SEPTEMBER 2008

COMPANIES ACT 2006: PROVISIONS COMING INTO FORCE ON 1 OCTOBER 2008

The Companies Act 2006 (the "2006 Act") effects the most sweeping and significant alteration of UK companies legislation for over 20 years. Significant portions of the 2006 Act were implemented on 1 October 2007 and 6 April 2008, with the remainder coming into force on 1 October 2008 and 1 October 2009.

MAIN CHANGES

The main provisions of the 2006 Act becoming effective on 1 October 2008 relate to reductions in share capital, the abolition of the prohibition on financial assistance for private companies and the introduction of new statutory duties for directors in connection with conflicts of interest. These changes are discussed in more detail below.

PROVISIONS TO BE IMPLEMENTED ON 1 OCTOBER 2008

Reductions in Capital (sections 610, 641(a) and (2) to (6) and 642-4 of the 2006 Act)

A private company will be able to undertake a reduction of its share capital (including share premium account and capital redemption reserve) by means of a special resolution supported by a solvency statement. It will no longer be necessary for a private company to obtain the approval of the Court (although it may still do so if it wishes); public companies will, however, still have to use the Court approved procedure. The need for prior authorisation in its articles of association before a company may undertake a reduction in its share capital is removed.

Solvency Statement. The protection for creditors of a company reducing its share capital under the Court approved process is to be replaced under the new statutory procedure by the requirement for the company's directors to provide a formal statement as to its solvency. The solvency statement is a statement that each of the directors has formed the opinion, taking into account all of the company's liabilities (including any contingent or prospective liabilities), that:

- at the date of the solvency statement, there is no ground on which the company could be found to be unable to pay or discharge its debts; and
- for the following 12 months, the company will be able to pay or discharge its debts as they fall due (unless it is intended that the company be wound up within that period, in which case the statement must confirm that the company will be able to pay or discharge its debts within 12 months after its winding up is commenced).

The solvency statement must be in writing, be dated, indicate that it is a solvency statement and include the name of, and be signed by, each director. It must not be qualified in any way. It will be a criminal offence if the directors make a solvency statement without having reasonable grounds for the opinions expressed in it.

Because of these criminal sanctions, what constitutes "reasonable grounds" for these purposes will depend on the facts in any given scenario. For companies with straightforward financial profiles, directors may be content to rely on their internal investigations, assessments and forecasts regarding the company's financial position and ability to pay or discharge its debts as and when they fall due over the following 12 months. However, for companies with more complex financial affairs, especially group companies with cross-guarantee arrangements for trading company liabilities, directors may wish to seek additional comfort in the form of an auditors' report. Because there is no statutory requirement for such a report, there is no certainty with regard to the form of report that auditors may be prepared to give. However, as the content requirements of the solvency statement mirror those matters required to be covered historically in a financial assistance whitewash auditors' report, it is anticipated that solvency statement reports will be similar in nature.

The new reduction of capital procedure should be a quicker and cheaper procedure than the Court approved process that was required under the Companies Act 1985 (the "1985 Act"), although this Court approved process will remain in place and can be used as an alternative to the new procedure.

Application of Reserve Arising on a Capital Reduction. Article 3(2) of The Companies (Reduction of Share Capital) Order 2008 provides that the reserve arising on a reduction of capital can be treated as realised profit. This helpfully clarifies the possible application of the reserve which, until now, was determined in accordance with generally accepted accounting practice.

In addition to creating distributable reserves, reductions (whether effected under the new solvency statement procedure or under the traditional Court approved procedure) can be employed for a variety of purposes: repaying excess capital, tidying up the share capital profile and/or eliminating a profit and loss account deficit.

FINANCIAL ASSISTANCE

The prohibition on a company giving financial assistance for the acquisition of its shares is to be abolished for private companies. Consequently, the whitewash procedure contained in sections 155 to 158 of the 1985 Act will become redundant and be repealed. A public company will still be prohibited from giving financial assistance (subject to all the current exceptions, as well as a new exception that permits post-acquisition financial assistance if a public company has become a private company by the time the assistance is given). Financial assistance given by a public company to acquire shares in its private holding company will also remain prohibited, as will financial assistance given by a private company subsidiary in relation to the acquisition of shares in its public company parent.

Despite the fact that the giving of financial assistance will no longer be prohibited, private companies proposing to give financial assistance on or after 1 October 2008 should still consider capital maintenance and corporate benefit issues. Matters which should still be considered include:

- whether the transaction is one which will directly benefit shareholders. For example, if a transaction comprises a loan waiver or gift in favour of a shareholder, that is likely to constitute a distribution which would need to be covered by distributable reserves. In the case of a transaction which comprises a distribution in kind, regard must be had to the new rules under Part 23 of the 2006 Act (which value as zero a distribution of an asset at book value but require the company to have positive distributable reserves in order to effect the transaction lawfully); and
- whether a transaction will be one which promotes the success of the company for the benefit of its members as a whole, having regard to the matters which directors must consider for this purpose under section 172 of the 2006 Act.

There are a number of ways companies and directors can demonstrate compliance with corporate benefit and capital maintenance rules, such as seeking a shareholder resolution to reduce or eliminate the risk of a company or shareholder challenge based on breach of duty by the directors, or reciting the corporate benefit in board minutes and confirming that the board has considered the matter and concluded that the transaction promotes the success of the company and should be approved.

The abolition of the prohibition on private companies giving financial assistance is a welcome change as it removes the complicated and costly exercise of performing the whitewash procedure or applying complicated transaction structures to avoid falling foul of its application. In practice, the extent to which lending banks will still require cashflow forecasts to be informally scrutinised (as they were required to be formally scrutinised through the whitewash procedure) has as yet to be seen.

DIRECTORS' DUTIES

Additional duties regarding the avoidance of conflict situations, declarations of interest and the obligation not to accept benefits from third parties come into force on 1 October 2008. For a full explanation of all statutory duties of directors under the 2006 Act from that date, please see our separate *Commentary* entitled "Statutory Duties of Directors of English Companies from 1 October 2008".

Duty to Avoid a Situation in Which a Director Has, or Can Have, a Direct or Indirect Interest that Conflicts, or Possibly May Conflict, with the Interests of the Company (section 175 of the 2006 Act)

A director must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. This applies, in particular, to the exploitation of property, information or opportunity, whether or not the company could take advantage of that property, information or opportunity. This duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company, since that is covered by the separate duty to declare to the company any interest in a proposed or existing transaction or arrangement with the company (see below).

A director will therefore be in breach of this duty if he is in a situation, or allows a situation to arise, which involves, or could involve, a conflict. This is unless the situation cannot reasonably be regarded as likely to give rise to a conflict of interest or the conflict situation was authorised in one of the ways mentioned below.

A conflict situation may be authorised:

- by the board of a company. For a private company, the board (excluding the conflicted director) is entitled to authorise a conflict unless there is an express prohibition on doing so in the articles of association of the company. If the company was incorporated before 1 October 2008, the directors must first be empowered to authorise such conflict situations by ordinary resolution passed by the members (companies incorporated after that date need not take that additional step). For a public company, this position is reversed and the board may only authorise a conflict of interest if the company's articles of association expressly permit them to do so;
- by shareholder approval. This can be obtained either by unanimous shareholder consent or by special resolution; or
- under the company's constitution. Section 180(4)(b) of the 2006 Act allows companies to enshrine provisions for dealing with conflicts of interests in its articles of association (or other part of its constitution) and anything done in accordance with such provisions will not lead to a breach of this duty by a director.

A breach may subsequently be ratified by the company's members (by ordinary resolution) although the director, if himself a member, and any person connected with him, may not vote on the resolution.

In addition to considering conflict situations which could arise directly in relation to himself, each director should also consider if any of his connected persons holds positions that could lead to the director being in breach of this duty.

The scope for conflict situations arising is potentially very broad and so careful consideration should be given to the question of where they may exist or may possibly come to exist. The following situations are examples of potential conflicts that may arise:

- where a director is on the board of, is a significant shareholder in, or is himself a supplier to or customer of, or a major shareholder in, the company;
- where a director also has a role with one of the company's advisers;
- where a director accepts an appointment as a director with another company, especially one which is in a competitive field of activity;
- where a director is also a director of the company's pension trustee company or a trustee of the pension fund; and
- where a potential bidder for the company approaches a director and the director is offered a role with the potential bidding group.

Each situation requiring approval of the board (*i.e.*, where it is not authorised by the members or under the company's constitution) will, however, need to be considered by the board and the decision to authorise the conflict by the board should be made only if, on balance, the board considers it in the best interests of the company to retain the services of the conflicted director in the relevant matter. Any such approval may be given subject to such limitations or conditions as the board considers appropriate in the circumstances.

Directors who sit on multiple boards will always need to consider carefully whether they are in a position that can "reasonably be regarded as likely to give rise to a conflict" and should seek independent legal advice in the case of any uncertainty. Also, those directors appointed as representatives of private equity investors should have particular regard to these rules (see our separate commentary entitled "Conflicts of Interest for Private Equity Portfolio Company Directors").

This duty will come into force on 1 October 2008 and applies to conflict situations which arise on or after that date (and so conflict situations that already exist at that date will not need to be separately authorised unless they lead to a further distinct situation giving rise to a conflict).

Duty to Declare Interests in Proposed Transactions or Arrangements with the Company (section 177 of the 2006 Act)

The statutory obligations concerning declaration of directors' interests has been enhanced under the 2006 Act.

Directors must declare to the other directors the nature and extent of any interest, direct or indirect, in a proposed transaction or arrangement with the company. The director need not be a party to the transaction for this duty to apply. For example, an interest of another person in a contract with the company may require the director to make a disclosure under this duty, if the other person's interest amounts to a direct or indirect interest on the part of the director. That would be the case if the director was economically interested in the other contracting party, for instance.

The declaration must be made before the company enters into the transaction or arrangement and where a declaration of interest proves to be or becomes inaccurate or incomplete, a further declaration must be made if the company has not yet entered into the transaction or arrangement when the director becomes, or should reasonably have been, aware of the inaccuracy or incompleteness.

No declaration will be required:

- where the director is not aware of his interest or where the director is not aware of the transaction or arrangement (unless he ought reasonably to have been aware of the relevant matters);
- if the interest cannot reasonably be regarded as likely to give rise to a conflict of interest;
- if, or to the extent that, the other directors are already aware of the interest (and for this purpose the other

directors are deemed to be aware of anything of which they ought reasonably to be aware); or

- if it concerns the terms of the director's service contract which have been (or are to be) considered at a board meeting or board committee.

There are no restrictions on the method for making such disclosures but the 2006 Act makes specific provision for declarations to be made in writing or by way of a general notice of declaration. 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 1985 Act (*i.e.*, before 1 October 2008), the duty of disclosure continues under that Act and not the 2006 Act.

Requirement to Declare Interests in Existing Transactions or Arrangements Entered Into by the Company (section 182 of the 2006 Act)

A director must declare the nature and extent of his direct or indirect interest in an existing transaction or arrangement entered into by the company. Again, the director need not be a party to the transaction for this duty to apply. However, this obligation does not apply if or to the extent that the interest has already been declared under the duty to declare an interest in a proposed transaction or arrangement as described above.

The declaration must be made as soon as is reasonably practicable, and even if the declaration is not made as soon as it should have been, it must still be made. Where a declaration of interest proves to be or becomes inaccurate or incomplete, a further declaration must be made.

No declaration will be required if any of the circumstances which exclude a director from having to make a declaration under section 177 of the 2006 Act apply.

In this case, declarations *must* be made:

- at a meeting of the directors;
- by written notice; or
- by general notice (see above).

Duty Not To Accept Benefits From Third Parties (section 176 of the 2006 Act)

Directors must not accept any benefit from a third party which is conferred because of his being a director or because of his doing or not doing anything in his capacity as a director. This duty will not be infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. Benefits conferred by the company, its associated companies, or persons acting on their behalf, and benefits received from a person who provides the director's services to the company, are excluded.

This duty will continue to apply after a person ceases to be a director in relation to things done or omitted by him while he was a director.

It should be noted that there is no "de minimis" that applies in relation to this duty. Unlike the duty to avoid conflicts of interest where conflicts can be authorised by the board, a director obtaining a benefit from a third party can only be authorised by the members of the company.

The practical consequences of this new legislation have been considered in the context of corporate hospitality offered to company directors. Certainly, receipt of disproportionate corporate entertainment could fall within its scope. It is therefore suggested that companies establish and properly maintain policies for receipt, and recording, of benefits by directors and a requirement for prior approval in appropriate circumstances.

OTHER PROVISIONS BECOMING EFFECTIVE ON 1 OCTOBER 2008

Right To Object to a Company's Registered Name and Adjudication of Objections (sections 69-74 of the 2006 Act)

Any person or company may object to a company's name if it is the same as, or misleadingly similar to, or chosen with the principal intention of seeking money from the objector or preventing the objector registering the name himself (if the objector has goodwill in the proposed company name). Any objection may be made at any time after the name is registered to a company names adjudicator appointed by the Secretary of Sate. This objection process should make it easier to overcome opportunistic registrations of company names.

Requirement for Companies To Have At Least One Natural Person as Director (section 155 of the 2006 Act)

All companies must have at least one director who is a natural person. Under transitional arrangements, those companies that did not have a natural person as a director on 8 November 2006 will have until 1 October 2010 to appoint one.

Minimum Age for Directors (section 157 of the 2006 Act)

All company directors who are natural persons must be 16 years of age or older. Any director who is a natural person under the age of 16 on 1 October 2008 will automatically cease to be a director on that date. Any person under the age of 16 who purports to act as a director or is deemed to be acting as a shadow director, could be liable to prosecution for civil and criminal offences under the 2006 Act even though their appointment is void.

Potential Donations and Expenditure to Independent Election Candidates (sections 362-379 of the 2006 Act)

If a political donation is made to, or political expenditure is incurred in connection with, an independent election candidate and no resolution has been passed by the company approving such donation, then the directors of the company and the directors of any relevant holding company may incur civil liability to the company under the 2006 Act.

FURTHER INFORMATION

This *Commentary* is intended to provide a summary of the main provisions of the 2006 Act where current law is changing significantly on 1 October 2008.

A web site on which the Government sets out its proposals in relation to secondary legislation and revised drafts of model articles of association for private and public companies, together with checklists for existing private companies summarising the key areas of change and a set of Frequently Asked Questions about the implementation of the 2006 Act, can be found at http://www.berr.gov.uk/bbf/co-act-2006.

LAWYER CONTACT

If you would like further advice or assistance in relation to the provisions of the 2006 Act coming into force on 1 October 2008, 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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