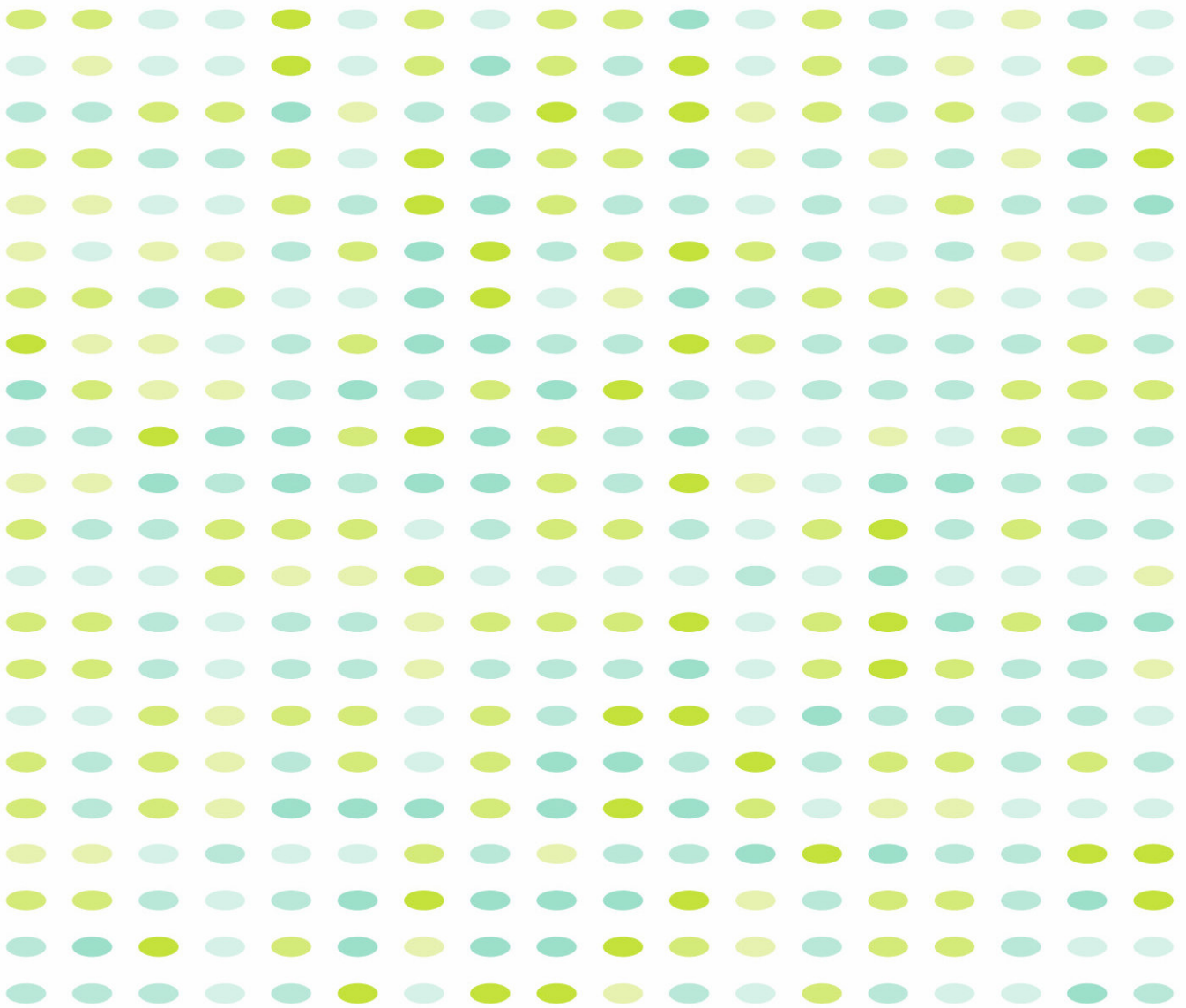


The SWAIN guide to: The Companies Act 2006



The SWAIN guide to: The Companies Act 2006

The South West Angel and Investor Network (SWAIN) connects private investors “Business Angels” with companies looking for investments.

SWAIN specialises in helping small and medium sized companies to find equity and assists private investors in the South West to search for investment opportunities businesses with growth potential.

The following guide has been produced in association with Michelmores to help you understand the changes which are being introduced by the Companies Act 2006.

Introduction to the Companies Act 2006:

The Companies Act 2006, represents the most significant change to UK Company Law in twenty years.

The Act, which was granted Royal Assent on 8th November 2006 is the longest ever to have been considered by Parliament. Its 1300 sections and 16 schedules are either now in force or will be implemented over the next 18 months. As the Companies Bill, the provisions were heavily debated in both the House of Commons and the House of Lords and were also subject to much scrutiny by the business community and the media.

The Act will repeal and replace virtually all of the existing Companies Act 1985 and Companies Act 1989. The Act implements significant new provisions, restates those sections of the 1985 Act which are to remain as law, removes many others and codifies certain aspects of Company Law which have developed over time through the courts.

It is essential that companies are prepared for these changes, and numerous others which are made by the Act, many of which are scheduled to become law in October of this year.

History of the Act:

March 1998	July 2001	2002	March 2005	Nov 2005	May 2006	2006	8 Nov 2006	1 Dec 2006
Company Law Reform Commissioned	Final CLR Report	Initial Response by White Paper	Further White Paper to Lords	Company Law Reform Bill introduced	Bill passed to House of Commons	Several amendments by Lords and Commons	Royal Assent granted	Final text of Act available

Implementation

Under recent government proposals, the provisions of the Act will be implemented over the next 18 months.

Aims of the Act

The reform of Company Law was intended to encourage an entrepreneurial and dynamic business environment and to “provide the best possible conditions for the success of British Industry”.

The Act aims to address concerns of over-regulation, particularly in relation to small companies. A “think small first” attitude pervades the Act, and is particularly evident in the revised requirements of corporate governance. The overall intention is to de-regulate, modernise and streamline Company Law for the 21st Century.

KEY PROVISIONS OF THE ACT:

Directors’ Duties

(i) Directors’ Duties under the Current Law

Directors’ fiduciary and common law duties have evolved through case law, and may be summarised as the following:

- the duty to act in good faith in the best interests of the company;
- the duty to exercise the appropriate level of care and skill;
- the duty to act within the powers conferred by the company’s constitution and to exercise those powers for a proper purpose;
- the duty to not fetter discretions;
- the duty to avoid conflicting interests and conflicting duties; and
- the duty to not make a secret profit.

The first of these duties was seen as the overriding duty by which a director was to discharge the duties of his office. Provided that

decisions were taken in good faith and in the best interests of the company, the director was afforded a substantial degree of protection.

The courts have interpreted the expression “good faith in the interests of the company” to mean the interests of the shareholders (or members) of the company as a whole (unless the company is insolvent or nearing insolvency in which case the interests of creditors should also be taken into account), and when considering the “interests of the members” the courts expect directors to balance the short-term interests of current members against the long-term interests of future members.

(ii) Directors’ Duties under the Companies Act 2006

The Act codifies directors’ duties, placing the six duties that have developed through case law on a statutory footing. The provisions are intended to replace the common law and equitable rules, however, it is expressly stated that “*regard is to be had to the corresponding common law rules and equitable principles*” in interpreting the statutory statement of directors’ duties.

There is also a new duty on directors 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 and in doing so have regard (amongst other matters) to ...*”

- *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; and*
- *the need to act fairly as between the members of the company.”*

This is one of the most controversial of the Act’s provisions.

The clause is seen to increase the duties of directors and to remove the protection previously afforded to directors acting in good faith in the best interest of the company.

There is concern that the Act does not provide guidance on the weight attributable to each “factor”, and that the list is expressed to be “not exhaustive”. In addition, as the wording of the clause is so far removed from the existing common law duty, it is unclear to what extent the principles which have developed through the case law of the last two centuries will apply to the new duty.

Another source of controversy in this provision is that there is no definition of “success”, although the government has suggested that it will normally mean a “long term increase in value”. Some commentators also perceive a need, in light of this provision, to document every material decision made by a director to illustrate that they have taken into account the specified criteria. This argument has been rejected by the Attorney General, Lord Goldsmith who said that the section did not require a “paper trail” for each such decision, however, we would suggest that as a matter of good corporate governance directors should routinely document their decisions in board minutes wherever possible.

The codified duties will apply to all the directors of a company, including shadow directors. Two of the duties will also apply to former directors, those being the duty to avoid conflicts of interest and the duty not to accept benefits from third parties.

Shareholder actions

(i) Shareholder actions under the current law

Under the current law, an action can only be brought by a shareholder in respect of an act taken by a director if they can establish an exemption to the principles set out in the case of *Foss v. Harbottle (1843)*. In that case, the court held that (i) the company, rather than a shareholder, is the proper plaintiff for a wrong done to the company (and as such, individual shareholders are not empowered to take action for a wrong to the company) and (ii) the court will not intervene where the wrong has been ratified by a shareholder vote.

There are a number of limited exceptions to the rule in *Foss v. Harbottle*, in particular, where there is control of the company by the wrongdoers and there would be a fraud on the minority. Claims can also be brought for ultra vires actions, for breaches which cannot be ratified by a simple majority vote and where personal rights of the shareholders have been infringed.

(ii) Shareholder actions under the Companies Act 2006

The Act sets out a new, statutory procedure for shareholder action, prescribing a wider range of circumstances in which a derivative action may be brought than is the case under the current law. Shareholders with court approval are given a statutory right to sue directors and/or potentially third parties, such as the company’s auditors, in a derivative action on behalf of the company for negligence, default, breach of duty or breach of trust, even if the director has not personally benefited from the breach. This right is irrespective of the size of the shareholding of the complainant, and whether or not that shareholder owned shares at the time of the alleged wrongdoing.

The particular concern with this section is that such claims will be brought on the grounds that a director has failed to comply with the new duty to act to promote the success of the company.

During the course of the Bill’s passage through Parliament this new right received much attention, and the relevant sections have

been amended in an attempt to guard against spurious actions. As a first step a complainant must apply to the court for permission to proceed with their claim. The court may then: dismiss a claim which has insufficient prima facie evidence; make a costs or civil restraint order against the applicant; adjourn the application to allow the company to provide rebuttal evidence; or, consider the evidence of independent shareholders.

There is a fear that, notwithstanding these safeguards, the increased potential to bring shareholder actions could result in abuse. It is foreseeable that tactical litigation could be brought against directors by well-funded special interest groups and activists (such as animal rights protestors) with minimal shareholdings in a company which is the target of their activities. Even if ultimately unsuccessful, such claims would create unwanted publicity for the company, divert valuable management time and cause disruption to the company's business.

It is still possible for a director's act to be ratified by shareholder approval under the new regime, however, in so doing, the votes of the director in question and any connected parties will be disregarded.

Companies should review the provisions of their Directors' and Officers' liability insurance policies to ensure that the defence of a derivative claim would be covered.

Substantial Property Transactions

The rules relating to Substantial Property Transactions are relaxed under the Act so that shareholder approval will not be required where a company buys or sells a non cash asset to or from a director or a director of its holding company (or a person connected with such a director) unless the asset is worth in excess of £5,000. This replaces the £2,000 threshold applicable under the Companies Act 1985.

The exceptions, where shareholder approval will **not** be required, have also been widened, and companies will also be permitted to enter into arrangements conditional upon obtaining shareholder approval.

Directors' Loans

The general prohibition on loans and quasi-loans between a company and its directors is abolished by the Act and replaced with a requirement to obtain shareholder approval.

The Act also abolishes the criminal penalty for breach of the provisions on loans and widens the scope of the exemption for expenditure on company business.

Financial Assistance

In respect of private companies, the statutory prohibition on financial assistance for the acquisition of the Company's own shares is abolished. The prohibition remains for public companies.

Electronic Communications and Website Disclosure

(i) Electronic Communication

The Act promotes electronic communication between a company and its shareholders by providing that a shareholder may communicate with the company by electronic means where the company has provided an electronic address in, for example, the notice of a meeting.

If authorised by a shareholders' resolution or under the company's articles of association, the Act also permits companies to provide certain information, such as the company's annual report and accounts, its summary financial statement or notice of an AGM, on the company's website. The company must, of course, notify its shareholders and others entitled to know of the information (usually by post) of the presence of the document or information on the website, and hard copy versions of the document or information must be provided to shareholders that request this.

If companies wish to take advantage of these provisions they should consider whether their articles of association should be amended at the next AGM.

(ii) Website disclosure

The Act requires that companies include the following information on their websites:

- the company name;
- the company's registration number;
- the company's registered office.

Auditors' Liability

Auditors will be able to limit their potential liability owed to a company for loss arising from negligence, default or breach of duty or trust in relation to the audit of the annual accounts. This will be done by contractual agreement between the auditors and the company.

The form of that agreement will be a Liability Limitation Agreement (**LLA**), the principle terms of which must be approved by the company's shareholders each year by ordinary resolution (unless a higher threshold is required by the company's articles of association). The limit of liability will only be enforceable if it is "fair and reasonable" having regard to the auditor's responsibilities and the professional standards expected of him.

Companies will be required to disclose any Liability Limitation Agreement which they have agreed with their auditors.

The government has, at the time of this note, reserved powers to prescribe the nature of this disclosure. It is anticipated that disclosure of LLAs will either be required in the company's annual accounts or the directors' report.

Capital

Both private and public companies will no longer be required to have an authorised share capital (i.e. a limit on the maximum amount of share capital which can be allotted).

If shareholders do wish there to be a limit on the number of shares that can be issued by a company, this will need to be included as a

restriction in the company's articles of association.

The authorised share capital of an existing private company, however, will continue until this is removed from the company's articles of association.

Directors of private companies will also not require any authority to allot shares where the company has one class of shares, unless the articles provide otherwise.

Directors and Company Secretaries

Private companies will no longer be required to have a Company Secretary, but they may choose to retain one.

It will also be possible to incorporate a company with only one director. However, there is a new requirement that all companies must have at least one natural person as a director.

On the incorporation of a new company, the directors will, under the Act, be permitted to provide a service address instead of a residential address, and it is this service address that will be entered onto the publicly accessible register of directors held at

Companies House. A separate, secure register will be kept of residential addresses.

Meetings and resolutions

(i) Notice of meetings

The notice period for all general meetings (other than the AGMs of a public company) will be 14 days. This is irrespective of whether a special resolution is proposed at the meeting.

In addition, the holders of 90% of the voting shares (or such higher percentage not exceeding 95% as may be specified in the company's articles of association) will be able to agree to hold a meeting on short notice.

(ii) AGM

The requirement for a private company to hold an annual general meeting is abolished, and such companies are also no longer obliged to lay accounts and reports before general meetings.

Private companies may, however, elect to hold AGMs in their articles of association.

(iii) Resolutions

Under the Act, the requirement that written resolutions be approved with the unanimous consent of the shareholders is replaced with a provision enabling such resolutions to be approved by a simple majority of the shareholders eligible to vote for an ordinary resolution and with the approval of 75% of the shareholders eligible to vote in the case of a special resolution.

Conclusion

Many of the provisions of the Companies Act 2006 are to be welcomed, particularly those that have been adopted to correct the over-regulation of small businesses.

This guide covers those provisions of the Act which are the most fundamental and of general applicability. Directors of a company should have particular regard to the new statutory duty

to act to promote the success of the company and should be alert to the increased risk of shareholder actions. They should also ensure that website compliance is made a priority, as these provisions are already in force.

Inevitably, given the size of the Act, there are many changes which we have been unable to address in this guide. Should you have any specific queries or require further information please do not hesitate to contact us (for contact details, please see below).

This guide states the law at April 2007 and is for information purposes only. It is not intended to constitute legal advice

For further information on any of the issues raised in this guidance note please contact:

Malcolm Dickinson, Stephen Morse
or Samantha Billingham on 01392 688 688

Exeter Office

Michelmores Solicitors

Woodwater House, Pynes Hill, Exeter EX2 5WR
Tel: 01392 688 688

London Office

Michelmores Solicitors

Clarges House, 6-12 Clarges Street, London W1J 8DH
Tel: 0207 659 7660