FRIED FRANK

UK CORPORATE UPDATE

The Companies Act 2006 - A reminder of the key changes



On 1 October 2008, a number of further provisions of the Companies Act 2006 came into force. Most importantly, these included measures removing the prohibition on private companies giving financial assistance for the acquisition of their shares or those in other private companies, and a new procedure allowing private companies to reduce their share capital without court approval. The codification of the duties of directors of both public and private companies was also completed by implementation of the new provisions on directors' conflicts and declarations of interest.

Removal of financial assistance prohibition for private companies

The restriction on the giving of financial assistance by a private company for the acquisition of shares in itself or another private company and the statutory procedure under which the financial assistance could be 'whitewashed' have been a time consuming complexity of many corporate transactions involving UK incorporated companies over a long period. Their repeal, from 1 October 2008, is welcome, but does not mean that financial assistance issues can now be ignored altogether.

For public companies the requirements of the EU second company law directive mean that both financial assistance in relation to the acquisition of shares in a public company and any financial assistance given by a public company are still subject to the regime under the Companies Act 1985, which remains in force until 1 October 2009, when it will be replaced by almost identical provisions in the 2006 Act.

Another source of concern to lawyers has been the extent to which the old common law restrictions on the giving of financial assistance which preceded the statutory prohibition would revive once the relevant provisions were repealed. There appears now to be general agreement among corporate lawyers that this is not the case, but the directors of private companies still need to consider the wider implications of the provision of financial assistance. As part of their general duties, they need to decide whether the transaction in question promotes the success of the company taking account of all relevant factors (corporate benefit) and they must also consider the wider position on capital maintenance. Particularly where a transaction takes place with or for the benefit of shareholders the impact of the statutory rules restricting distributions must be considered and also whether the transaction would cause a material reduction in net assets, in which case sufficient distributable reserves must be available to cover this.

As a practical matter there are steps which directors of private companies should take in relation to the giving of financial assistance. These include:

- ensuring that their board minutes reflect adequately directors' consideration of corporate benefit;
- checking that their company's constitution permits their giving of the assistance (for example, Table A to the Companies Act 1948 prohibits the giving of financial assistance);
- checking that there has been proper consideration of the capital maintenance issues mentioned above.

The extent to which directors and lenders will continue to look for comfort from auditors and possibly shareholders in relation to transactions involving financial assistance has been widely discussed. There now appears to be an emerging consensus that abolition of the prohibition will generally mean that the directors should not require comfort from auditors before giving financial assistance and that in future it will not be necessary for a "non-statutory" form of whitewash

procedure involving auditors assessment of ongoing solvency to be required . This common sense approach, which preserves the de-regulatory intention behind the repeal is welcome.

New reduction of capital procedure for private companies

The new reduction of capital procedure for private companies, which removes the need for court approval also raises questions about the extent to which directors may wish to seek comfort from auditors. The new procedure requires, in addition to the passing of a special resolution, a solvency statement to be signed by each of the directors. This states that each of the directors has formed the opinion that at the date of the statement there is no ground on which the company could be found to be unable to pay its debts and that the company will be able to pay its debts as they fall due over the next twelve months. In reaching these opinions, the directors must take into account all the company's liabilities, including those which are contingent or prospective.

Any director who makes the solvency statement (which is then delivered to the Registrar of Companies) without having reasonable grounds for the opinions expressed in it is guilty of a criminal offence.

The solvency statement to be given by directors under this procedure is very similar to the statement required of directors undertaking a financial assistance whitewash under the recently repealed provisions of the Companies Act 1985 (see above). The important exception is that the whitewash procedure, required a statement from the auditors to the effect that the auditors had enquired into the company's affairs and were not aware of anything which would indicate that the directors' opinions were unreasonable. No such statement is needed in relation to the new capital reduction procedures. In contrast to the position in relation to financial assistance, where it seems auditors' comfort letters will not generally need to be sought, the extent to which directors' will seek auditors' comfort in relation to the solvency statements is unclear. Their decision as to whether or not to seek an outside opinion will depend on a number of factors, including the complexity of the company's financial position, the reasons for undertaking the capital reduction, whether or not there are any non-executives on the board and, not least, the ability of the auditors to provide the comfort asked for. In theory however, the solvency statement route should provide a cheaper, simpler and quicker procedure than the court approved reduction, although given the uncertainties mentioned above it is unclear whether the new procedure will be the preferred alternative in all cases.

It is also worth noting that the Companies Act 2006 has helpfully clarified the position in relation to capital reductions undertaken to create distributable profits - one of the commonest reasons for carrying out the procedure. Previously, the issue of whether a reduction of capital created distributable reserves was a question of accounting practice, but the Companies Act 2006 states expressly that the reserve arising from a capital reduction using the solvency statement procedure may be treated as realised profit.

Directors' duties: Conflicts and declarations of interest

One of the major innovations introduced by the Companies Act 2006 was the codification of the common law relating to duties of directors. The majority of the new statutory provisions came into force in 2006, but to allow listed companies, in particular, enough time to make the necessary procedural and constitutional changes, implementation of the new law on directors' conflicts and declarations of interest was deferred until this year.

The central "no conflicts" rule requires a director to avoid a situation in which he has, or can have a direct or indirect interest that conflicts or may possibly conflict with the interests of the company.

This prohibition is broadly drafted and, on the face of it applies not only to situations in which a director pursues a personal business interest at the company's expense, but also, for example, where he has multiple directorships in which case avoiding situations of potential conflict may, in practice, be almost impossible. However the legislation also contains a new power for the remaining directors to authorise conflicts which, is in addition to the possibility of authorisation by the articles or by shareholders, and should assist directors to avoid breaching the prohibition on conflicts. Private companies formed after 1 October 2008 need do nothing in order to take advantage of the provisions allowing the directors to authorise conflicts, unless there is something which prevents this in their articles. Private companies formed before that date either need to pass an ordinary resolution or change their articles to allow this. Public companies must change their articles to allow directors to authorise conflicts and many listed companies used the opportunity of the 2007 AGM to do this.

Authorisation is, of course, only effective if quorum requirements are met without the relevant director voting, or would have been met without his vote being counted.

The extent to which companies will choose to use the new power for directors to authorise conflicts or whether they will rely on the statutory "safe harbour" set out in the legislation which states that the general duties are not infringed by anything done by the directors

in accordance with provisions in the company's articles dealing with conflicts of interest is currently unclear. It has been common, until now, for companies' articles to set out the circumstances in which the duty is not breached. Another approach is for articles to give the board power to set out how a director should deal with a particular conflict. There does not yet seem to be a consensus as to whether one particular approach is preferable.

Directors should bear in mind, in particular, that in exercising their power to authorise the conflicts of another director, they need to take account of their fiduciary duties, in particular to promote the success of the company and to exercise independent judgement.

Obtaining shareholder approval for conflicts removes the need for directors' to consider their fiduciary duties, but may be time-consuming and expensive. Further helpful guidance on these issues is set out in a paper issued by the GC100 group (representing in-house counsel from the largest listed UK companies) published on 18 January 2008.

Directors' duties: Declarations of interest

The new legislation deals separately with a director's duty to declare an interest in a proposed transaction or arrangement with the company. Rather than comply with the 'no conflicts' rule, in this situation a director must declare the nature and extent of the relevant interest to the other directors, and must also declare the interests of any connected persons so far as he ought reasonably to be aware of them. Failure to comply is treated as a breach of fiduciary duty and the director may be liable to account for any profit he makes.

It is a criminal offence for a director to fail to declare an interest (or that of a connected person) in an existing transaction or arrangement. In both cases, the director is relieved from responsibility for making a declaration in relation to matters of which he ought not to be reasonably aware.

The duty on directors to make declarations of interest is generally familiar because of the similar provisions set out in the Companies Act 1985. Two important differences under the new regime are that the extent of relevant interests, as well as their nature, needs to be declared and declarations must be updated to reflect changes of circumstance.

Directors' duties: Duty not to accept benefits from third parties

A new provision (which reflects the common law position regarding exploitation of the office of director for personal benefit) prevents a director from accepting benefits from third parties which are conferred because of his being a director or doing (or failing to do) something as a director. Members' (but not directors') approval for acceptance of benefits may be given and the prohibition does not apply where acceptance of the benefit cannot reasonably be regarded as giving rise to a conflict.

Concern has been expressed as to whether this prohibition should lead to an outright ban on all forms of corporate hospitality for directors.

The "reasonableness" test mentioned above is not particularly helpful and some companies are providing corporate governance guidelines which may impose a financial limit on the value of goods or hospitality which can be accepted. Others simply state that the primary responsibility for deciding whether or not to accept gifts or hospitality rests with the directors. In any event whether guidelines are in place or not, directors must take responsibility for considering the nature and the amount of any benefit, the circumstances in which it is provided and, most importantly, whether or not it could be regarded as creating a conflict.



If you have any questions about any of the points covered in this bulletin, please contact Jerry Walter, Helen Shilling or your usual Fried Frank contact.

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