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The Companies Act 2006

Deferred reform

November 2006

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Companies Act 2006: Deferred reform

On 8 November 2006 the Companies Bill finally became the Companies Act 2006. Eventually the new Act will:

- simplify the administrative burden on smaller private companies, which make up the vast majority of the corporate population;
- facilitate shareholder engagement, particularly in quoted companies; and
- update and clarify the law in various areas, particularly in relation to directors' duties.

But only a handful of the Act's 1,200-odd sections and 16 Schedules came into force at the time of Royal Assent. The Government has said that the remaining parts will all be in force by **1 October 2008**. Between now and then, around 70 sets of Regulations are expected to be published, filling in details that are not in the Act and – most importantly – specifying how various parts of the Act will affect existing companies. Until the key Regulations have appeared, it is difficult for companies to decide what changes may need to be made to constitutional arrangements and company secretarial procedures, or even to know when they should start familiarising themselves with the detail.

This note summarises those provisions of the Act that are likely to be most significant for companies and their advisers, grouped into the following topics:

1. Directors and corporate governance
2. General meetings, resolutions and shareholder rights
3. Capital maintenance and transactions benefiting shareholders
4. Auditors and accounts
5. Company administration
6. Further reform of company law

It also assesses the likely timetable for their introduction. As and when the picture becomes clearer, we will publish further articles and run client seminars on key aspects of the new Act.

Those parts of the Act which give the FSA power to make rules implementing the EC Transparency Directive (which must be done by 20 January 2007) came into force on Royal Assent. So far the FSA has only published 'near final' rules, and has promised to publish in December guidance on certain aspects of the new regime in a special edition of its newsletter, List!. Once this newsletter has appeared we will publish a further article describing the changes.

Provisions of the new Act that relate principally to takeovers and electronic communications between companies and their shareholders will also come into force by 20 January 2007. For further details of these change see our article "The Companies Act 2006: takeovers and electronic communications", which can be found by clicking here.

Banks and other lenders can find details of those provisions of the Act which will particularly affect them in our article entitled "The Companies Act 2006: issues for lenders", which can be found by clicking here.

A single Companies Act

Eventually the new Act will repeal and replace nearly all of the Companies Act 1985: the only significant parts of the 1985 Act that will remain relate to company investigations and community interest companies. Around 800 sections of the new Act contain rules that are entirely new or that are significantly different from the existing law; the remaining 400 or so sections are intended simply to restate those parts of the 1985 Act that have not been amended.

Most company legislation will therefore be contained in a single consolidated Act. In principle, provisions that are restated from the 1985 Act should have the same effect, but lawyers are likely to scrutinise any differences in language to assess whether the meaning has inadvertently been changed in the process.

Timetable

Apart from those sections of the Act that relate to takeovers, electronic communications, and the implementation of the Transparency Directive (which are described in separate LawNow articles), and a few other minor and technical sections enabling the Government to bring other parts into force in the future, no timetable has yet been set for all or any particular parts of the Act to come into force. Before the Act received Royal Assent, the Government indicated that as far as possible it favours a Big Bang approach of bringing all the remaining sections in at the same time – i.e. probably on 1 October 2008. However, from early next year it will begin consulting on when and how parts of the Act should be brought in.

Two particular factors are likely to influence the timetable: the Government's concern that existing companies should not have to go to the trouble and expense of convening EGMs to change their articles and pass other resolutions in order to take advantage of, or come into line with, the new Act; and the need to implement other EC Directives that are already on the horizon: for example, in order to implement changes to the Second Company Law Directive on maintenance of capital in public companies, some of the rules restricting public companies from giving financial assistance, buying back their own shares, and issuing shares for non-cash consideration, will have to be relaxed by April 2008.

Application of the Act to existing companies

It is not yet clear how certain provisions of the Act will apply to existing companies. The DTI issued a consultation paper in August this year presenting various options for transitional provisions, but it has not made specific proposals, and the consultation was limited in scope. Formal consultation on Regulations to make transitional arrangements is expected to start in January, and is not expected to complete before April 2007 at the earliest. At present it is therefore difficult for companies to plan their strategy for responding to the Act.

As and when the picture becomes clearer, we will publish further articles and run client seminars on key aspects of the new Act.

Overview of the Act

1. DIRECTORS AND CORPORATE GOVERNANCE

Statutory statement of directors' duties

For the first time, the duties owed by directors to their company have been set out in statute, making them clearer and more accessible than at present. Sections 171-182 are intended to 'codify' the principal duties that have been established in cases to date, although slight changes have been made in relation to conflicts of interest.

Fiduciary duties

A director must:

- Act in accordance with the company's constitution, and only exercise powers for the purposes for which they are conferred.

- "Act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:
  - the likely consequences of any decision in the long term
  - the interests of the company's employees
  - the need to foster the company's business relationships with suppliers, customers and others
  - the impact of the company's operations on the community and the environment
  - the desirability of the company maintaining a reputation for high standards of business conduct; and
  - the need to act fairly as between members of the company."

The obligation to "have regard" to these 'statutory factors' is said to embody the concept of "enlightened shareholder value", tempering an aggressively narrow view that companies exist simply to maximise the returns to their owners with a recognition that it is in a company's long term interests to take account of social and environmental concerns.

The key question, of course, is whether the obligation has any real 'teeth' – i.e. could directors be found liable for failing to have due regard to these factors, or for attaching insufficient weight to them? The formula "have regard (amongst other matters)" clearly acknowledges that, depending on the circumstances, directors may legitimately decide that other pressures and constraints outweigh any or all of these statutory factors. Judges have normally been reluctant to re-examine commercial judgements of this kind made by directors, but this has not prevented the courts from occasionally attacking decisions where, on the facts they knew or ought to have known, the directors have failed to take into account all relevant factors, or taken irrelevant factors into account, or come to a conclusion that no reasonable director, properly directing himself as to his duties, could have reached.

In the Explanatory Notes published with a late draft of the Bill, the Government stressed that the obligation to "have regard to" the statutory factors cannot be discharged merely by paying lip service to them: directors must exercise the same level of skill, care and diligence as they would in carrying out any other function. When assessing whether in taking any decision a director has acted with reasonable skill and care, the courts will take into account all the circumstances, including the director's own role and expertise, the seriousness of the matter in issue, and what it is reasonable to expect of a director in that situation. Broadly speaking, therefore, directors are expected to do all that they reasonably can to take the statutory factors into account; the more significant a decision, the more important it will be to ensure there is a paper trail showing that the board has actively

considered how a particular decision will impact the company's employees, customers, suppliers, the environment and its commercial reputation.

But as long as a director can show that he did actually consider these statutory factors, even if he ultimately decided that they were less important than other factors, he will probably have discharged his duty. In any event, liability will only follow if the company can show that it suffered a loss as a result of the director's breach of duty.

The new duty to "have regard to" the interests of the company's employees has a direct precedent in section 309 of the 1985 Act. As to whether a claim could ever be brought by or on behalf of the company against a director for breach of that section, it has been said that "the obvious difficulties are, not only to prove … the fact of a director having acted without due regard to the interests of the employees, but also to prove what damage was suffered by the company."

A director must also:

- Exercise independent judgement, and not fetter his discretion except pursuant to an agreement that was considered to be in the best interests of the company when it was entered into.
- Avoid conflicts of interest.
- Not accept benefits from third parties.
- Declare his interest in any proposed transaction or arrangement.

Changes to rules on conflicts of interest

Where a transaction is proposed between a director and his company, so that the director's duties to the company may be in conflict with his personal interests, the rules of equity currently require shareholders to approve the transaction. Companies' articles usually modify this equitable duty, instead simply requiring directors to disclose their interest to the rest of the board.

Section 178 of the Act reflects the current position in section 317 of the 1985 Act and in the articles of most companies by requiring an interested director to disclose the nature of his interest to the rest of the board before the transaction is approved. One change is that disclosure need not be made if the interest cannot reasonably be regarded as likely to give rise to a conflict of interest or if the other directors are already aware of the director's interest.

Existing equitable rules prevent a director from exploiting personally without permission any opportunity that properly belongs to the company, even if the company is not itself in a position to exploit it. Believing this to

hinder entrepreneurial and business start-up activity, the Government has included provisions in section 176 of the Act that allow the other directors, provided they have no interest in the matter, to authorise a director to proceed notwithstanding his conflict of interest. Directors of public companies will only be able to authorise such conflicts if the articles allow it. There could, of course, be difficulty if none of the directors is without an interest in the matter; in that case, only a shareholder resolution could absolve the conflicted director.

Duty of skill and care

The standard of skill and care expected of directors reflects the combined objective and subjective test in section 214 of the Insolvency Act 1986, which has been applied in recent cases – i.e. the higher of the knowledge, skill and experience reasonably expected of a director in that position, and the knowledge, skill and experience of that particular director.

Relevance of case law

Although the new duties expressed in the Act will displace those formulated in previous cases, cases on directors' duties will continue to be relevant for the purpose of determining how those duties should be applied in particular circumstances. Historically, courts have sometimes decided that a particular duty implies additional obligations: for example, the Court of Appeal recently ruled that the director's duty under the current law to act in what he in good faith considers to be the best interests of his company imports an obligation to disclose his own breach of the duty. This 'dynamic' approach is unlikely to change under the new Act.

Some have suggested that the duty in the new Act to "promote the success of the company" may be subtly but significantly different from the existing duty to act "in the best interests of the company". It seems to us more likely, however, that the courts will regard the wording in the Act simply as a new label for the same fundamental duty.

The DTI has said that next year it will publish plain English guidance on the duties of directors under the new Act.

Transactions between directors and their companies

Various changes will be made to the rules on substantial property transactions between companies and their directors, on loans to directors, payments to directors for loss of office, and on long-term service contracts, principally to make the rules more accessible and consistent, and to remove a number of ambiguities.

For example:

- All companies will be able to make loans to their directors if, after full details have been provided, the loan is approved by shareholders. At present such loans are generally prohibited, subject to various exceptions.
- Companies will be able to enter into transactions that would currently fall within section 320 of the 1985 Act before shareholder approval has been obtained, as long as the transaction is made conditional on such approval.
- Shareholder approval will be required where a company proposes to make a payment to a director in compensation for loss of his employment as a director of the company (not just for loss of his office as a director) which goes beyond his existing contractual entitlement.
- The complex rules in section 346 of the 1985 Act determining which persons are "connected" to a director for these purposes will also be re-written and extended to catch a director's civil partner, a person who lives with the director "as partner in an enduring family relationship", the director's parents, and any infant children or step-children of the director's partner who live with him.

Transactions with third parties: ultra vires

Unless a company's objects (which will be contained in its articles – see section 5 below) are specifically restricted, they will be deemed to be unrestricted as far as third parties are concerned.

Sections 35-35B of the 1985 Act, which deal with a company's capacity and the power of directors to bind it, will be replaced with new provisions that do not make any substantive change to the current rules. A third party will continue to be protected if he deals with the company in good faith. Third parties dealing with a company will still have to concern themselves with the question of whether the director they are dealing with has sufficient authority.

As between the company and themselves, directors will still have a duty to observe the company's constitution, including any restrictions on the company's activities.

Service addresses

All directors – and not just those at serious risk of violence or intimidation - will be able to provide a service address for the public record. A director's residential address will still have to be filed at Companies House but will be kept on a separate register, access to which will be limited to certain public authorities and credit reference

agencies. The company itself will also maintain a record of each director's residential address, but this will not be open to public inspection.

As there are around five million registered directors, Companies House have said that they are unable to remove all existing residential addresses from the record. However, the Act does give the Secretary of State power to establish a procedure whereby a particular director can, if the circumstances justify it, apply to have all his existing details removed.

Appointment and eligibility

At least one director of every company will have to be a natural person (who need not be domiciled in the UK).

The 70-year age limit for directors of public companies and subsidiaries of public companies will be abolished. There will be a 16-year minimum age limit for directors of all companies.

Company secretaries

Private companies will no longer be required to have a company secretary, but they may choose to do so. Where a company secretary *is* appointed, he will have the same status as under the 1985 Act – in particular, he will be able to file documents at Companies House and be one of the signatories to a deed made by the company.

Personal liability

Derivative actions initiated by shareholders

As a general rule, if a wrong is done to a company, only the company itself (and not a shareholder) can bring an action for damages or some other remedy. In practice, the directors must decide whether or not to bring a claim. Clearly, if the wrong was done by the directors themselves, or a majority of them, no claim is likely to be pursued. Unless shareholders are able to force the board to bring a claim, either by passing an ordinary resolution to replace the existing directors, or by giving a direction to the board by means of a special resolution, the company and the shareholders will have no remedy in respect of any loss the company has suffered. Minority shareholders can therefore find it difficult to force directors to overturn their decision not to bring an action.

However, where it can be shown that an act amounts to a 'fraud on the minority' – basically, some wrongdoing by the directors or majority shareholders, or some ultra vires action, illegality or infringement of a shareholder's personal rights - and that the wrongdoers are in control of the company, the courts have for some years allowed minority shareholders to bring a "derivative action" - in effect, allowing the shareholder to prosecute a claim on

behalf, and for the benefit, of the company. A derivative claim can only be brought at the discretion of the court. Moreover, no claim can be brought where a majority of independent shareholders do not wish the action to proceed.

Because of the difficulty in bringing such claims, the Government accepted the Company Law Review's recommendation that derivative actions should be put onto a statutory footing. In the event, the sections in the Act dealing with derivative actions proved to be among the most controversial, due largely to companies' fear that the new rules would make it easier for activist shareholders and special interest groups to sue directors. For the reasons given below, we believe these fears to be largely unfounded.

Sections 260-264 of the Act deal with derivative claims. As at present, a claim can only be brought with the permission of the court. In practice, the court will hear evidence from the company and the claimant at a preliminary hearing, and decide whether to allow the claim to proceed. Historically, most claims have been struck out at this stage. Over the last three years, there have only been seven reported cases on derivative actions, and in the only one of these where permission was granted the company did not oppose the application. Also at this stage, the court is likely to be asked to decide whether the company should be made to bear the claimant's costs of bringing the action. Arguments over whether permission should be granted, and what order should be made as to costs, can take many days: in one famous case, the preliminary hearing lasted 18 days.

Under the new Act, a derivative claim can only be brought:

- 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" (whether arising before or after the claimant became a shareholder). At present, a claim can only be brought in respect of a director's negligence if he himself has benefited from it; the new regime is therefore much wider in this regard; and
- where it appears to the court that the claimant has a prima facie case. In all but the most open and shut cases, the court will probably be reluctant to dismiss a claim on the basis of what may be rather limited evidence at a preliminary hearing, so few claims are likely to fail at this stage.

There is no need to show that an act amounts to a 'fraud on the minority', or that the wrongdoers are in control of the company. But the court must dismiss the claim if it is satisfied that:

- a (hypothetical) director acting so as to promote the success of the company for the benefit of its members as a whole would not continue the claim; or

- where the act or omission is yet to occur, it has been authorised by shareholders or, where it has already occurred, it was authorised beforehand by shareholders or has subsequently been ratified by them.

In effect, therefore, the court will have to put itself into the position of an independent director of the company and decide whether or not it is appropriate for a derivative claim to be pursued. This kind of judgement, which depends upon a mixture of 'commercial' and 'legal' factors, is of a sort that courts are usually reluctant to make.

In deciding whether to give permission, the court must take various matters into account, including whether the shareholder is acting in good faith; the importance of the claim to the company; whether the company has decided not to bring the claim; and whether the shareholder could bring a claim in his own right, rather than on behalf of the company. The court is also required to have particular regard to the views of any disinterested shareholders: for example, if the company produces evidence that a majority of those shareholders do not favour pursuing the claim, this is likely to weigh heavily with the court. To get a derivative claim struck out, a company will want to show that, essentially, the board's decision not to pursue a claim against a director is a reasonable one in the circumstances: it will help if the board can show that it has taken independent legal advice and, preferably, that the decision has the support of the majority of disinterested shareholders.

Until the new rules are applied in practice by the courts, it is difficult to know whether the number of derivative claims is likely to increase. It has been suggested that the possibility of bringing claims in respect of directors' negligence or breach of duty, without having to show 'fraud on the minority', means that more claims are likely. But even activist shareholders are still likely to be discouraged from bringing such claims by the fact that any damages recovered will go to the company, and not the shareholder personally.

Application for relief

Under a section that will replace section 727 of the 1985 Act, if a director "has reason to apprehend that a claim will or might be made against him in respect of negligence, default, breach of duty or breach of trust", he will be able to apply to court for relief without having to wait for the claim to be made.

Indemnities

The new rules introduced on 6 April 2005, allowing companies to indemnify their directors in certain circumstances, and to advance funds to them to meet defence costs, will be restated without significant amendment. However, the rules will be extended to allow a corporate trustee of an occupational pension scheme (or a member of its group) to indemnify its directors against liability incurred in connection with the company's

activities as trustee of the scheme, other than fines, penalties or the costs of defending criminal proceedings in which the director is convicted. At present, the rules do not appear to allow such indemnities, meaning that directors of corporate trustees may be in a worse position than non-corporate trustees, who can be indemnified out of the scheme's assets.

The exception that allows companies to lend money to their directors to fund their defence costs will be extended to cover not just proceedings relating to the company but also relating to any associated companies.

Defective accounts; fraudulent trading

Contrary to its original proposal to make the maximum sanction for approving defective reports and accounts a term of imprisonment, the Government finally decided that the maximum penalty should be an unlimited fine. But the maximum prison term for fraudulent trading will be increased from seven to ten years.

Liability for offences committed by company

The general principle adopted in the new Act is that where the only victims of the offence are the company or its members, the company itself should not be liable for the offence. But where the members of the company are only some of the potential victims, the company itself should be liable. A director or other officer of the company will be personally liable where he "authorises, permits, participates in, or fails to take all reasonable steps to prevent" the offence.

In the light of responses to its original consultation, which criticised the proposals on both policy and technical grounds, the Government decided not to extend to "senior executives" and "responsible delegates" the category of "officers in default".

Corporate governance of listed companies

In anticipation of new European rules on corporate governance, the FSA has been given power to make or amend Handbook rules (such as the Listing Rules) to implement any EC Directives on corporate governance that apply to companies listed on a regulated market. "Corporate governance" is broadly defined to include the manner in which directors conduct themselves, and the relationship between boards and shareholders. This section of the Act came into force on Royal Assent, but no such rules have yet been made by the FSA.

2. GENERAL MEETINGS, RESOLUTIONS AND SHAREHOLDER RIGHTS

Quoted companies

Shareholder rights to raise questions

Shareholders in quoted companies who hold at least 5% of the voting rights, or who number at least 100 (with an average of at least £100 of share capital each) will have the right to publish on the company's website free of charge a statement of any concerns about the audit, or the circumstances in which the auditors have resigned, that they intend to raise at the AGM. But contrary to the Government's original plans, the auditors will not be legally obliged to answer shareholder questions.

A proposal in an early draft of the Bill to grant shareholders of quoted companies a right, within a 15-day "holding period" after the accounts become available, to propose a resolution to be moved at the general meeting where the accounts are laid was also dropped. Instead, as originally proposed, shareholders in public companies (whether quoted or not) will be able to require the company to circulate resolutions and any accompanying statement at the company's expense (rather than their own) if the materials are provided to the company before the end of the financial year.

Exercise of voting rights

To make it easier for beneficial owners to exercise voting rights held by the registered holder (who is often a nominee or intermediary), all companies will be permitted, but not required, to change their articles to allow registered holders to nominate someone else (such as the beneficial owner) to exercise some or all of their statutory rights as a member, including the right to appoint a proxy and to circulate a proposed resolution or statement prior to a general meeting.

Without any change being made to the articles, members of companies whose shares are admitted to trading on the Official List or another EU regulated market will be entitled to nominate someone else to receive copies of all communications sent by the company to its members generally, including notices of meetings and copies of reports and accounts. But until the company's articles are changed to permit such nominated persons to exercise voting rights directly, they will need to arrange for the registered member to vote in accordance with their wishes. To facilitate this process, the new Act will allow registered members who hold shares on behalf of several beneficiaries to exercise their rights in different ways.

The provisions in the Act allowing companies to communicate electronically with shareholders will apply to nominated persons. For further information on these provisions see our article entitled "The Companies Act 2006: takeovers and electronic communications", which can be found by clicking here.

There are still various technical difficulties to be ironed out in connection with the direct enfranchisement of beneficial owners, and Regulations are likely to be published next year.

In case voluntary shareholder engagement does not appear to be working in practice, the Government has taken power in the Act to make regulations forcing institutional shareholders to publicly disclose their voting records. A number of institutions have already started to do so voluntarily, including Fidelity International, one of the UK's largest fund managers, which has published its voting record at shareholder meetings on every motion proposed by companies in which it invests in the UK, Europe, the US and Asia between since 1 July 2004. The Government has promised that it will not introduce such regulations without prior consultation and a proper cost/benefit analysis.

Polls

Quoted companies will have to disclose the results of any poll on their website - some already do so as a matter of best practice. Shareholders who hold at least 5% of the voting rights, or who number at least 100 (with an average of at least £100 of share capital each) will be able to require the directors to obtain an independent report on any polled vote.

All companies

Right to inspect a company's register of members

In the original Bill, a company would have been entitled to refuse a request from any person to inspect its register of members if it could persuade a court that the request was not made for a "proper purpose". Following a number of high-profile cases in which animal rights activists have obtained the names and addresses of shareholders in pharmaceutical companies, these provisions have been tightened up. In effect, the person requesting the information must tell the company what the information will be used for, and who it will be passed to, and if the company can persuade a court that this is not a proper purpose it may obtain permission to reject that particular request and any similar ones made in future.

In addition, the Solicitor-General expressed the intention (subject to consultation) that public companies will be exempt from the obligation to supply details to Companies House of those who hold less than 5% of any class of

shares, and for private companies not to require the addresses of their members. This is intended to be a practical way of ensuring that the restriction of the right to inspect a company's register of members is not circumvented by the information being publicly available at Companies House.

Proxies

Members of both private and public companies will be able to appoint more than one proxy. Proxies will be given the same rights as registered holders to ask questions, demand a poll and vote on a show of hands at general meetings (as well as on a poll).

Rights issues

The statutory minimum period of 21 days for acceptance of rights offers will be retained, but the Act allows the Secretary of State to make regulations to vary this period upwards or downwards (but to no less than 14 days).

Transfer of shares

Directors will have a statutory obligation to provide a proposed transferee of shares with reasons for any refusal to register the transfer.

Class rights

Various technical changes will simplify the variation of class rights provisions currently in force under sections 125-127 of the 1985 Act.

New rules will also expressly allow companies to include in their articles provisions that can be changed only with the consent of a particular majority (e.g. 90% of all the members) – so-called conditional entrenchment. But an entrenched provision can always be over-ridden by a unanimous resolution of all the members.

Political Donations

Technical changes will also be made to the regime requiring companies to obtain shareholder authorisation before making any donation to an EU political party or organisation or incurring any EU political expenditure. The regime has been criticised for being too wide, so that it could catch various activities that would not normally be thought of as party political, and for requiring an excessive number of shareholder resolutions.

Amongst other things:

- private companies will be able to authorise donations and/or expenditure by written resolution;
- a holding company will be able to seek authorisation of donations and expenditure in respect of both the holding company itself and one or more subsidiaries (including wholly-owned subsidiaries) through a single approval resolution;
- a specific exemption will be introduced for donations to non-political funds of a trade union.

3. CAPITAL MAINTENANCE AND TRANSACTIONS BENEFITING SHAREHOLDERS

Financial assistance

The restriction on private companies financially assisting the acquisition of their own shares or those of their (private company) parent will be repealed, as will the whitewash procedure. Even a private company subsidiary of a public company will be free of the restriction in relation to an acquisition of its own shares or the shares in an intermediate private company holding company. But public companies will still be prohibited from giving financial assistance for the acquisition of their own shares or those of their parent company (whether public or private).

A public company will be able to re-register as private in order to give financial assistance (as some public companies presently do in order to take advantage of the whitewash procedure) – for example, where a takeover bid of a public company is financed by debt and the bank wants to take security over the target's assets.

Directors will still need to consider whether a proposed arrangement is in the best interests of their company. There has also been a concern that the removal of the statutory prohibition on private companies giving financial assistance will revive the common law maintenance of capital rules, without giving recourse to the whitewash procedure to cure the problem. To try to alleviate this concern, Lord Sainsbury confirmed that a saving provision made under the Act will clarify that the removal of the prohibition will not prevent private companies from entering into transactions which they can lawfully enter into currently under the whitewash procedure. However, it is not yet clear whether, and to what extent, companies will actually have to demonstrate that they could have complied with the conditions for a whitewash – for example, will the company have to be able to show that it has net assets and that the assistance has no adverse impact on its net assets or, to the extent that it does, that the assistance is being provided out of distributable profits?

Assuming that this uncertainty over the common law rules can be resolved satisfactorily, the relaxation of the rules on financial assistance is likely to simplify many M & A transactions which involve only private companies.

Reduction of capital

Private companies will be able to reduce their share capital by passing a special resolution, supported by a directors' solvency statement signed by all the directors, rather than having to go to court. The statement will be similar to a statutory declaration of solvency for the purposes of a financial assistance whitewash under the current law. The current procedure for companies to reduce their capital by applying to court will remain and in some circumstances may be advantageous.

Redeemable shares

The procedure for private companies to purchase or redeem their own shares out of capital will be retained, but as companies will be able to cancel shares and return various non-distributable reserves to shareholders by means of a reduction of capital, the procedure will probably be used less often.

Shareholders in both public and private companies will be able to adopt articles that allow the directors to decide the terms on which redeemable shares are to be redeemed (rather than having to set out those terms in the articles). The terms of redemption must be decided before the shares are actually allotted.

***Intra-group transfers and the rule in* Aveling Barford**

Section 848 of the Act will confirm the generally-held view that assets can be transferred intra-group at their book value, rather than a higher market value, provided that the transferor has distributable profits. If an asset is sold at less than its book value, the company will need to have sufficient distributable profits to cover the amount of the difference between the sale price and book value.

Authorised share capital abolished

Concerns over whether a company has sufficient headroom to issue new shares will disappear, as the Act abolishes the concept of authorised share capital. However, an early proposal to allow companies to issue shares of no par value was dropped: shares must have a fixed nominal value.

The existing requirements for public companies to have a minimum share capital will be kept, as they reflect the Second Company Law Directive.

Allotment of shares by private company

Unless its articles provide otherwise, a private company's directors will no longer need shareholder approval to allot shares, although approval will be necessary if the company has, or will have as a result of the allotment, more than one class of shares.

Re-denomination of shares

A simplified procedure will allow limited companies to convert their share capital from one currency to another, and to re-denominate their shares after conversion to achieve round share values, without having to go to court or buy back shares out of capital and issue new shares.

4. AUDITORS AND ACCOUNTS

Business review

In March 2005 amendments were made to the 1985 Act to require all large and medium-sized companies to include in their directors' report for financial years starting on or after 1 April 2005 a "business review" containing:

- A description of the principal risks and uncertainties facing the company;
- A fair review of the company's business containing a balanced and comprehensive analysis, consistent with the size and complexity of the business, of:
  - the development and performance of the business during the financial year; and
  - the position of the company at the end of that year.

"To the extent necessary for an understanding of the development, performance or position of the business of the company", the review must also contain:

- analysis using financial key performance indicators (KPIs); and
- where appropriate, analysis using other key performance indicators, including information relating to environmental and employee matters.

Medium-sized companies need not include any KPI analysis of non-financial information. The scope of the business review is designed to reflect, but go no further than, the EC Accounts Modernisation Directive.

At the same time, new provisions were introduced to require quoted companies to produce an OFR for financial years starting on or after 1 April 2005. In May 2005 the Accounting Standards Board published the final version of its accounting standard on the OFR. The OFR covered a wider range of matters than the business review and would have had to include some forward-looking information.

However, in November 2005 the Chancellor took the decision to scrap OFR, announcing instead that quoted companies would simply have to produce a business review. Following protests by environmental groups and others, the Government agreed to consult further on what should replace the OFR. The new Act therefore includes sections which will extend the scope of the business review for quoted companies to bring it closer to the OFR, but without going quite as far.

In particular, quoted companies will have to ensure that, "to the extent necessary for an understanding of the development, performance or position of the company's business", their business review includes:

- the main trends and factors likely to affect the future development, performance and position of the company's business; and
- information about (i) environmental matters (including the impact of the company's business on the environment); (ii) the company's employees; (iii) social and community issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies; and (iv) "persons with whom the company has contractual or other arrangements which are essential to the business of the company". Category (iv) is potentially broad and, as well as key suppliers and customers, it could include any party which has granted the company a key licence or with whom the company has any critical joint venture or other contractual arrangement. In Parliament, the Minister stated that it does not require companies to list all their suppliers: it is intended to elicit information about significant relationships, such as major suppliers or key customers that are critical to the business, and which are likely to influence, directly or indirectly, the performance of the business and its value. It will be for the directors to exercise their judgement on what they need to report. For example, if a company relies on a single supplier for a key component, so that if the supplier were to become insolvent this would have a serious impact on the company's business, the business review should disclose the existence of the relationship.

If the review does not contain the required information, it must say so. Information cannot be withheld from the business review on the grounds that it is confidential or commercially sensitive. But it is not necessary to include information about a person if its disclosure "would, in the opinion of the directors, be seriously prejudicial to that

person and contrary to the public interest". This carve-out is intended to protect suppliers and others who do business with companies that are at risk of attack by extremist groups.

Although the Act does not include a general safe harbour for forward-looking information included in the business review, under section 471 a director will be liable to compensate the company for any loss suffered as a result of any omission or untrue or misleading statement in the directors' report only if the director either knew that the statement was untrue or misleading, or was reckless as to whether it was, or (in relation to omissions) only if he dishonestly intended to conceal a material fact.

It is not yet clear when companies will first have to comply with the provisions in the Act concerning the business review. However, the Act will not apply to any financial reporting period that begins before the Act received Royal Assent on 8 November 2006. Next year the ASB has promised to publish an accounting standard on the business review.

Companies that already publish an OFR on a voluntary basis are likely to continue to do so, but when the relevant provisions of new Act come into force they will need to ensure that their OFR complies with the new business review requirements.

Time limits for filing annual accounts

Private companies will have to file annual reports and accounts at Companies House within nine months of the year end (down from ten months at present), and public companies within six months (down from seven).

Limitation of auditors' liability to company

Auditors have campaigned for many years for changes to section 310 of the 1985 Act to allow them to impose limits on the amount of damages that an audit client could recover in respect of a negligent audit. In particular, they have argued that their share of liability should be proportionate to the degree of fault rather than their being potentially liable for the whole of any loss even where their negligence was a minor factor. Arguments have raged inconclusively over whether such a change would hinder or enhance competition between audit firms. It is certainly true, however, that it would reduce the risk of one of the Big Four being destroyed by a single huge claim.

Chapter 6 of Part 17 of the new Act is therefore a welcome development for the audit profession, as it makes it possible for auditors to limit their liability by agreement with a company on an annual basis. A so-called "liability limitation agreement" will not be subject to the Unfair Contract Terms Act 1977, but will not be able to limit the

auditor's liability to less than an amount that a court considers is "fair and reasonable in all the circumstances of the case". In deciding what is fair and reasonable, the court must have regard in particular to:

- the auditor's statutory responsibilities;
- "the nature and purpose of the auditor's contractual obligations to the company"; and
- the professional standards expected of him.

The court must not take account of events arising after the loss or damage occurred, or of the (im)probability of the company recovering from any other party who may also have been at fault.

As a result, as soon as the relevant sections of the Act become law, audit firms are likely to ask their clients to sign a liability limitation agreement restricting their liability to an amount proportionate to the auditor's fault and, most likely, subject to a monetary cap. Companies will have to assume that such restrictions are valid unless and until they challenge them successfully in court.

A company that has entered into a liability limitation agreement with its auditors will have to disclose this in its annual financial statements.

Recognising that audit firms may propose similar restrictions, so that in practice companies may have little choice but to accept the terms proposed, the Government has reserved the right in future to make regulations prohibiting or prescribing certain terms in order, particularly, to prevent anti-competitive behaviour.

A liability limitation agreement will not be able to limit auditors' liability for past audits.

Auditors' duty of care

After consideration, the Government decided not to codify in statute the principle expressed by the House of Lords in *Caparo Industries plc v Dickman* [1990] 2 AC 605 that the auditors' statutory duty is owed to the company's shareholders as a body, to enable them to exercise their rights in general meeting (for example, to approve or disapprove the election or re-election of directors, or the appointment or reappointment of the auditors), but not to individual shareholders or the public at large who may have relied on the accounts when deciding whether or not to invest in the company. The courts will therefore be left to determine on a case by case basis the circumstances when auditors are liable to pay damages to third parties who rely on the audited accounts.

Appointment of auditors

There will be a presumption that auditors of private companies will be automatically reappointed each year.

Resignation of auditors

A firm which ceases to hold office as auditor of a quoted company will always have to make a statement about the circumstances of its departure. The statement will have to be circulated to the company's shareholders unless a court is persuaded that the auditor is "abusing his rights". A copy must also be sent to Companies House and the Financial Reporting Council.

Quoted companies

Quoted companies will have to publish their annual accounts and reports and any preliminary results on their websites.

True and fair view

Apparently in response to concerns that the introduction of IFRS and changes to UK GAAP are eroding the concept of the 'true and fair view', section 399 of the Act provides that the directors of a company must not approve annual accounts unless they are satisfied that they give a true and fair view. It also requires auditors to have regard to this standard in carrying out their audit. The existing requirement for auditors to state in their report whether or not the accounts give a true and fair view has been retained.

Audit report

Section 521 of the Act makes it a criminal offence for an auditor knowingly or recklessly to cause a misleading, false or deceptive audit report to be made. The maximum penalty will be an unlimited fine - not imprisonment, as originally proposed.

For the first time, the audit report will have to be signed by the lead auditor, as well as the audit firm. However, the risk attaching to this will be reputational rather than legal: section 518 provides that the signatory will not be subject to "any civil liability to which he would not otherwise be subject".

Auditors' terms of engagement

Regulations may be made in future requiring auditors or companies to publish audit engagement letters and/or details of the services provided by the auditors (and their associates) to the company, and the remuneration received.

5. COMPANY ADMINISTRATION

Resolutions and meetings

Company decision-making processes will be streamlined. In particular:

- Private companies will not be required to lay their accounts or to appoint an auditor (if they have one) at an AGM. Companies that wish to continue to hold AGMs may do so.
- Public companies will have to hold their AGM within six months of their financial year end.
- EGMs of both private and public companies will only require 14 days' notice, even if a special resolution is proposed.
- Other than resolutions to remove a director or auditor, all resolutions of private companies will be capable of being passed in writing.
- Instead of needing unanimity, an ordinary resolution will be capable of being passed in writing by a simple majority of the total voting rights of eligible members; and a special resolution in writing by 75%.
- The percentage of shares or voting rights necessary to hold a meeting in a private company at short notice will be reduced from 95% to 90%.
- A company will be able to change its name either by special resolution or by any other means provided in its articles.

Formation of companies

Single member companies

It will be possible to have single member public companies, as well as private ones.

Constitution

The memorandum of association will be a brief document simply stating that the subscribers have agreed to become members and to take at least one share each. Other matters currently contained in the memorandum,

such as the company's objects, can instead be incorporated in the articles. For existing companies, such provisions will be treated as if they were in the articles.

The Secretary of State will be given power to prescribe 'default' articles for all types of company, rather than just for those limited by shares. Before the Bill started its passage through Parliament, the Government published in draft new simplified sets of model articles for private and public companies limited by shares. It also intends to create a set of model articles for private companies limited by guarantee. All of these model articles will be included in secondary legislation to be published next year.

When the new model articles are introduced, they will apply automatically to companies that are incorporated after that date, but not to companies incorporated before. In both cases, shareholders will be able to choose to adopt all or any part of the new model articles.

Company names

New provisions will enable a person to object to a company's name if that name is the same as, or confusingly similar to, a name in which the objector has goodwill. The objection will be upheld if the name was not adopted in good faith or if the main reason for its choice was either to obtain money from the person objecting or to prevent their using the name.

Business names

The Business Names Act 1985, which governs the use of trading names by certain companies, partnerships and sole traders, will be repealed and replaced with similar provisions.

Private companies offering shares to the public

A private company that is intending to re-register as public will be able to offer shares to the public without waiting for the re-registration to complete. The definition of "offer to the public" currently in section 742A CA 85 (which is quite different to the definition used for prospectus purposes) will remain largely unchanged.

As with section 742A, an offer is not made to the public if (broadly speaking) it is (i) made to persons who are already connected to the company, such as existing shareholders and employees and members of their families; (ii) made in connection with an employee share scheme; or (iii) not "calculated to result" in the shares or debentures being offered to persons other than the original recipients of the offer. In the latter case, doubts remain about whether "calculated to result" requires an element of intention by the issuer and its directors (as the

Government has said) or whether it is enough that, objectively speaking, the shares are **likely** to end up in the hands of third parties (as case law suggests). It is regrettable that this uncertainty has not been removed.

Paper-free holding and transfer of shares

The Act extends the power under section 207 CA 89 for the Secretary of State to make regulations providing for shares to be transferred electronically. It is under this power that the Uncertificated Securities Regulations 2001, which enable shares in quoted companies to be transferred through CREST, were made. It will now enable further regulations to be made requiring, as well as permitting, any specified type of company to provide for its shares to be held and transferred electronically. Such regulations will only be introduced after further consultation.

Companies House filings

There will be a new offence of knowingly or recklessly delivering information to the registrar of companies that is misleading, false or deceptive in a material particular.

From 1 January 2007 it will be possible to incorporate a company on-line, and companies will be able to file most documents and particulars electronically.

The Registrar will be given limited powers to accept informal corrections to, or replacements for, documents that have been filed. At present, the formal position of Companies House is that corrections or replacements can only be effected pursuant to a court order.

6. Further reform of company law

Company law reform power

To help ensure that company law remains up to date, the original Bill contained power under Part 31 for the Secretary of State to make orders to amend primary legislation "in relation to companies" (so-called "company law reform orders"). Such orders would have been subject to a consultation process with interested parties and an accelerated Parliamentary approval process. However, this power was dropped after the Delegated Powers and Regulatory Reform Committee of the House of Lords published a damning report saying that it would give Ministers too much discretion to amend primary legislation without proper Parliamentary scrutiny.

As a result, amendments to the new Act or to the 1985 Act that are required in future – e.g. to implement amendments to the Second Company Law Directive and the Directive on migration of companies between Member States, and to make changes recommended by the Law Commission on company charges (see below) –

will have to be introduced using powers under the European Communities Act 1972 or by means of new primary legislation.

Company charges

Because no consensus of support for the Law Commission's proposals emerged from the recent consultation exercise, the Act does not make any significant changes to most of the existing rules on registration of company charges.

But the current requirement for a company incorporated outside Great Britain but with an established place of business here to register a charge over any property situated in England and Wales – which in practice has resulted in companies attempting to file such charges at Companies House and providing lenders with a copy of the rejection letter (a process known as a "Slavenburg filing") – has not been replicated in the new Act. Instead, the Secretary of State will be able to make regulations requiring overseas companies that have a presence here to register specific charges over property situated in Great Britain. For further details of these and other changes see our separate LawNow article which looks at the new Act from the perspective of lenders.

The Government has said that it intends to consult further about making more radical reforms to the current regime for company charges.

Further information

Materials relating to the new Act

The new Act itself is expected to be published at the end of November or in early December, along with Explanatory Notes and a table of derivations and destinations (showing how sections in the 1985 Act are mapped to sections of the new Act). It is expected to be available via the DTI's website.

As this article was written before the Act was published, some references to section numbers may be incorrect.

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