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An Introduction to the Companies Act 2006



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■ Introduction

The Companies Act 2006 ('the 2006 Act') received royal assent on 8 November 2006. It runs to 47 parts and 1300 sections, and will, when brought into force, almost entirely replace the Companies Act 1985 ('the 1985 Act'). The 2006 Act is the result of extensive consultation in the field, adopting most of the recommendations of the Company Law Review Steering Group. Its aim is to:

- make it easier to set up and grow a business;
- encourage shareholder confidence;
- increase shareholder engagement; and
- improve the UK's position as "one of the most attractive places in the world to set up and run a business" (Government's March 2005 White Paper, *Company Law Reform* ('CLR') p.9).

The 2006 Act attempts to meet these objectives by consolidating, and making a number of substantial changes to, company law. For instance, the burden on small companies is eased by new rules relating to model articles of association, company secretaries, AGMs, written resolutions, capital maintenance and share capital. Clarity of legal rights and obligations is promoted, with the 2006 Act containing statutory provisions relating to derivative actions together with a statutory statement of directors' duties. Auditor transparency is also increased, but auditors are permitted, for the first time, to limit their liability. Shareholders are given a variety of enhanced rights (many of which also apply to indirect investors), whilst provision is made for protecting the private details of both shareholders and company directors. And institutional shareholder engagement is encouraged by rules that may force institutional investors to explain how they

have used (or failed to use) the rights attaching to shares that they hold or control.

■ The Statutory Statement of Directors' Duties

The general approach

The Government has adopted the recommendations of the Law Commission and the Company Law Review Steering Group that the law relating to directors' duties should be made more "consistent, certain, accessible and comprehensible" by the introduction of a statutory statement of directors' general duties. The elegantly drafted statutory statement is contained in ss. 170 to 181 of the 2006 Act. It begins uncontroversially by obliging directors to "act in accordance with the company's constitution" (s. 171(a)), "only exercise powers for the purposes for which they are conferred" (s. 171(1)(b)), and exercise independent judgment (s. 173(1)).

Reasonable care, skill and diligence

More interesting is the obligation of directors to act with reasonable care, skill and diligence, imposed by s. 174(1). In assessing whether a director has complied with this obligation, the court must, as under the wrongful trading provisions of the Insolvency Act 1986, bear in mind both "the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company", and "the general knowledge, skill and experience that the director has" (ss. 174(2)(a) and (b)). This provision is particularly welcome, offering an adaptable test catering for different situations and directors of varying levels of knowledge, skill and experience. The insolvency cases analysing this combined objective and subjective test will no doubt be applied by analogy when the 2006 Act

comes into force. The introduction of this test also clarifies an issue on which there was conflicting common law authority.

The duty to promote the success of the company

This brings us to one of the 2006 Act's key developments—the director's duty to promote the success of the company. This new, and somewhat controversial, duty requires a director to act in a way that 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—(a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationship with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company” (s. 172(1)).

The matters specifically listed in s. 172(1) are noteworthy because they impose an obligation on directors to consider a company's long-term sustainable growth. To date, actions against directors have usually centred on short-term decisions or deals (for instance, an allegation that a director committed a company to a particular loss-making transaction). The 2006 Act's emphasis on wide-ranging considerations may pave the way for a new sort of claim to be launched against directors (say, for example, where a series of decisions produce a short-term profit but lead, over time, to a company acquiring a poor reputation and being shunned by its former customers, causing large losses). It is for this reason that the Government was right to concede that the new s. 172(1) duty constitutes a ‘radical’ change to the existing common law rules. Importantly, the 2006 Act gives guidance as to how the common law decisions on directors' duties are to interact with the new statutory formulae. Whilst the statutory provisions “have effect in place of the common law rules and equitable principles”, regard “shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general

duties” (s. 170(3) and (4)). Furthermore, the Government has promised to publish plain English guidance explaining what directors must do to comply with the new codified duties.

Conflicts of interest

Also embodied in the 2006 Act is the hitherto equitable duty of company directors to avoid situations in which their duties to the company may conflict with their own interests or their duties to third parties. As one would expect, the breadth of the equitable principle is retained, with a director being required to “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” (s. 175(1)). This duty is said to apply, in particular, to the exploitation “of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity)” (s. 175(2)). However, two subsequent rules—which deal with occasions when the no-conflict rule is infringed and how otherwise improper behaviour can be authorised—clarify, and arguably dilute, the previous limits of the no-conflict principle.

The early cases laid down a very strict test for ascertaining when a director had breached the no-conflict rule. This was subject to some relaxation in, for example, *Wilkinson v West Coast Capital* [2005] EWHC 3009 (Ch) so that there could be no conflict where the opportunity fell outside the scope of a company's business. The 2006 Act reflects the recent trend, providing that the statutory duty is not infringed “if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest” (s. 175(4)(a)). Thus company directors will avoid having to disgorge profits made where there has only been a hypothetical or extremely remote possibility of conflict of interest. The second important change comes from the statutory recognition that a company's board can (subject to that company's constitution), authorise a director to enter into a transaction that would otherwise involve a conflict so long as (a) the relevant board meeting is quorate without counting the director in question or any other interested director, and (b) the matter is agreed without counting the votes of the director in question or any

other interested director (see s. 175(4), (5), and (6)). This is important as the case law was unclear as to whether board or shareholder approval was necessary to authorise such a conflict.

■ Shareholders' Rights

The CLR declared that some of its proposals for company law reform were aimed at “ensur[ing] greater transparency and accountability within the company's operations, and greater opportunity for all shareholders to play an informed part in company business” (CLR p. 16). In order to implement these aims, the 2006 Act:

- makes it easier for shareholders to use proxies;
- contains provisions that allow shareholders to confer various rights on third parties (including indirect investors); and
- expands and places on a statutory footing the rights of shareholders to bring derivative claims on behalf of a company in which they hold shares.

Furthermore, the 2006 Act restricts the circumstances in which information about those who hold shares in a company can be obtained from the register of shareholders.

Proxies

SS. 324 to 331 of the 2006 Act deal with the ability of a member to appoint a proxy and the rights that such a proxy will have. S. 324(1) provides that “a member of a company is entitled to appoint another person as his proxy to exercise all or any of his rights to attend and to speak and vote at a meeting of the company”. This provision expands the rights currently conferred on proxies by s. 372 of the 1985 Act by removing the rule that proxies are not allowed to vote on a show of hands and by allowing a proxy of a member of a public company the right to speak at meetings. Indeed, s. 285, which overrides any inconsistent provision in a company's articles, provides that a proxy cannot have fewer votes on a show of hands than the member that that proxy represents would have if he were present in person. The 2006 Act contains further provisions that enhance the rights of proxies, expressly providing that proxies will

be counted in determining whether a meeting is quorate (s. 318(3)(c)) and may be appointed to chair general meetings (s. 328). In addition to encouraging shareholder participation, these measures are likely to go some way towards stamping out abuses of the proxy system by a company's board which wishes to see its proposed resolutions carried.

Rights that can be conferred by shareholders on third parties

Part 9 of the 2006 Act is introduced in recognition of the fact that a large proportion of quoted shares are held by intermediaries such as brokers on behalf of both institutional and private investors ('indirect investors'). In such cases, the intermediary—and not the indirect investor—has legal title to the shares and has the power to exercise all rights attaching to them. This state of affairs created, in the Government's eyes, a difficulty: intermediaries may have little incentive to exercise actively the rights attaching to the shares that they hold (for instance, if the intermediary is an execution-only broker). To combat this difficulty, the 2006 Act paves the way for significant rights to be conferred on indirect investors.

There are three strands to Part 9. The first applies where there is specific provision in a company's articles to the effect that a member may "nominate another person or persons ... to enjoy or exercise all or any specified rights of the member in relation to the company" (s. 145(1)). In the rare cases in which such a provision exists, and a third party is nominated by the member to enjoy specified rights, s. 145(2) provides that references in the 2006 Act to a member exercising such rights shall instead be read as a reference to the nominated person (see s. 145(2)).

The second strand of Part 9 is likely to have a more significant practical effect. It essentially gives a third party nominated by a member of a company traded on a regulated market the right to certain specified types of information (s. 146). In particular, those who are nominated to enjoy such 'information rights' are entitled to see communications that a company sends to its members (including annual accounts and reports: see s. 146(3)). Further, those holding information rights must

be told, when they are sent a copy of a notice of a meeting, that they *may* have the right under an agreement that they have with the actual member (e.g. their broker) to be appointed as that member's proxy or to give that member instructions as to how he should use his votes: see s. 149. Whilst these novel provisions do not *oblige* intermediaries to confer information or voting rights on indirect investors for whom they hold shares, the expectation is that they will exert commercial pressure on the likes of brokers to offer such rights in their client packages.

Some indirect investors even gain a limited number of substantive governance rights under the third strand of Part 9. In particular, s. 153 allows 100 or more members or indirect investors who meet the test set out in s. 153(2)(c) to require:

- the circulation of a members' statement in support of a proposed resolution under s.314;
- the circulation of a resolution for a public company's AGM under s. 338;
- an independent report on a poll under s. 342; and
- website publication of audit concerns under s. 527.

In summary, Part 9 can be said to include mechanisms for enfranchising indirect investors that are both novel and radical.

Derivative actions

Derivative actions, by which a shareholder can bring a claim in respect of a cause of action vested in a company in which he holds shares, have been placed on a statutory footing by the 2006 Act. There are two important changes. First, the circumstances in which a derivative action can be brought have been clarified and considerably expanded. Second, the procedure for bringing a derivative claim has been rationalised. These changes are aimed at providing a "modern, flexible and accessible criteria for determining whether a shareholder can pursue an action" (see the Law Commission's report, *Shareholder Remedies*, para 6.15).

Much of the uncertainty present in the old case law as to when a member could bring a derivative claim has apparently been swept away; there

will be no need under the statute for an inquiry as to whether there has been a "fraud on the minority" or whether a director has personally benefited from a particular action. Rather, the 2006 Act provides that the derivative claim will be available in respect of a "cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust *by a director of the company*" (s. 260(3)). Importantly, this provision makes it clear that, for the first time, a derivative action can proceed in relation to the mere negligence of a director, and possibly also in relation to a mere breach of the strict rule against conflict of interests, without the presence of any additional element of bad faith or gain. Such causes of action can also be brought against a shadow or former director and any relevant third party, such as one who dishonestly assists a director's breach of fiduciary duty, or one who knowingly receives property transferred in breach of fiduciary duty (s. 260(3) and (5)). These provisions, then, constitute a considerable expansion of the derivative claim.

The 2006 Act also provides a new statutory code for the procedural aspects of derivative claims (ss. 260 to 264). The member who seeks consent to bring a derivative claim (or continue a claim commenced by the company) must first convince the court that he has a prima facie case for the giving of permission to continue the claim (s. 261(2)). If such a case is shown, the court may make directions for evidence to be filed by the company (s. 261(3)).

Further, rules are laid down as to how the court should decide whether a derivative claim brought by a member should continue. The court must refuse permission if (a) a person acting in accordance with the director's duty to promote the success of the company would not continue the claim, or (b) the act or omission in relation to which the member complains has been ratified or authorised by the company (s. 263(2)). Should the application overcome these hurdles and avoid automatic refusal, the court must turn to assess a list of six relevant factors, which include whether the applicant is acting bona fide, and whether the applicant has any claim in his own right that arises in relation to the claim that he is attempting to bring on the company's behalf (see s. 263(3)).

Before granting or refusing permission, the court shall also pay “particular regard to any evidence as to the views of members of the company who have no personal interest, direct or indirect in the matter”, ensuring that the court embarks on a broader enquiry beyond that presented by the main parties (s. 263(4)).

The clarity and accessibility of these new procedural rules may well encourage shareholders to commence derivative actions rather than seeking redress through less structured forms of relief, such as unfair prejudice actions.

Shareholder details

S. 365(1) of the 1985 Act confers a right to inspect and make copies of a company’s share register on both members of a company and members of the public. The ability to access member information is important to various entities that might wish to communicate with members, such as other members or potential take-over bidders. However, the right to open access was sometimes abused—for instance by those intent on intimidating shareholders in an attempt to force a company to withdraw from a particular contract or industry sector. The absolute right to inspect and copy the register is therefore confined by s. 116 of the 2006 Act, which introduces a scheme under which a person seeking information must make a “request” to the relevant company. An applicant who submits a request must provide their name and address, the purpose for which the requested information will be used, and similar details in relation to any other person to whom the applicant will disclose the requested information (see s. 116(3) and (4)). The company receiving the request must, within five working days of receipt, either comply with it or make an *inter partes* application to court on the ground that the information is not requested for a “proper purpose” (s. 117(1)). The term “proper purpose” is not defined in the 2006 Act, and will no doubt generate interesting case law. Further, companies must be alive to the strict five working day limit for making an application to court. In order to make these provisions effective, power is reserved to make regulations altering the content of companies’ annual returns, which currently include information about

shareholders. The 2006 Act also creates two criminal offences in relation to misleading requests made, and misuse of information obtained, under the new s. 116 procedure: see s. 119.

■ Institutional Shareholder Reporting

Over half of UK equities are held by institutional investors (on behalf of those who invest in pensions, unit and investment trusts, collective investment schemes etc). These institutional investors have a significant opportunity to hold company directors to account by virtue of the rights conferred on them by their huge shareholdings. However, the Government has concerns as to how effectively these rights have been exercised. It therefore included within the 2006 Act power to create subsequent regulations that have the effect of forcing institutional investors to explain how they have exercised (or failed to exercise) voting rights attaching to shares that they hold and to shares held on their behalf (ss. 1277 to 1280). It remains to be seen whether the introduction of these regulations will be necessary, or whether the carrot and stick approach embodied in the 2006 Act will be sufficient to engage institutional shareholders to the extent sought by the Government.

■ Deregulation

The CLR endorsed a ‘think small first’ approach, which underpins several provisions in the 2006 Act aimed at simplifying the law applicable to small companies (see CLR p. 29 et seq).

Changes to a company’s constitution

The CLR described Table A as “a product of the mid-19th Century both in terms of the language that it uses and in substance” (CLR p. 33). Hence, the 2006 Act paves the way for new model articles for private companies limited by shares, private companies limited by guarantee, and public companies. These model articles will apply where no other articles are registered for a company, or where other articles are registered, to the extent that they do not exclude or modify the model articles applicable to the relevant class of company (s. 20). The model articles for private companies limited by shares are not yet published but will,

the Government promises, be streamlined, be written in plain English, and not reproduce matters which are dealt with in the 2006 Act. (A draft is annexed to the CLR).

Company secretaries

Private companies are no longer required to have a company secretary (s. 270), on the basis that such a role is “almost certainly unnecessary” in the vast majority of private companies (CLR p. 37). Public companies, on the other hand, are still required to have a company secretary (s. 271).

Written resolutions

Under s. 381A of the 1985 Act, members of private companies could, if they acted unanimously, make written resolutions on virtually any matter within their competence. The only two restrictions on this power related to resolutions to remove directors and auditors prior to the expiry of their respective periods of office, both of which required a substantive meeting. The 2006 Act retains these provisions in relation to resolutions to remove directors and auditors (s. 288(2)), but does away with the unanimity requirement in relation to all other resolutions.

After the 2006 Act comes into force, written resolutions will require the same ordinary or special majority as would have been required for a resolution to be passed at a meeting of members (ss. 282(2) and 283(2)). However, the ordinary or special majority on a written resolution must be of the *total* voting rights of eligible members, and not merely of those members who choose to vote (s. 289(1)). The process of passing written resolutions is further streamlined by provisions permitting the electronic dissemination of proposed resolutions (ss. 291(3)(a), 298 and 299) and by the abolition of the requirement imposed by s. 381B of the 1985 Act to send such resolutions to the company’s auditors.

AGMs

The 2006 Act also abolishes the requirement to appoint auditors or lay accounts at the AGM of a private company (ss. 414 and 485). Indeed, private companies are relieved of the requirement to hold an AGM altogether; contrast the rules for public companies, which will have to hold AGMs within 6 months of the end of their accounting period (s. 336).

Capital maintenance

The capital maintenance rules contained in the 1985 Act were castigated in the CLR as giving rise to “some of the most complex and technically challenging provisions of the [1985 Act] – 94 sections of detailed rules in total ... capital maintenance is largely irrelevant to the vast majority of private companies and their creditors” (CLR p. 40). Hence, the capital maintenance rules for private companies are significantly relaxed by two separate sets of provisions contained in the 2006 Act. Firstly, the rules prohibiting a private company from giving financial assistance for the purchase of its own shares are abolished (ss. 677 to 682). Secondly, a new out-of-court procedure is created by ss. 709 to 723 for the purchase or redemption of a private company’s shares out of capital if formalities relating to directors’ and auditors’ statements and publication of notice regarding the proposed payment are complied with, and a special resolution of members who are not interested in the distribution is obtained.

Auditors’ Liability

Part 16 of the 2006 Act contains detailed provisions relating to auditors’ liability. The attention-grabbing introduction of liability limitation agreements (LLAs) is tempered by provisions that:

- define the permissible scope of LLAs;
- prohibit auditors from excluding their liability or obtaining an indemnity from a company where they have acted improperly; and
- impose criminal sanctions for knowingly or recklessly inserting misleading details in an auditors’ report.

Part 16 begins by declaring void any exemption of an auditor’s liability or any indemnity, direct or indirect, granted by a company to an auditor in respect of the latter’s negligence, default, or breach of duty or trust in conducting an audit (s. 532). A company, however, can indemnify an auditor against costs incurred when the auditor successfully defends civil or criminal proceedings or makes a successful application for relief under s. 1157 of the 2006 Act on the basis that it has acted honestly, reasonably and ought in all the circumstances to be relieved from liability (s. 533).

SS. 534 to 538 deal with LLAs. S. 534 provides that an LLA is an agreement that purports to “limit the amount of liability owed to a company by its auditor in respect of any negligence, default, breach of duty or breach of trust, occurring in the course of the audit of accounts, of which the auditor may be guilty in relation to the company”. Crucially, s. 537(1) provides that an LLA “will not be effective to limit the auditor’s liability to less than such amount as is fair and reasonable in all the circumstances of the case.” In determining what is fair and reasonable, the court must have regard to, in particular, the auditor’s responsibilities under Part 16 of the 2006 Act, the nature and purpose of the auditor’s contractual obligations to the company, and the professional standards expected of him. It is expressly stipulated that “matters arising after the loss and damage in question has been incurred or matters (whenever arising) affecting the possibility of recovering compensation from other persons liable in respect of the same loss or damage” should not be taken into account when ascertaining what is fair and reasonable (s. 537(3)).

The 2006 Act places further restrictions on the permissible scope of an LLA: LLAs can only cover one financial year (s. 535(1)) and they must be authorised by a company’s members (s. 536). Furthermore, the 2006 Act anticipates that a company which has entered into an LLA will have to disclose various details concerning the agreement in accordance with regulations to be passed by the Secretary of State (s. 538).

Auditors will no doubt welcome the introduction of the LLA.

Nevertheless, it is envisaged that the interpretation and application of the “fair and reasonable” test will generate a considerable body of case law in the 2006 Act’s infancy, meaning that auditors will be unable to place great reliance on the terms of any particular LLA for some time to come.

Auditors will be less enthusiastic about the spectre of criminal liability introduced by the 2006 Act. A new offence, triable either way, of recklessly or knowingly including misleading, false or deceptive details in audit reports is introduced by s.507.

Furthermore, under s. 505 every copy of the auditor’s report must state the name of the auditor and, if the auditor is a firm, the name of the person who signed the report as senior statutory auditor. In exceptional circumstances (risk of violence or intimidation), confidentiality of the auditor may be preserved (see s. 506); otherwise failure to comply with s. 505 results in criminal liability for the company and every officer in default (s. 505(3) and (4)).

Bringing the 2006 Act into force

There is, unfortunately, no simple answer to the question of when the 2006 Act enters into force. A handful of provisions came into force when the 2006 Act received royal assent on 8 November 2006, including the majority of Parts 43, 44, 46 and 47: see s. 1300. These mainly relate to transparency obligations, corporate governance and liability for stock exchange statements.

The Companies Act 2006 (Commencement No 1, Transitional Provisions and Savings) Order 2006 (SI 2006/3428) details those relatively uncontroversial sections which have already come into force and those which will come into force in April 2007.

The business world will have to await the Government’s detailed plans for bringing the rest of the 2006 Act into force, although the intention is to bring all parts into force by October 2008. It is expected that consultation for the purposes of implementation will commence in February 2007.

Conclusion

In summary, the 2006 Act will introduce a regime that is modern and comprehensible, whilst also implementing some changes that are no less than radical. It is likely to play a part in ensuring that the UK continues to be a favoured location for incorporation in the global market place.

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The first supplement to Robin Hollington Q.C.'s book
Shareholders' Rights (4th edition, Sweet & Maxwell)
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