the powers only for the purposes for which they were conferred.**

- **Duty to promote the success of the company for the benefit of its members.**

- **Duty to exercise independent judgement.**

- **Duty to take reasonable care, skill and diligence.**

The following duties came into force on 1 October 2008:

- **Duty to avoid conflicts of interest.**
- **Duty not to accept benefits from third parties.**
- **Duty to declare to the company's other directors any interest a director has in a proposed transaction or arrangement with the company.**

The duty to avoid conflicts of interest codifies the Common Law Rules on conflicts of interest, with some important modifications. A director must avoid situations in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the company's interests. This applies in particular to multiple directorships and to the exploitation of property, information or a business opportunity. This would be the case even if the company is not in itself in a position to take advantage of it. A statutory duty provides that there will be no breach if the matter is validly authorised by the company.

Under Common Law, only the shareholders can authorise a director's conflict of interest. However, under the new Act, authorisation by non-conflicted directors is permitted in a private company, provided that the company's Articles do not invalidate the authorisation. This is an important relaxation. Shareholder approval is still required if all directors are or may be conflicted.

The government has commented that the duty is a heavy one and is intended to be so. The duty does not, however, arise if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest.

This particular duty does not apply to a conflict of interest arising in relation to a transaction or arrangement between a director himself and the company, in which case a director must declare his interest in much the same way as before.

So far as the duty to declare interests is concerned, the new statutory duty reflects the position in the Companies Act 1985 and in the Articles of most companies, with slight modifications. A director must disclose the nature and extent of his interest **before** the company enters into the proposed transaction. The notification must be updated if it becomes inaccurate or incomplete. If he complies, the transaction is not liable to be set aside on equitable or Common Law grounds.

3. How do the directors 'promote the success of the company'?

The new wording including the duty to promote the success of the company has led to many questions being raised; few of which in fact have been answered. In particular there are concerns as to whether 'the company' has a separate set of interests, by virtue of its separate legal entity, or whether the interests of the members as a whole will always be paramount.

We also may have differing views as to what is meant by success.

Lord Goldsmith (government spokesman on the Act) has commented that he views this as meaning a 'long term increase in value'.

The intention is that directors will not be required to decide questions in any different way than they would have done prior to the 2006 Act.

Relevant Factors

In deciding how to promote the success of the company, directors are required to have regard to the following factors:

- The likely consequences of any decision in the long term,
- The interests of the company's employees,
- The need to foster the company's business relationships with suppliers, customers and others.
- The impact of the company's operations on the community and the environment.
- The desirability of the company maintaining a reputation for high standards of business conduct.
- The need to act fairly as between members of the company.

As some of these factors could very well be contradictory, the list (section 172) has given rise to some significant concern. Note however that the directors must consider these factors and can then decide it is irrelevant, then move on. Also the government has made it clear that the new provision is not intended to impose additional bureaucracy and is, conversely, intended only as a confirmation of good practice.

The concept of promoting the success of the company and the non-exhaustive list of factors, has been the most controversial aspect of the new Act as far as director's duties are concerned. The government has described Section 172 as a radical departure in articulating the connection between what is good for a company and what is good for society at large. It is said to reflect cultural change in the way that companies conduct their business – that it is not recognised that pursuing the interests of shareholders and embracing the wider responsibilities flagged in the list of factors are complimentary purposes, not contradictory ones. However, commentators are not agreed that this is the case.

Directors are concerned that the list of factors in particular may make them more vulnerable to action by liquidator in the event of insolvency, or to a derivative action by shareholders under the new, more comprehensive regime (see paragraph 4 below).

4. Will the streamlined shareholder dispute mechanisms leave directors more open to liability?

In short, in all likelihood, our view is that it will.

Before the 2006 Act shareholders had only a very limited right to

take action against directors in the name of the company. They might seek to do this if the directors have been negligent or in breach of their duties to the company. There were very strict conditions to the shareholders being able to do this. This is called a derivative action.

The new right in the 2006 Act undoubtedly makes it easier for shareholders to take directors to court in a wider range of circumstances. It also allows the shareholders to claim against a third party in the same action.

The legislation has sought to deal with directors concerns by introducing a 3 stage process:

- An aggrieved shareholder unilaterally (ex parte) applies to court for permission to make the claim; and permission will be granted only if the court is satisfied a prima facie case has been made out.
- At Stage two the court decides whether, based on the evidence of both sides, the claim should be allowed to proceed.
- Only if stage 2 is satisfied will the matter proceed to stage 3 which is full trial of the issues.

These stages should reduce the risk that the changes lead to more litigation. However there remains that risk that activist and dissenting shareholders will use the new procedures at least to create adverse publicity and put decisions of boards of directors under much greater scrutiny.

5. Are there any other significant changes relating to directors I should be aware of?

- A company must have at least one director who is a person (not a company).
- Directors will be required to file an address for service on the public record. A directors' home address will be held as protected information at Companies House.
- A new minimum age of 16 is set for directors.
- No age limit (consistent with age discrimination legislation)
- All companies are able to make loans to their directors if, after full details have been provided, the loan is approved by shareholders. Prior to the 2006 Act, such loans were generally prohibited, subject to various exceptions.
- Companies are able to enter into transactions (substantial property transactions) that previously required prior shareholder consent, before that approval has been obtained, as long as the transaction is made conditional on such approval.
- Shareholder approval will be required where a company proposes to make a payment to a director in compensation for loss of his employment as a director of the company

(not just for loss of his office as director) which goes beyond his existing contractual entitlement.

6. Could you just summarise what we should be considering by way of action points relating to the changes relating to directors?

- Conduct an in-depth review of the articles of association of the company (however this may be premature in the light of new model articles being circulated currently, but not yet finally agreed).
- Review directors' and officers' indemnity insurances.
- Consider the review and/or implementation of board policies for management and decision making.
- Ensure proper minute taking of board decisions to ensure best practice.
- Ensure proper training and induction policies for directors regarding their duties.
- Ensure the mechanism for dealing with conflicts of interests is understood.
- Maintain a record of directors' interests.

PART THREE – SUNDRY CHANGES WORTHY OF NOTE WHICH CAME INTO FORCE ON 1 OCTOBER 2008

1. Reduction of Capital

There is a new procedure for private companies to make capital reductions supported by a solvency statement, instead of by Court Order.

2. Director Capacity

Companies will have to have at least one natural person as a director, so a company cannot be a sole director of another company.

3. Age

There is a new minimum age of 16 for directors.

PART FOUR – PROVISIONS TO BE COMMENCED ON 1 OCTOBER 2009

4. Default Model Articles

There will continue to be default model Articles, but there will be separate model Articles for private companies and public companies. There is a draft of model Articles available and this is quite different from Table A as it relies heavily on statutory provisions within the Companies Act 2006.

5. Memorandum of Association

The company's Memorandum will become a formal document regarding the position at the point of registration. The Articles will be the only continuing constitutional document.

For companies formed before 1 October 2009 any provisions contained in their Memorandum which go beyond the newly required limited information will be regarded as provisions of their Articles of Association.

Companies will no longer be required to specify their objects.

6. Director Addresses

The information that companies must file relating to its directors will change so that for each director, a service address and a country of usual residence will be required in addition to the home address. This will apply from 1 October 2009 for new appointments. For existing directors, a service address and the country of residence will be required in annual returns made up to dates after 30 September 2009. Home addresses will not be put on the public record after that date.

CONCLUSION

With 1,300 sections, this briefing could not cover every provision of the 2006 Act which is in force or which will come into force. If detailed legal advice is required please contact a member of our Company Department Team.

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