MILLS & REEVE

What Universities need to know about the Companies Act 2006
Provisions affecting private and charitable companies
January 2009

The new Act

The Companies Act 2006 ("Act") finally received Royal Assent on 8 November 2006 bringing into existence the longest piece of legislation ever to pass through Parliament (760 pages, 1300 sections, 16 schedules, 275 pages of explanatory notes and over eight years in consultation!). Its brief was, in general terms, to simplify and modernise company law so as to ensure that it meets the needs of today's business.

The new Act is just the starting point. A plethora of secondary legislation, needed to add detail to the bare bones of the Act, has been published in the past two years and the paper mountain continues to grow.

New regulations were brought into force imposing obligations with effect from **1 January 2007** on the disclosure of company information on, amongst other things, a company's website, its business letters and its order forms (in electronic, hard copy or any other form). Also, from that date provisions facilitating improved electronic filing at Companies House were introduced. From **20 January 2007** an updated e-communication regime came into effect making it easier for companies to communicate with their shareholders via website postings or e-mail (subject to the company obtaining specific shareholder approval to do so).

A small number of minor amendments and amendments relating to takeovers came into force on **6 April 2007**. A large chunk of the Act, including some of the most controversial parts (namely the new regime for codification of directors' duties and the new procedure for disgruntled shareholders to bring actions against directors, the derivative claim) came into force on **1 October 2007**.

More of the Act was introduced on **6 April 2008**, including a number of accounting and audit changes, and on **1 October 2008**, including the rules relating to directors' conflicts of interest, the abolition of financial assistance for private companies and the new solvency statement procedure for capital reduction by private companies. New rules on company constitutions and the rest of the share capital changes are amongst the provisions delayed until **1 October 2009**. A detailed table of commencement dates is available on the Department for Business, Enterprise and Regulatory Reform's website.

Mills & Reeve LLP is a limited liability partnership regulated by the Solicitors Regulation Authority and registered in England and Wales with registered number OC326165. Its registered office is at Fountain House, 130 Fenchurch Street, London, EC3M 5DJ, which is the London office of Mills & Reeve LLP. A list of members may be inspected at any of the LLP's offices. The term "partner" is used to refer to a member of Mills & Reeve LLP.

Key changes

The key changes introduced (or to be introduced) by the Act affecting **all companies** are:

- the introduction of a statutory statement of directors' duties;
- changes to the rules regarding directors' conflicts of interest;
- protection against disclosure of directors' and shareholders' home addresses;
- the introduction of a new procedure for members to bring claims against directors on behalf of the company; and
- a new power for companies, subject to shareholder approval, to agree to limit their auditor's liability.

In addition, there are a number of changes affecting **private companies** including:

- more straightforward provisions relating to accounts;
- shorter, simpler default constitutions;
- no requirement to have a company secretary or hold an AGM;
- easier use of written resolutions for taking decisions;
- abolition of the prohibition on financial assistance for the purchase of a company's own shares; and
- simpler rules on share capital.

First statutory statement of directors' duties

This new codified statement sets out the seven duties owed by directors to their companies. The first four came into force on **1 October 2007** and the latter three were introduced on **1 October 2008**. The new statutory duties for directors are as follows:

- to act within their powers;
- to promote the success of the company for members' benefit;
- to exercise independent judgment;
- to exercise reasonable care, skill and diligence;
- to avoid conflicts of interest;
- not to accept benefits from third parties; and
- to declare interests in proposed transactions or arrangements with the company.

There is no definitive guidance from the Government on the interpretation of the new duties, although in June 2007 the DTI (now the Department for Business, Enterprise & Regulatory Reform) issued a collection of ministerial statements on the meaning of the new directors' duties provisions, extracted from the Parliamentary debates on the Bill. It is accepted that generally the statutory statement repeats the pre-existing common law (although in certain cases different wording is used) and should not therefore mean a change in focus for directors. However, the duty on directors to act in the best interests of the company is replaced with a new duty to "*act in the way [the director] considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a whole.*"

What does it mean to promote “success”? The ministerial statements highlight explanations given by Lord Goldsmith who summarised it as meaning:

- for commercial companies - a long term increase in value; and
- for charities – the achievement of its objectives.

The Act specifically states that where companies (eg charitable companies) include in their constitutional documents purposes other than the benefit of their members this duty is modified to be *promoting the success of the company to achieve these purposes.*

The Act provides a non-exhaustive list of six factors that directors must “have regard to” when reaching decisions in the performance of this duty. The six factors are as follows:

- the likely consequences of any decision in the long term;
- the interests of the company’s employees (compare section 309 Companies Act 1985 (now repealed));
- 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 members of the company.

The ministerial statements indicate that “have regard to” means “think about” or “give proper consideration to”. Unfortunately there is no pronouncement on what directors should do if two factors conflict, instead directors are reminded to focus on their overarching objective. There is potential for a further layer of complexity where a company’s constitutional documents set out its purposes as being other than for the benefit of members, as is the case for charitable companies.

The Act is clear that the duty is subject to any requirement to consider or act first in the interests of the company’s creditors and in applying the factors a director must obviously also comply with the duty to use reasonable skill and care. In eexercising reasonable skill and care, directors should consider whether any of the factors are relevant to a decision and, if they are, they must then consider what weight to give to them and how best to record their deliberations to show proper attention has been paid to discharging the duty. As was previously the case, this ought to require carefully prepared relevant board minutes with an eye on the discharge of the duty and the relevant factors rather than a box ticking approach which the Government has emphasised on a number of occasions will not suffice. There is a difficult balance to strike between considering the proper exercise of directors’ duties and merely adding meaningless bureaucratic procedures. The sensible view would be to take a proportionate approach in decision making and recording decisions rather than merely paying lip service to the factors by using standard paragraphs in board minutes.

It remains to be seen whether such a change will alter the actual decisions of the directors however it is clear that, at the very least, procedures for board deliberations and thought processes in reaching such decisions need to be updated in light of the new statement. Further information on this can be found in our briefing – Changes to directors’ duties.

Changes to the rules relating to conflicts of interest

Conflicts of interest is a topic which regularly gives rise to concerns for HEIs in relation to their spin outs, subsidiaries and any joint venture companies with which they are involved where a university employee or representative acts as a director.

The Act seeks to change the law in this area. The new provisions, which came into force on **1 October 2008**, distinguish:

- **Conflicts** where the **company is not party** to the conflict of interest - eg where the director (or his employer) wishes separately to exploit any business opportunity otherwise available to the company. Under the new law there is a statutory duty on directors to avoid a situation where the interests of the director and those of the company may conflict. However, the Act's provisions introduce a new option whereby, provided the articles do not invalidate it, the unconnected directors of a private company can authorise the conflict and therefore prevent the director being in breach of this duty (broadly speaking under the old law this ability to authorise a conflict was only available to the members). The new duty applies where the situation giving rise to the conflict arose on or after **1 October 2008**; the law that applied before that date will continue to apply to situations that arose before **1 October 2008**.

  For private (non-charitable) companies incorporated on or after **1 October 2008**, independent director authorisation of these types of conflicts will be possible provided that their constitutional documents do not prohibit it. For existing private (non-charitable) companies incorporated before **1 October 2008,** shareholders must agree (before, on or after **1 October 2008**), by ordinary resolution, that independent director authorisation can be given. Charitable companies (and public companies) must include an express ability for the unconnected directors to authorise conflicts in their constitutional documents;

- **Conflicts** relating to proposed arrangements where the **company will be a party** - here the director must declare the interest to the other directors before he enters into the transaction and must update the other directors if the declaration proves inaccurate or incomplete. There are exemptions to the duty, for example, if the directors are already aware of the director's interest or it cannot reasonably be regarded as likely to give rise to a conflict. The new law will apply where the duty to declare an interest arose on or after **1 October 2008**. Section 317 of the Companies Act 1985 ("s317") will continue to apply in relation to a duty which arose before that date;

- **Conflicts** relating to an existing arrangement where the **company is already a party** - again the director must declare the interest as soon as reasonably practical and again must update the other directors if the declaration proves inaccurate or incomplete. There are similar exemptions to those set out in the paragraph immediately above. Breach of this duty will however be a **criminal offence**. The new law will apply to transactions or arrangements entered into by a company on or after **1 October 2008** and s317 continues to apply in relation to those entered into before that date.

In relation to conflicts of interest arising from directors' transactions with the company, declarations of interest made under the old law were preserved when the new law came into force on **1 October 2008** and are treated on and after that date as if made under the new law.

If they have not done so already, HEIs (and companies) should review their arrangements and procedures for addressing conflicts. One issue of concern arises in relation to the duty to update the board if a previous declaration proves incorrect or inaccurate. The duty to notify the board may conflict with a duty of confidentiality owed elsewhere and the director absenting himself from board

meetings (the current practice) is unlikely to be a satisfactory solution. Consequently, HEIs may wish to consider whether they still want to appoint directors to boards or whether instead to rely on appointing board observers and influencing activities of the company through shareholder rights, for example, in a shareholders' agreement.

Further details can be found in our briefing – Directors' conflicts of interest – the new regime

Confidentiality of home addresses

The Act sets out new provisions protecting **all** directors (not just those at risk of violence or intimidation as is presently the case) against disclosure of their usual residential address in records kept by Companies House. Under the new provisions (that, unfortunately, have now been delayed until **1 October 2009**) only a service address will be made public (although certain bodies carrying out public functions and credit reference agencies may still be permitted to access usual residential addresses). Draft regulations have been published clarifying the circumstances in which it will be possible to apply to remove the usual residential addresses of some directors and shareholders (broadly those at serious risk of violence or intimidation) from historic company records from 2003 onwards (when Companies House began holding records electronically rather than on microfiche). Further information on this can be found in our briefing – More provisions affecting directors.

Shareholder derivative claims

A new procedure for members to bring claims against directors on a company's behalf for negligence, default, breach of duty or breach of trust was introduced on **1 October 2007**. The new court procedure is to be used for all derivative claims commenced on or after **1 October 2007** but, where the director's act or omission in question occurred before this date, the court will determine the outcome on the basis of the common law applicable at the time of the act or omission.

The new procedure has received significant comment due to a fear that it may lead to increased shareholder action and on the basis that it represents a significant change in the long established principle that it is for the company (not a shareholder) to bring proceedings where the company is the injured party. The Act requires the shareholder in question to obtain the court's permission to continue a claim so as, in part, to guard against US-style class actions from aggrieved or activist shareholders. Further information on this can be found in our briefing – Derivative claims by members against directors.

Auditors' liability

With effect from **6 April 2008** companies are able to agree a cap on their auditors' liability for negligence, default, breach of duty or breach of trust arising from an audit for the financial year specified in a "liability limitation agreement". To be enforceable the cap must be fair and reasonable and the courts are able to set aside any limitations that do not satisfy that test. The principal terms of the "liability limitation agreement" must be authorised by the shareholders unless such a requirement has previously been waived. The Act also contains provisions aimed at increasing auditors' independence. Further details on this can be found in our briefing – Accounts and auditors.

Deregulation for private companies

One of the principal aims of the Act is to introduce and promote a less regulated, simpler regime for private companies. To this end private companies:

- have been able to conduct almost all business by written resolution (requiring a simple majority or not less than 75% of eligible votes rather than the present unanimity) (in force since **1 October 2007**); and
- no longer need to hold AGMs (subject to their constitutional documents) (in force since **1 October 2007**);
- no longer need to have a company secretary (subject to their constitutional documents) although if they do, the secretary will have the same authority as is currently the case (in force since **6 April 2008**); and
- are able, in most cases, to reduce their share capital without court approval (in force since **1 October 2008**).

Further details on this can be found in our briefing – Easing the administrative burden.

Accounts

The Act has imposed a new over-arching duty on directors not to approve accounts in relation to financial periods beginning on or after **6 April 2008** unless they are satisfied that they give a true and fair view of the financial position of the company. Auditors are also obliged to take this duty into consideration when giving an opinion on the accounts. Additionally, the Act includes provisions concerning the duty to prepare a directors' report incorporating a business review that will apply unless the company is subject to the small companies regime. The purpose of the business review is to inform shareholders and help them to assess how the directors have performed their duty to promote the success of the company. The provisions of the Act relating to form and content of accounts and reports came into effect for accounting periods beginning on or after **6 April 2008** and the new business review requirements came into force on **1 October 2007** for reports for financial years beginning on or after **1 October 2007**. Directors are liable for statements or omissions in their directors' reports if they knew the statement to be untrue or misleading, were reckless as to whether it was untrue or misleading or knew the omission to be a dishonest concealment of a material fact. Such directors, however, are liable only to the company not to individual investors or third parties. Further details on this can be found in our briefing – Accounts and auditors.

Constitutional documents

As part of the push towards greater simplicity, the Act makes some major reforms to the way that companies are constituted and administered. These provisions will come into effect on **1 October 2009**. The memorandum of association of companies incorporated under the new Act will simply be a snapshot of information about the company on formation and instead the articles of association will contain all the rules on the internal workings of the company. A company's objects will be unrestricted unless otherwise specifically provided for. Model articles of association for private, public and companies limited by guarantee have been published that will be the default articles for companies incorporated from **1 October 2009**. Of course, it will still be possible for companies to adapt the model forms to their own requirements.

Abolition of financial assistance for private companies

On **1 October 2008** the restriction on a **private company** giving financial assistance in connection with the acquisition or purchase of its own shares was removed; the "whitewash" procedure (involving approval by special resolution, a directors' solvency declaration and a report from the auditors) was also abolished. The removal of the prohibition applied to any financial assistance given by a private company on or after **1 October 2008** even if the shares in question were acquired, and the liability incurred, before that date.

The general prohibition on the giving of financial assistance by a public company (or by its private company subsidiary) for the purchase of shares in the public company remains (for the time being at least) and from **1 October 2009** criminal liability for breach will extend to the company as well as to every officer of the company in default.

Some commentators feared that when the statutory prohibition on financial assistance was removed, pre-existing common law rules on maintenance of capital would still operate in some situations to stop a private company giving assistance for the purchase of its own shares. However these fears have now been allayed. A savings provision in the fifth Commencement Order to the Act clarifies that the repeal of the financial assistance prohibition does not prevent private companies from entering into transactions which they could previously have lawfully entered into by carrying out a "whitewash" procedure. Further details on this can be found in our briefing – Abolition of the financial assistance restriction.

Share capital

On **1 October 2008** a new procedure came into force, applicable save where it is proposed to reduce share capital to zero, pursuant to which a private company may reduce its capital without court approval by way of a special resolution supported by a directors' declaration of solvency.

The Act will abolish the requirement for companies to have an authorised share capital with effect from **1 October 2009** although shares must still have a nominal value. Transitional provisions will treat an existing company's authorised share capital as a restriction in its articles removable by ordinary resolution. Companies will not be required to restrict the total number of shares they can allot but may continue to do so if they wish.

So what next?

The various Commencement Orders introducing changes made by the Act from **October 2007**, **April** and **October 2008**, and **October 2009** set out **transitional arrangements** for **existing companies**. If not already dealt with, companies should review whether they need to take action in relation to provisions already in force and to be ready for the final changes to be brought into force in **October 2009**.

To comply with the provisions that came into effect in **January 2007**, companies need to:

- review their website and order forms to ensure that they state their company name, registered number, place of registration and registered office addresses. Further information on this can be found in our briefing – New website and e-mail disclosure requirements for companies;
- decide how to implement the new regime for communications between the company and its shareholders and holders of debt securities eg reviewing practices, procedures and documentation for regular communication such as email and website postings and the communications provisions in the articles of association of the company. Further details on this can be found in our briefing – Company communications with shareholders.

To comply with the provisions that came into effect on **1 October 2007**, companies should:

- brief directors and other key personnel on the effect of the changes and generally raise awareness of the Act with the appropriate people;
- review procedures for recording board deliberations and decisions;

- check the company's directors' liability arrangements and Directors' and Officers' liability insurance bearing in mind the potential for increased liability which might arise now the new statutory duties for directors and new derivative claims procedure are law (the availability and level of cover of such insurance may impact on your ability to recruit directors);
- **for** subsidiary companies, review all practices and procedures relating to the convening of meetings and AGMs and passing of written resolutions in order to take advantage of the relaxations that the new legislation has introduced; and
- for subsidiary companies, review and update articles of association, where appropriate.

To comply with the provisions that came into effect on **6 April 2008**, companies should:

- **decide** whether to dispense with a company secretary and, if so, update the company's secretarial arrangements (including in its articles) to ensure that other officers undertake responsibility for the secretary's duties;
- be aware that formal documents (deeds) may now also be executed by the witnessed signature of one director. Companies wishing to take advantage of this alternative method of execution should check their internal signing authorities;
- brief directors and other key personnel on the effect of the new duty relating to approval of accounts and the new requirements regarding the contents of the directors' report and the form and contents of financial reports. Further details on this can be found in our briefing – Accounts and auditors; and
- be aware of the ability to agree caps on auditors liability.

To comply with the provisions that came into effect on **1 October 2008**, companies should:

- brief directors on the streamlined procedure for private company reductions of share capital and the repeal of financial assistance and the 'whitewash' procedure;
- brief directors and other key personnel on the new provision in force relating to conflicts of interest and review arrangements and procedures as follows:
- put internal procedures in place for dealing with situational and transactional conflicts on an ongoing basis; and
- consider whether to take advantage of new provisions which allow for independent directors to authorise situational conflicts (ie conflicts where the company is not a party to the conflict). In order to take advantage of the statutory relaxation:
  - public and charitable companies need to amend their constitutional documents accordingly; and
  - private (non-charitable) companies incorporated before **1 October 2008** need to pass a shareholders' ordinary resolution.

  Changes to constitutional documents could address issues such as disclosure and use of confidential information obtained otherwise than as a director of the company, absence from board meetings at which any matter relating to the conflict of interest might be discussed and putting in place arrangements not to receive documents or information relating to any matter that gives rise to the conflict. More information is available in our full briefing – Directors' conflicts of interest – the new regime.

As regards the changes to be brought into force in **October 2009**, some early forward planning would be sensible in relation to matters such as:

- considering whether amendments should be made to constitutional documents limiting directors' ability to allot shares where the company has only one class of share capital;
- noting the impending legislation in respect of confidentiality of directors' residential addresses;
- ensuring that appropriate personnel continue to remain up to speed on the changes made by the Act and those that are forthcoming this Autumn and reviewing any guidance issued from time to time.

More briefings on the Act

More briefings are available on the Companies Act 2006 page on our website.

Claire Clarke
claire.clarke@mills-reeve.com
01223 222403

James Hunter
james.hunter@mills-reeve.com
01603 693267

Tim Winn
tim.winn@mills-reeve.com
0121 456 8355

The contents of this document are copyright © Mills & Reeve LLP. All rights reserved. This document contains general advice and comments only and therefore specific legal advice should be taken before reliance is placed upon it in any particular circumstances. Where hyperlinks are provided to third party websites, Mills & Reeve LLP is not responsible for the content of such sites.