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THE COMPANIES ACT 2006

Major new legislation affecting UK companies

January 2007

Background

The Companies Act 2006, the longest piece of legislation ever and running to 1,300 clauses and 16 Schedules, received the Royal Assent on 8 November 2006. The first of its provisions came into force in January 2007 and the rest of the Act will take effect between now and October 2008. The Government will shortly begin consulting on the detailed timetable.

The Act re-enacts and consolidates most of the 1985 and 1989 Companies Acts, and for the first time directors' duties are codified. One of its intentions is to simplify the administration of private companies, such as the convening of meetings and the passing of written resolutions. These are described below in the section headed "Issues for Private Companies".

Quoted companies could find that life is a little more complicated, particularly the areas which are intended to increase shareholder engagement.

First provisions implemented in January 2007

The first of the Act's provisions which came into force on 1 January 2007 relate to facilitating e-communications with the Registrar of Companies.

Companies must also ensure their full name, place of registration, number and registered office appears on its website and emails, in addition to its business letters and order forms.

On 20 January the provisions linked to the EU Transparency Obligations Directive commenced. These will mainly affect quoted companies and relate to:-

- enhanced electronic communications with shareholders (see in "Issues for Public and/or Quoted Companies" on the back page);
- provisions concerning a public company's right to investigate who has interests in its shares; and
- the statutory basis of directors' liability to the company in relation to the directors' report, their remuneration report and summary financial statements.

On 6 April this year it is also intended to implement the provisions which affect takeovers by way of public offers.

What needs to be done now?

- Both private and public and/or quoted companies should familiarise themselves with the proposed changes as they will have a significant impact on a number of areas of their procedures.
- Quoted companies might, at their AGMs this year, consider adopting the enhanced electronic communications with shareholders or wait until the substantive provisions are brought into effect and make all the necessary changes at that stage.
- Private companies, unless they consider enhanced electronic communications with their shareholders is important, should wait until the key provisions of the Act are implemented before doing anything further.
- When the Government announces the timetable for the introduction of the main provisions of the Act, both private and public companies should carry out a review of their articles and consider to what extent they want to update them to take advantage of the new regime. Model articles of association for private and public companies are to be published under the Act which many companies will adopt with modifications.

Issues for Private Companies

The Act will make a significant number of administrative and procedural changes for the running of private companies. It is likely that most private companies will, in due course, wish to take advantage of the new regime and amend their current articles by incorporating, in whole or in part, the new model articles for private companies published pursuant to the Act. A company's existing articles of association will, however, continue to apply and, with limited exceptions, will not be overridden by the Act.

(cont'd)

Set out below are a number of the main changes that will affect private companies.

Abolition of authorised share capital

Currently companies are incorporated with a specific authorised shares capital (eg £1,000 divided into 1,000 ordinary shares of £1 each). Once this ceiling has been reached, no further shares can be issued until its authorised share capital has been increased. The Act abolishes the concept of authorised share capital for both private and public companies.

A company will only have an issued share capital and when issuing new shares it will only have to consider whether it has the necessary authority to allot new shares and will not have to consider whether it has sufficient authorised share capital.

However, the government has indicated that where existing articles set out a company's authorised share capital, this will continue to operate as a restriction on the issued share capital and shareholders' consent will need to be obtained to exceed this cap.

Authority to allot new shares

Under the Companies Act 1985, before issuing new shares, directors need to consider whether they have the relevant authority either in the company's articles or given by a resolution of its members. Under the Act the procedure for issuing new shares is simplified in the case of a private company with only one class of shares.

The default position is that private companies with only one class of share will be deemed to have the authority to allot and issue new shares of that class unless the articles of association say otherwise. However in order to give a degree of shareholder control, many companies might continue to require in their articles that shareholder authority is required to issue new shares in general or beyond a certain level.

In the case of the issue of shares (or the grant of an option to subscribe new shares) pursuant to an employees' share scheme, express authority continues not to be required and the statutory right of pre-emption in the Act does not apply.

Written resolutions - abolition of unanimity requirement

The existing position is that if a private company wishes to avoid the necessity of holding a shareholders' meeting to pass a resolution, it may do so by a written resolution signed by all shareholders – whether the resolution is an ordinary or special resolution. This requirement for unanimity is relaxed under the Act and the consent levels are the same as for the passing of an ordinary resolution (more than 50% of eligible members) and a special resolution (75% of eligible members).

The effect of this important relaxation is that, in the case of private companies, actual meetings of shareholders are likely to become rare and resolutions will simply be passed by written resolutions.

Notice periods for shareholders' meetings

Subject to provisions in a company's articles, all shareholders' meetings for companies will only require "at least" 14 clear days notice and there will no longer be a distinction between the period of notice required for meetings convened to pass special or ordinary resolutions. For public companies AGMs will still require at least 21 days notice.

The right to call meetings on shorter notice has also been relaxed so that 90% of shareholders (as opposed to the current threshold of 95%) can agree the shorter notice period.

A company secretary no longer required

The current requirement for a private company to have a company secretary is abolished although private companies will still be able to appoint a company secretary if they so wish. Existing provisions in articles which provide for a company secretary will continue to apply unless amended.

AGMs no longer required

Under the present legislation private companies can elect not to hold AGMs, to lay accounts at the AGM or to appoint auditors annually though larger private companies normally tend to hold AGMs. The new default position will be that private companies do not have to hold AGMs unless they opt to do so in their articles or by shareholders' resolution.

Abolition of rules prohibiting financial assistance in connection with the acquisition of private company shares

The old chestnut against the prohibition of financial assistance by companies in connection with the acquisition of their shares is to be abolished for private companies (though retained for public companies). Thus, the cumbersome whitewash procedure which private companies had to go through in order to provide financial assistance will no longer be necessary.

Alternative procedure for capital reductions

There will now be a simplified procedure for private companies to undertake a capital reduction eg the reduction or elimination of a share premium account to create or increase distributable reserves. All that is required is a members' resolution and a directors' solvency statement and there will no longer be the need for court approval.

Directors' Duties

This area of the Companies Act 2006 has probably attracted the most publicity though in practice the intention of the Act is to codify, rather than alter, the current position regarding directors' duties contained in the extensive case law on the subject.

General Duties

The "general duties" of directors that are codified in the Act are: -

- to act in accordance with the company's constitution;
- only to exercise powers for the purpose for which they are conferred;
- to act in the best interests of the company;
- to exercise independent judgement;
- to exercise reasonable care, skill and diligence;
- to avoid conflicts of interest; and
- not to accept benefits from third parties.

The Act explicitly retains the current position that the general duties are owed to the company - so that, firstly, it is only the company's loss caused by a breach which can be recovered and not an alleged loss by a shareholder and, secondly, that it is only the company that can bring an action for breach (though in certain circumstances shareholders can, with the consent of the court, bring derivative actions on behalf of the company).

Duty to act in the best interests of the company

The primary duty of directors is to act in what they consider to be in the best interests of the company. The Act expresses this duty as a requirement for each director to act:-

"…in a 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..."

The requirement to act in the best interests of the company is now expressed as a requirement to "promote the success of the company". But the important point is that the subjective element is retained; as long as the director acts in good faith (and this is believed by the courts) the fact the director displayed poor judgement is of no consequence if he genuinely believed a course of action would promote the success of the company.

In deciding whether a particular course of action is in the interests of the company, the Act specifies six particular factors to which the directors must "have regard" in fulfilling this primary duty. These are:-

- 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 relationship 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 between members of the company.

These are only factors to which the directors must "have regard", they do not qualify or override the general duty.

Failure to take such matters into account will only have any practical consequences if it can be shown (by the company) that had the relevant factor been taken into account, the decision would have been different and the company has suffered loss as a consequence.

Duty to exercise reasonable care, skill and diligence

The general duty of a director to exercise reasonable, care, skill and diligence is no higher than that established by case law. There are, in effect, two levels of tests that are required to establish the expected degree of care, skill and diligence namely:

- the general knowledge, skill and experience that may reasonably be expected of a person carrying out the particular functions carried out by the director; and
- the general knowledge, skill and experience the particular director has.

Whilst the first test might only require a reasonable level of experience, the particular expertise of the director will raise the required level.

Duty to avoid conflicts of interest

The existing common law duty is summarised as follows: -

"A director of a company 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."

It applies to the exploitation of any property, information or opportunity whether or not the company could take advantage of the property, information or opportunity. The duty is not, however, infringed if the matter has been authorised by the directors at a properly convened board meeting (where the relevant director is not counted towards the quorum) at which the director does not vote or, if he does, his vote would not have affected the outcome.

Issues for Public and/or Quoted Companies

A number of the provisions applicable to private companies, such as the abolition of authorised share capital and the reduced period of notice for general meetings (other than AGMs), will also apply to public companies. Other provisions in the Act only apply or will be mainly relevant to public companies and/or quoted companies. Some of these are described below.

Business reviews

The Act expands the content requirements for the business review of quoted companies in the annual directors' report. This review must now include:-

- the main trends and factors likely to affect the future development and performance of the company's business;
- information about environmental matters, the company's employees and social and community issues including information about the company's policies on these issues and their effectiveness; and
- information about persons with whom the company has contractual or other arrangements essential to the company's business, unless disclosure would seriously prejudice that person and be contrary to public interest.

However, the government introduced a safe harbour which restricts directors' civil liability for the content of the directors' report and the directors' remuneration report. Directors will only be liable to the company for any loss it suffers as a result of any untrue or misleading statement in a report where the director knew or was reckless as to whether the statement was untrue or misleading or there had been a dishonest concealment of a material fact.

Enhancing shareholder engagement

In an attempt to improve governance and facilitate shareholder engagement including enfranchising indirect investors (eg where shares are registered in nominee names) the Act includes provisions whereby: -

Nomination rights: The registered owner of shares in quoted companies can nominate the beneficial owner to receive copies of shareholder notices and accounts. This could impose a considerable cost on public companies who might find that one nominee name (eg Barclays Nominees) represents thousands of underlying beneficial owners. For this reason electronic communications will become more common. The beneficial owner will then have the right to be appointed a proxy of his nominee or to appoint the nominee as his proxy. The intention is to give the beneficial owner the same rights eg to speak at general meetings, as are enjoyed by his nominee.

Proxies: Enhanced powers so that proxies may speak at general meetings (not currently permitted in the case of public companies) and to vote on a show of hands.

Communications with shareholders

There is a new regime for the communication between companies and shareholders and holders of debt securities of information and documents required to be sent to shareholders. Website publication of information and documents such as accounts and general meeting notices will become the default position which it is estimated will save quoted companies millions of pounds each year. Although the consent procedure is detailed, the Act in practice places a positive obligation on shareholders to request hard copy of documents. Companies will have to make provision in their articles (or update existing provisions) or seek approval at a general meeting to use e-communications with shareholders.

Administrative changes

Directors' home addresses: New directors (whether of a public or private company) will be able to provide a service address and to give their home address (both to the company and the Registrar of Companies) only for the purpose of a restricted access separate list.

Shareholders' register: There is a new procedure for individuals who want to look at a company's register of members and who will now have to provide a written explanation of the purpose for which the information is required. There are severe sanctions for providing inaccurate or misleading information.

Political donations: The regime which governs political donations has to some extent been clarified to allow greater procedural flexibility when seeking shareholders' consent.

Paper free transfer and holdings of securities: Though no specific provisions have been included, the right is given to the Secretary of State to make regulations permitting paper free holdings and transfers of shares.

AGMs and filing of accounts: The period has been reduced slightly from seven months to six months for the holding of AGMs and filing of accounts.